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## li. Testamentary Transfers

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## II. TESTAMENTARY TRANSFERS

## A. Gifts in Contemplation of Death Under § 2035

Often a decedent will have transferred property out of his estate within a reasonably short period of time before his death. Should that transfer occur within three years of the decedent's death § 2035 provides a rebuttable presumption that the transfer occurred in contemplation of death.<sup>1</sup> If the transfer is deemed to have been made in contemplation of death, the full value of the property transferred as of the decedent's death is to be included in the decedent's estate under § 2035.<sup>2</sup>

In 1974 there were several decisions in which the contemplation of death issue was litigated.<sup>3</sup> However, in only one decision was the estate able to rebut the § 2035 presumption. *Estate of Mary E. Sprague*<sup>4</sup> provides an excellent example of the evidentiary subtleties which can be crucial to the estate tax ramifications of an *inter vivos* transfer.

In *Sprague* the decedent transferred her farm to her daughter five months prior to her death. At the time of the transfer the decedent was approximately ninety years old and had suffered several rather severe physical ailments. Because of the relative proximity of the transfer to the date of death, and the fact that the transferee was a natural object of decedent's bounty, the government understandably included the value of the farm in the estate.

The Tax Court discussed four distinct factors in holding that the thought of death was not the "dominant motive"<sup>5</sup> of the transfer.<sup>6</sup>

<sup>1</sup>INT. REV. CODE OF 1954, § 2035(b).

<sup>2</sup>*Id.*, § 2035(a).

<sup>3</sup>In two 1974 decisions the presumption in § 2035 was not rebutted, *Estate of Elizabeth Moesch*, 43 P-H Tax Ct. Mem. 1197 (1974) and *Estate of Minnie Caplan*, 43 P-H Tax Ct. Mem. 177 (1974). See also *American Trust and Sav. Bank v. United States*, 74-2 U.S. Tax Cas. ¶ 13,018, at 8859-59 (N.D. Iowa 1974) for a 1974 decision wherein an excellent jury instruction regarding the contemplation of death issue is set forth.

Life insurance policies present a particularly difficult problem with respect to § 2035. For a detailed analysis of this problem, see Graves and Finley, *Irrevocable Term Life Insurance Trusts and Gifts in Contemplation of Death Under § 2035*, 32 WASH. & LEE L. REV. 855 (1975). See also the following 1974 decisions regarding the transfer of life insurance policies within the three year presumptive period: *Detroit Bank v. United States*, 369 F. Supp. 672 (E.D. Mich. 1974); *Estate of Ross H. Compton*, 43 P-H Tax Ct. Mem. 1381 (1974); *Estate of Melvin Goldberger*, 43 P-H Tax Ct. Mem. 87 (1974).

<sup>4</sup>43 P-H Tax Ct. Mem. 692 (1974).

<sup>5</sup>*United States v. Wells*, 283 U.S. 102, 116, 117, 118, 119 (1931).

<sup>6</sup>43 P-H Tax Ct. Mem. at 693.

First, the court reasoned that although the decedent was indeed very old, age in itself was not conclusive.<sup>7</sup> Therefore, the court proceeded to the second of the four criteria discussed. The decedent had a history of health problems pre-dating her death by about six years.<sup>8</sup> Nevertheless, because there was no indication that the decedent knew or perceived any of her illnesses to be fatal, the court reasoned that no death motive was established.<sup>9</sup> A third critical factor which the *Sprague* court examined was the amount of property which the decedent retained until death. Because almost two thirds of her possessions had not been transferred, the Tax Court considered that the testamentary character of the transfer in question was negligible.<sup>10</sup>

The final and perhaps most persuasive factor was that the estate presented evidence of a bona fide justification for the transfer. Evidence was produced which indicated that the decedent had a desire to relieve herself of the burdens of management of the farm when she made the transfer.<sup>11</sup> Because the court held that such a desire was one associated with life rather than death motives<sup>12</sup> the transfer was deemed not to have been made in contemplation of death.<sup>13</sup>

The objective framework in which the evidentiary battle of § 2035 must be fought has been settled for years.<sup>14</sup> In *Sprague* the estate made a rigorous effort to present life motive evidence to the court and that effort saved a considerable amount of estate taxes. The legacy of *Sprague* is two-fold. First, the motive for a transfer of property with substantial value must be documented carefully, especially as the transferor grows older. Second, no matter how insurmountable the task may seem, the § 2035 presumption can be rebutted provided a good faith effort is made to collect and present coherently evidence of motive that is inextricably tied to lifetime concerns.

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<sup>7</sup>*Id.* at 694, citing *United States v. Wells*, 283 U.S. 102, 118 (1931).

<sup>8</sup>43 P-H Tax Ct. Mem. at 693.

<sup>9</sup> *Id.* at 694. Two decisions were distinguished. The Tax Court held *Chotin v. United States*, \_\_\_ F.2d \_\_\_ (Ct. Cl. 1973), *cert. denied* 414 U.S. 1130 (1974) inapposite on the grounds that therein the decedent had actual knowledge of her fatal illness. *Estate of Robert W. Hite, Sr.*, 49 T.C. 580 (1968), was distinguished because the health of the decedent was so poor that the court reasoned that he could not help but know that the illness was fatal.

<sup>10</sup>43 P-H Tax Ct. Mem. at 695.

<sup>11</sup>*Id.* at 694-95.

<sup>12</sup>*Id.*, citing *John K. Broderick, Executor*, 38 B.T.A. 1421 (1938).

<sup>13</sup>43 P-H Tax Ct. Mem. at 695.

<sup>14</sup>See *Estate of Oliver Johnson*, 10 T.C. 680 (1948).

*B. Retention of Life Estate Under § 2036*

Section 2036(a) of the Internal Revenue Code,<sup>1</sup> like several other provisions of the Code,<sup>2</sup> requires in certain instances that property which has been transferred by a decedent during his lifetime be included within a decedent's gross estate.<sup>3</sup> Specifically, this section dictates that transferred property be included in the decedent's gross estate to the extent that the decedent retained or reserved at the time of the transfer

- (1) the possession or enjoyment of, or the right to the income from, the property, or
- (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.<sup>4</sup>

In order for the section to apply, however, the decedent must have retained or reserved such an interest "for his life or any period not ascertainable without reference to his death or for any period which in fact does not end before his death."<sup>5</sup>

<sup>1</sup>INT. REV. CODE OF 1954, § 2036(a).

<sup>2</sup>See, e.g., INT. REV. CODE OF 1954, §§ 2035, 2037, 2038.

<sup>3</sup>"Gross estate" is generally defined in § 2033 of the Code.

<sup>4</sup>INT. REV. CODE OF 1954, § 2036(a).

<sup>5</sup>*Id.* Section 2036(b) generally limits the application of § 2036(a) to transfers made after March 3, 1931. Despite the length of time that has passed since that date, litigation persists as to whether a particular transfer was completed prior to March 3, 1931 so as to escape taxation. In the 1974 decision *Estate of Thomson v. Commissioner*, 495 F.2d 246 (2d Cir. 1974), decedent transferred property in trust in 1928. The trust instrument directed that income be accumulated and added to principal unless decedent directed that it be distributed to either or both of the beneficiaries. No question existed as to the taxpayer's right to exclude the principal of the trust from his gross estate. The Government contended, however, that the taxpayer should have included in his gross estate accumulations of income added to corpus after 1931. Relying on the United States Supreme Court case of *United States v. O'Malley*, 383 U.S. 627 (1966), the Second Circuit affirmed the Tax Court's holding in favor of the Government.

In *O'Malley* the Supreme Court held that transfer as used in § 2036(a) includes past accumulations of income. Thus, where a decedent exercised a retained power to distribute or accumulate income, accumulations were includible in the decedent's gross estate. The *Thompson* court merely extended such an analysis to § 2036(b). In so holding, however, the court appears not to have considered the legislative history of § 2036(b). That section was enacted to alleviate any hardship that may have resulted as a consequence of a taxpayer's reliance on the law as it stood prior to *Commissioner v. Estate of Church*, 335 U.S. 632 (1949). In particular, prior to *Church*, the law was that reservation of a life estate prior to the enactment of the predecessor of § 2036(a) in 1931 was not an interest requiring inclusion in one's gross estate. In *Church* the Court took the opposite position, holding that reservation of a life estate

(1) Retention of "Possession of", "Enjoyment of", or "Right to Income from" Property.

In considering the scope of the first subsection of § 2036(a)(1), it is helpful to note that two difference types of retained life interests are encompassed by the statutory language. The first includes transfers in which the decedent reserves "the possession or enjoyment of the property." The second class of life interest included within § 2036(a)(1) consists of transfers in which "the right to the income from the property" is reserved by the decedent.<sup>6</sup> The courts have treated

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before the 1931 enactment constituted an interest which was includible in one's gross estate. To alleviate the hardship of one relying on the law as it existed prior to the *Church* decision, Congress enacted § 2036(b). Thus, it might be argued that the meaning of the word transfer in § 2036(b) was to be construed differently than it is in § 2036(a) in order to take into account congressional purpose in enacting the former.

\*This second type of retained life estate under § 2036(a)(1), did not spawn much significant litigation in 1974. In *American Nat'l Bank & Trust Co. v. Commissioner*, 33 CCH Tax Ct. Mem. ¶ 32,803 at 1158 (1974), a husband instigated the creation of two trusts, one with his wife as settlor which was the subject of the litigation, and one in which he was the settlor. The assets transferred to the trust executed by his wife consisted of securities originally acquired by the husband or other family members but which had been registered in his wife's name for several years. Under the provisions of this trust, the wife was entitled to the trust income for her life. Similarly, the trust instrument executed by the husband provided that he should be entitled to its income. In actual practice, however, the husband apparently took receipt of the trust assets back from both trusts and continued to manage them as he had before their creation. Additionally, the husband used the income from the two trusts' assets for family living expenses.

Upon the wife's death her executor did not include the value of the trust under which she was settlor and held a life estate, arguing that her deceased husband had actually owned the securities prior to the trust's creation. The Tax Court, in a memorandum opinion, rejected this contention, recognizing the existence of a presumption in favor of the Commissioner, and stressing the fact that the securities had been recorded in the wife's name for almost twenty years prior to the creation of the trust. *Id.* at 1167. Additionally, the Tax Court stressed that the trust assets in question had not been included in the husband's estate for federal estate or state inheritance tax purposes. These actions, the court found, "amount to admissions by the parties that decedent was in fact the settlor . . . and the owner of the trust corpus before the trust was established." *Id.* at 1166.

In *State Bank v. United States*, 74-2 U.S. Tax Cas. ¶ 13,015, at 85,801 (N.D.N.Y. 1974), decedent gave her son, a practicing attorney, her passbook and a withdrawal slip for the amount of \$24,900, instructing him to invest this amount in a mutual fund trust for the benefit of all her children. Her son, however, fearing that the decedent might not have sufficient remaining assets for herself, created a trust in which decedent retained a right to the income and principal. The decedent allegedly became aware of these unwanted retained powers when she subsequently received income from the trust in 1963 and 1964. After her death in 1965, the estate asserted that upon learning of her retained powers, decedent instructed her son to amend the trust to

the two varieties of reserved life interests independently.<sup>7</sup>

One of the issues relating to the first type of retained life interest under § 2036(a)(1), reserving possession or enjoyment of the property, is whether a decedent's continued occupancy of realty following its transfer to his or her spouse constitutes an interest which requires inclusion of the property in the decedent's gross estate.<sup>8</sup> The issue has arisen because of the Internal Revenue Service's position,<sup>9</sup> accepted by courts,<sup>10</sup> that the express reservation of a right to possession or enjoyment of real property by the decedent is not necessary for § 2036(a)(1) to apply. It is sufficient for inclusion that at the time of the transfer there existed an express or implied understanding between the decedent and the transferee that the interest or right to possession or enjoyment of the property would be retained or later conveyed to the transferor-decedent.<sup>11</sup> Thus, the continued occupancy of the transferred property by the decedent following the trans-

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conform to her original intent. By way of affidavit, the decedent's son stated that he had begun the process of amending the trust documents, but had not been able to complete the revision prior to his mother's death due to his business and personal affairs.

Plaintiff taxpayer asserted that the intent of the decedent to make an absolute gift should prevail over the unauthorized form of the trust. However, the court dismissed this contention stressing that the existence of reserved powers in the trust necessitated inclusion, regardless of intent or the exercise of powers. *Id.* at 85,806-85,807. Similarly, the court summarily disposed of plaintiff's second contention, that the delivery of the passbook and withdrawal slip constituted a completed gift. *Id.* at 85,807-85,808.

One final case relating to a reserved right to trust income was decided in 1974. In *Armata v. United States*, 74-1 U.S. Tax Cas. ¶ 62,998, at 84,423 (Ct. Cl. 1974), the court held that a retained right to income continued in existence even though the decedent had been adjudicated incompetent because the trustee had no discretion over how much to pay to decedent. The trustee only had discretion as to the manner of payment.

<sup>7</sup>*See generally*, C. LOWNDES, R. KRAMER & J. MCCORD, *FEDERAL ESTATE & GIFT TAXES* §§ 9.11, 9.12 (3d ed. 1974).

<sup>8</sup>The Internal Revenue Service has ruled that where a decedent continues to occupy property following its conveyance to someone other than his or her spouse, such evidence by itself implies the existence of an agreement of retained enjoyment by the donor. Rev. Rul. 70-155, 1970-1 CUM. BULL. 189. This position is consistent with the court decisions confronting the issue. *See e.g.*, *Guynn v. United States*, 71-1 U.S. Tax Cas. ¶ 12,742, at 86,819 (4th Cir. 1971) (transfer to daughter); *Estate of Emil Linderme, Sr.*, 52 T.C. 305 (1969) (transfer to son).

<sup>9</sup>Treas. Reg. § 20.2036-1(a) (1958).

<sup>10</sup>*E.G.*, *Union Planters Nat'l Bank v. United States*, 361 F.2d 662 (6th Cir. 1966); *Estate of Binkley v. United States*, 358 F.2d 639 (3d Cir. 1966); *Stephenson v. United States*, 238 F. Supp. 660 (W.D. Va. 1965); *Estate of Allen D. Gutches*, 46 T.C. 554 (1966), *acquiesced in*, 1967-1 CUM. BULL. 2.

<sup>11</sup>Treas. Reg. § 20.2036-1(a) (1958). *See also* cases cited in note 10, *supra*.

fer to his or her spouse might be viewed under some circumstances as an implied understanding of a right on the part of the decedent to possess or enjoy the property, thereby triggering § 2036(a)(1). Prior to 1974, such a view was consistently rejected by the courts.<sup>12</sup> In the recent case of *Estate of Francis M. Hendry*,<sup>13</sup> however, the Tax Court complicated the law in this area by holding that, under certain circumstances at least, an interspousal transfer might be included within the scope of § 2036(a)(1).

Specifically, in *Hendry*, the decedent in 1948 conveyed to his wife a parcel of realty on which he had previously operated a citrus and cattle business. Neither at the time of the conveyance, nor at any time thereafter, was there any written agreement between decedent and his wife relating to continued use, enjoyment, or possession, or income from, the property or relating to any right to determine who would possess or enjoy the property or the income. However, decedent's wife believed that the property in question belonged to both her and the decedent prior and subsequent to the conveyance. Additionally, following the conveyance, decedent continued to operate the property as a cattle and citrus farm just as he had previously. Moreover, in 1954, decedent and his family took up residence on the property, where they lived until decedent's death. Based on these facts, the Tax Court held that an implied agreement existed between the decedent and his wife that the decedent would retain possession and enjoyment of the property, requiring its inclusion in decedent's gross estate pursuant to § 2036(a)(1).

In holding that the property in question was includible in decedent's gross estate, the Tax Court held that where the circumstances imply a pre-arranged understanding the burden of proof is on the petitioner to establish that an implied understanding or arrangement between the parties did not exist.<sup>14</sup> The Tax Court further held that

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<sup>12</sup>See e.g., *Union Planters Nat'l Bank v. United States*, 361 F.2d 662 (6th Cir. 1966); *Estate of Binkley v. United States*, 358 F.2d 639 (3d Cir. 1966); *Estate of Allen D. Gutchess*, 46 T.C. 554 (1966), *acquiesced in*, 1967-1 CUM. BULL. 2; *Stephenson v. United States*, 238 F. Supp. 660 (W.D. Va. 1965); *Estate of Robert W. Wier*, 17 T.C. 409 (1951), *not acquiesced in*, 1966-1 CUM. BULL. 4; *Estate of Everett Otte*, 41 P-H Tax Ct. Mem. 317 (1972). See also *Guyann v. United States*, 71-1 U.S. Tax Cas. ¶ 12,742, at 86,819 (4th Cir. 1971). The Internal Revenue Service itself acknowledged that continued occupancy by decedent following a transfer to his or her spouse does not by itself constitute evidence of an agreement or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 70-155, 1970-1 CUM. BULL. 189.

<sup>13</sup>[1974 Transfer Binder] CCH TAX CT. REP. (62 T.C. , No. 92), at 3036 (1974).

<sup>14</sup>In support of the court's determination that the taxpayer bore the burden of proof of establishing that no implied agreement existed, the court cited several cases dealing with a transfer to non-spouse donees. As already noted, however, both the courts and

decendent's estate failed to meet this burden, stressing the fact that decedent continued to control the managerial aspects of the business operated on the property, and emphasizing that the income from such operations was deposited in decedent's personal checking account. Thus, the court distinguished cases holding that mere continued occupancy by a decedent with his spouse following a transfer of the property to the spouse did not require inclusion in the decedent's estate.<sup>15</sup>

While the ultimate holding in *Hendry* appears to be correct, the Tax Court's reasoning and approach is open to criticism. In particular, the court's finding of an implied agreement relating to the possession and enjoyment of the property is contradicted by the court's own finding of fact. For an agreement to exist, even if it be no more than an implied understanding, participation by two or more parties is required.<sup>16</sup> In the instant case, if any agreement existed, it existed between decedent and his wife. But it was specifically found by the court that decedent's wife believed that the property at all times belonged to both the decedent and herself. Consequently, it is stretching the concept of agreement to say that the wife in *Hendry* implicitly agreed that her husband would retain rights of possession and enjoyment when she was not even aware that he had relinquished to her all legal rights in the property.

Even assuming that such an agreement did in fact exist, however, the court's approach is still subject to criticism in that the court could have reached the same result in a simpler manner. In *Commissioner v. Estate of Church*,<sup>17</sup> the United States Supreme Court set forth the now well-established principle<sup>18</sup> that

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the Internal Service had distinguished cases in which property has been transferred to one's spouse, and cases in which the donees were persons other than the transferor's spouse. See notes 8-11 and accompanying text, *supra*. Additionally, the court's action requires the taxpayer to prove a negative proposition, a task which is not without its difficulty especially in the present setting. See *Union Planters Nat'l Bank v. United States*, 361 F.2d 662 (6th Cir. 1966).

<sup>15</sup>See cases cited at note 10, *supra*.

<sup>16</sup>Agreement is defined as

[a] coming or knitting together of minds; a coming together in opinion or determination; the coming together in accord of two minds on a given proposition; in law a concord of understanding and intention between two or more parties with respect to the effect upon their relative rights and duties, of certain past or future acts or performances . . . .

BLACK'S LAW DICTIONARY 89 (4th ed. 1968).

<sup>17</sup>335 U.S. 632 (1949).

<sup>18</sup>The principle noted in the text is itself cited in the court's opinion in *Hendry* for



an estate tax cannot be avoided by any trust transfer except a *bona fide* transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with . . . no right to possess or to enjoy the property then or thereafter.<sup>19</sup>

In the instant case there can be no doubt that the transfer by decedent to his spouse did not fulfill this requirement. As already noted, the decedent continued to operate the cattle and citrus business on the property just as he had done prior to the transfer. Additionally, the income from such business was in no way shared with the wife, but rather was deposited in decedent's personal account. Finally, the wife was not even aware of the conveyance made by her husband. Thus, it should be concluded, apart from the fact that the husband later occupied a residence on the property with his family, that the transfer was in no way *bona fide* and, therefore, was not sufficient to take the property out of the decedent's gross estate.

To concentrate on the nature of the transfer, rather than on a fictitious agreement between the deceased and the transferee-spouse, would have the advantage of avoiding the difficult question of whether under certain circumstances a deceased spouse's continued occupancy of transferred property constitutes evidence of agreement sufficient to require the property to be included in the deceased's estate. It should be noted, however, that under *Hendry's* teaching, where the property involved is income producing, the question will continue to arise as to whether a deceased's continued occupancy of transferred property might be viewed as an implied understanding regarding the rights of possession and enjoyment, mandating inclusion in the decedent's gross estate.<sup>20</sup>

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support of the proposition that "[t]he mandate underlying the includibility of an interest pursuant to section 2036(a)(1) is broad." [1974 Transfer Binder] CCH TAX CT. REP. (62 T.C. , No. 92), at 3036, 3042 (1974).

<sup>19</sup>335 U.S. 632, 645 (1949) (emphasis added).

<sup>20</sup>As previously noted, the *Hendry* court recognized that mere co-occupancy by the transferor with his or her spouse following transfer does not by itself establish the existence of an implied understanding so as to require inclusion in decedent's gross estate. See text accompanying note 14, *supra*. However, the court stated that Estate of Allen D. Gutchess, 46 T.C. 554 (1966), *acquiesced in*, 1967-1 CUM. BULL. 2 (holding that land transferred by a husband to a wife should be included in the husband's gross estate because he continued to occupy the property with his wife until his death) should be carefully confined to its narrow factual situation and that it would be dangerous to abstract broad legal principles from it. [1974 Transfer Binder] CCH TAX REP. (62 T.C. \_\_\_\_\_, No. 92), at 3036, 3044 (1974).

## (2) Retention of the Right to "Designate" the "Enjoyment of" or "Income from" Property.

Section 2036(a)(2) provides that transferred property<sup>21</sup> in which the decedent retained the right to control possession or enjoyment shall be included in the decedent's gross estate.<sup>22</sup> "Control of enjoyment" has been construed rather broadly in the accompanying Treasury Regulations and is said to include a "reserved power to designate the . . . persons to receive the income from the transferred property."<sup>23</sup> On the other hand, power over "possession" has generally included the right to control the occupancy of non-income producing property.<sup>24</sup>

The apparent simplicity of this statutory provision is shattered by its interaction with another provision of the Internal Revenue Code, § 2038. The latter section includes property in the decedent's gross estate over which the decedent possessed at death a power to "alter, amend, revoke, or terminate."<sup>25</sup> The provisions overlap in multitudinous ways and form a hazardous path for the unwary.<sup>26</sup> The operation of both sections can be prevented, however, if the decedent's right to designate or power to modify is limited by an "ascertainable external standard." Developed in the Tax Court<sup>27</sup> and endorsed by the Second Circuit,<sup>28</sup> the well established doctrine of external standards provides that a right which is so qualified that it is enforceable in equity by beneficiaries thereof "does not circumvent the obvious purpose of § 2038 to prevent transfers akin to testamentary dispositions from escaping taxation."<sup>29</sup>

The complex interaction between §§ 2036(a)(2) and 2038 and the ascertainable standard doctrine provided the framework in which the Ninth Circuit Court of Appeals had to analyze the facts presented in

<sup>21</sup>Just as under § 2036(a)(1), transferred property means property transferred during the lifetime of the decedent. See text accompanying notes 1-3 *supra*.

<sup>22</sup>INT. REV. CODE OF 1954, § 2036(a)(2).

<sup>23</sup>Treas. Reg. § 20.2036-1(b)(3) (1958), as amended T.D. 6501, 25 F.R. 10869 (Nov. 16, 1960).

<sup>24</sup>*Id.*

<sup>25</sup>INT. REV. CODE OF 1954, § 2038.

<sup>26</sup>See C. LOWNDES, R. KRAMER & J. McCORD, FEDERAL ESTATE AND GIFT TAXES § 9.22, at 231-34 (3d ed. 1974) [hereinafter cited as C. LOWNDES].

<sup>27</sup>Estate of Budlong, 7 T.C. 756 (1946).

<sup>28</sup>Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

<sup>29</sup>*Id.* at 78 (dictum). In C. LOWNDES, the principle is stated thus: "a 'power' subject to an ascertainable external standard is really not a power at all, but rather it is a direction — imposing obligations rather than granting discretion." C. LOWNDES § 8.9, at 157.

a perplexing 1974 decision, *Leopold v. United States*.<sup>30</sup> In *Leopold*, the decedent created identical trusts for each of his two minor daughters under which he, as joint trustee, was to distribute all of the income to them during their natural life, retaining the right in his sole discretion to determine at what intervals it would be distributed. However, the trust contained certain additional provisions applicable during the minority of each beneficiary for "the support, education, maintenance and general welfare of the said [minor]."<sup>31</sup> Any accumulated income was to be paid to each child upon her reaching the age of twenty-one. Finally, the decedent had the power as trustee to invade the corpus of each trust for the benefit of the minor beneficiary when he decided it "necessary and proper" to do so.<sup>32</sup>

The government contended that the entire corpus of the trust and the accumulated income earned by the trust during the decedent's lifetime should be included in the decedent's estate under §§ 2036(a)(2) and 2038.<sup>33</sup> The government reasoned that the decedent's

<sup>30</sup>75-1 U.S. Tax Cas. ¶ 13,053, at 8863-31 (1975). The *Leopold* decision was rendered originally on September 9, 1974, but was subsequently revised and therefore reported as of Jan. 2, 1975.

In another 1974 decision involving an allegedly ascertainable standard, the Tax Court stated:

Words such as *support, education, maintenance, care, necessity, illness and accident* are generally regarded as providing ascertainable standards; while words such as *happiness, pleasure, desire, benefit, best interest, and well being* are generally not regarded as being sufficiently definite so as to provide ascertainable standards.

Estate of Fred A. Cutter, P-H TAX CT. REP. & MEM. DEC. (43 P-H Tax Ct. Mem) ¶ 62.42 (1974) (emphasis added). In *Cutter*, the decedent had transferred assets to eight inter vivos trusts for his grandchildren and retained the power to pay income if "necessary" for the benefit of the beneficiaries, and to invade principal needed for their "support and education." *Id.* at 215. The Tax Court found it "clear that the invasion of the principal power is limited by an ascertainable standard." *Id.* at 216. With regard to the decedent's power to pay trust income when "necessary" for the benefit of the beneficiaries, however, the court held otherwise. The court determined that "the term 'benefit' suggest[ed] more than support, and [was] so overly broad as to be incapable of being used as an ascertainable standard." *Id.* at 216. The Tax Court concluded that the term "necessary" provided no further limitation to decedent's prerogatives:

[T]he word "necessary" embodies no more than the decedent's gratuitous directive to do what would have been required had the word been omitted. The word neither adds nor detracts from what would otherwise have been the decedent-trustee's discretionary power to distribute trust income "for the benefit of" each beneficiary.

*Id.* at 218.

<sup>31</sup>75-1 U.S. Tax Cas. at 8863-32.

<sup>32</sup>*Id.*

<sup>33</sup>*Id.*

(1) discretionary powers to pay all of the principal over to an income beneficiary during her lifetime and (2) discretionary right to accumulate or pay prior to majority and to determine when to pay the trust income after majority constituted together a power to "alter" or "terminate" the trust under § 2038.<sup>34</sup> Additionally, the government contended that these powers provided the decedent the right to designate who should enjoy the benefits of the income under § 2036(a)(2).<sup>35</sup>

The district court in *Leopold* concluded that the decedent, by virtue of his power to invade the corpus when "necessary and proper," retained enough control over the remainder interest to render it includable under § 2038.<sup>36</sup> However, because the decedent-trustee had retained "no power to affect the beneficial enjoyment" of the income interest, "except to the extent that such power was limited by an ascertainable standard," exclusion of the life estate was allowed.<sup>37</sup> Additionally, the district court ruled that income accumulated prior to the decedent's death should be excluded, apparently because its distribution was not subject to any discretion.<sup>38</sup>

On appeal, the estate concluded that the discretion held by the decedent with respect to the remainder interest rendered its actuarial value includable. Therefore, the issue before the Ninth Circuit was the proper estate tax treatment of the income interest. Although the appellate court agreed with the district court that the decedent's power to distribute income was governed by an ascertainable standard<sup>39</sup> and should to that extent be excluded from the decedent's estate,<sup>40</sup> the court also recognized that income could be generated by

<sup>34</sup>*Id.*

<sup>35</sup>*Id.*

<sup>36</sup>The findings and conclusions of the district court are located at 72-1 U.S. Tax Cas. ¶ 12,837, at 84,716 (C.D. Cal. 1972).

<sup>37</sup>75-1 U.S. Tax Cas. at 8863-33 (the Ninth Circuit discussing district court opinion).

<sup>38</sup>*Id.*

<sup>39</sup>The Ninth Circuit stated that because the trustee was *authorized* to make payments for the beneficiaries' "support, education, maintenance and welfare," the trustee was *required* to maintain them in their accustomed way of life. *Id.* Since *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970), mere authorization has been deemed sufficient to create an enforceable right by the beneficiary, and therefore the *Leopold* court's holding that an ascertainable standard existed is sound. For an extended discussion of ascertainable standards see Part IV of this survey, *infra*.

<sup>40</sup>The court was proper in excluding the actuarial value of this income interest since it was a present right to immediate enjoyment that the trustee could add to, but could not alter. *See, e.g., Walter v. United States*, 341 F.2d 182 (6th Cir. 1965); *Rev. Rul. 70-513*, 1970-2 CUM. BULL. 194. *See also Du Charmes Estate v. Commissioner*, 164 F.2d 959 (6th Cir. 1947).

the trust in excess of the amount needed for "support and maintenance" during the infancy of the beneficiaries. Since the decedent had the discretion to pay over this income or accumulate it, the *Leopold* court held that its value should be included in the decedent's estate under §§ 2036(a)(2) and 2038.<sup>41</sup> However, the Ninth Circuit did agree with the district court that the income already accumulated should be excluded.<sup>42</sup> Therefore, while the district court allowed the estate to exclude the present value of an entire life estate in the corpus of the trusts, the Ninth Circuit decreased the amount of these exclusions by the actuarial value of income likely to be generated in excess of the beneficiaries' objective needs before they reached majority.

The holding of the *Leopold* court is of questionable validity. Specifically, the Ninth Circuit's division of the income interest of the trusts into three separate parts is rather extraordinary and deserves close scrutiny. The court created three categories: (1) income accumulated by the time of the decedent's death; (2) future income necessary for the objective needs of the beneficiaries; and (3) future income in excess of these needs. The court's reasoning as to the effect of the decedent's unbridled invasion powers on the inclusion of these three income interests is unique. The decision serves only to further confuse the perplexing question of the amount to be included in a decedent's estate when the decedent retains the uncontrolled discretion to pay the principal of a trust over to the income beneficiary and thereby terminate the trust.<sup>43</sup>

The essential problem created by retention of an unlimited power by a grantor-trustee to invade corpus for the benefit of the income beneficiary is whether the corresponding power to convert a present but incomplete ownership right, the income interest, into a full ownership right, is sufficient to require inclusion of the value of the income interest in the grantor-trustee's estate under § 2038.<sup>44</sup> When the Supreme Court considered the issue in *Lober v. United States*,<sup>45</sup> it

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<sup>41</sup>75-1 U.S. Tax Cas. at 8863-34, citing *Lober v. United States*, 346 U.S. 335 (1953).

<sup>42</sup>75-1 U.S. Tax Cas. at 8863-34.

<sup>43</sup>Authorities agree that the determination of the amount to be excluded as a result of an unlimited power to invade in favor of the income beneficiary is a difficult one. See C. LOWNDES, § 8.13, at 168; J. MERTENS, *THE LAW OF FEDERAL GIFT AND ESTATE TAXATION*, § 25.44, at 738 (1959).

<sup>44</sup>Certainly the broad language of Treas. Reg. § 20.2038-1(a) (1958), as amended T.D. 6600, 27 F.R. 4985 (May 29, 1962), would seem to require inclusion of the income interest, since therein § 2038 is said to reach property subject to "any change" by virtue of a power to "alter, amend, revoke, or terminate."

<sup>45</sup>346 U.S. 335 (1953).

apparently reasoned that the power to terminate the trust by paying the trust principal over to an income beneficiary was sufficient to require inclusion of the trust property as a whole. In *Lober*, the grantor-trustee could in his sole discretion accumulate or pay the income of the trust to the beneficiaries until their majority.<sup>46</sup> At twenty-one any accumulated income was to be paid to the beneficiaries and at twenty-five the principal itself was to be distributed.<sup>47</sup> Most importantly, however, the trustee could terminate the trust and pay over the principal when he chose to do so.<sup>48</sup>

The Supreme Court reasoned that by virtue of his power to accelerate the trust principal the decedent had sufficient indirect power to alter each income beneficiary's interest to warrant its inclusion along with the value of the remainder interest over which the direct powers existed.<sup>49</sup> In reaching this result, the Court rejected the argument that because the income beneficiaries had a vested interest that could only be *increased* in size, their interest should be excluded from the grantor's gross estate.<sup>50</sup> The fact that their interest was subject to mere change alone seemed sufficient to make § 2038 fully operable.<sup>51</sup>

After *Lober*, therefore, it appeared that

any interest whose immediate enjoyment [could] be affected by the decedent [was] taxable to his estate, even though his power [was] limited to enlarging the transferee's interest in the transferred property and . . . [therefore] the value of any interest, [although] indefeasibly vested in the transferee, [could] not [be] excluded from the amount taxable to his estate.<sup>52</sup>

However, subsequent developments refined *Lober*<sup>53</sup> and have indicated that where at the time of the decedent's death the income beneficiary is enjoying a "*present right to immediate enjoyment*" of the income, the actuarial value of that interest will be excluded from the grantor-trustee's estate, despite his power to terminate the trust

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<sup>46</sup>*Id.* at 335.

<sup>47</sup>*Id.*

<sup>48</sup>*Id.* at 336.

<sup>49</sup>*Id.* at 337.

<sup>50</sup>*Id.*

<sup>51</sup>*Id.*

<sup>52</sup>C. LOWNDES, § 8.13, at 170.

<sup>53</sup>*Walter v. United States*, 341 F.2d 182 (6th Cir. 1965); Rev. Rul. 70-513, 1970-2 CUM. BULL. 194.

and thereby enlarge the beneficiary's interest.<sup>54</sup> This interpretation of *Lober* seems justified because the Supreme Court did indicate that the income interest before it was not a "present right to immediate enjoyment" and arguably based its decision to deny exclusion on that fact.<sup>55</sup> The government has to-date acquiesced in this refinement of *Lober*.<sup>56</sup> It would appear, therefore, that the absence of the "present right to immediate enjoyment" of the income indeed was the crucial part of the *Lober* decision and had become, prior to *Leopold*, the test for determining whether or not the unlimited power to invade the corpus would require total inclusion under §§ 2036(a)(2) and 2038.<sup>57</sup>

However, in *Leopold* the Ninth Circuit inconsistently applied this test to determine whether the various income interests should be included in the decedent's estate. The court correctly perceived that the ascertainable standard language created, on behalf of the income beneficiaries, a fixed, indefeasible income right that would appear to be responsive to the "present and immediate" use criteria which even the government had accepted as an exception to the total inclusion doctrine of *Lober*.<sup>58</sup> In addition, the refusal in *Leopold* to exclude that part of the future income interest over which the decedent-trustee had retained the discretion to either pay or accumulate seems proper, since the practical enjoyment of the income was an uncertainty and the decedent's power to convert that uncertain interest into a present and complete ownership right was substantial.<sup>59</sup> In fact, this income interest was strikingly similar to the one in *Lober* which was included in the decedent's estate because of the power to accelerate the principal.

The troublesome part of *Leopold* is that the court's decision to exclude the income already accumulated from the decedent's estate runs directly counter to the *Lober* doctrine. The Ninth Circuit observed that the trustee had no discretion over the already accumulated income at death because he had to distribute it to the benefici-

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<sup>54</sup>In *Walter v. United States*, 341 F.2d 182 (6th Cir. 1965), the Sixth Circuit, after discussing the *Lober* decision, reasoned that it followed from *Lober* that "in this case [the trust] is exempt from the tax only to the extent that *enjoyment* was vested in the [beneficiary] and was beyond the scope of the power retained . . . ." *Id.* at 186 (emphasis added). The *Walter* court apparently reasoned that the vesting of actual enjoyment as opposed to mere legal title made its case different from that in *Lober*.

<sup>55</sup>*Lober v. United States*, 346 U.S. 335, 337 (1953).

<sup>56</sup>Rev. Rul. 70-513, 1970-2 CUM. BULL. 196.

<sup>57</sup>This is the position expressed by Lowndes and Kramer, C. LOWNDES § 8.31, at 168-173.

<sup>58</sup>See note 20 *supra*.

<sup>59</sup>See and compare text accompanying notes 24-37 *supra*.

ary at age twenty-one.<sup>60</sup> Because the accumulated income did not become part of the corpus of the trust and therefore become subject to the "necessary and proper" powers of the trustee, the court reasoned that the accumulations should be excluded from the decedent's estate.<sup>61</sup>

The court's observation that the accumulations were separate from corpus and, therefore, not subject to the same broad powers is clearly sound.<sup>62</sup> However, what the Ninth Circuit failed to deal with is what the effect of the trustee's power to terminate the trust by paying over the entire corpus to the income beneficiaries should have been regarding inclusion of these accumulations.<sup>63</sup> Under the *Lober* doctrine, the decedent's power to convert the beneficiaries' vested right to income in the future (the accumulated income) to a complete ownership right by terminating the trust should have required inclusion under § 2038, as the court had reasoned that it should with respect to the future income stream that could be paid or accumulated. Both were vested rights to future income that under *Lober* are subject to inclusion by virtue of an unlimited power to accelerate.

The *Leopold* decision serves, therefore, to obfuscate once again an issue which had begun to develop a degree of certainty. Before the Ninth Circuit decision, because of the *Lober* decision and its subsequent refinements, the "amount-to-be-included" issue under §§ 2036(a)(2) and 2038 was reasonably well settled. The value of the entire trust property together with all accumulations as of the date of the decedent's death was to be included, unless an income beneficiary was enjoying an income interest of "present and immediate enjoyment." If such an income interest existed, the government and courts have allowed the exclusion of its value as determined actuarially. In *Leopold*, two of the three income interests which the court recognized were vested interests, but were not interests of "present and immediate" use. Despite this fact, the Ninth Circuit held in an ill-reasoned

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<sup>60</sup>75-1 U.S. Tax Cas. at 8863-34.

<sup>61</sup>*Id.*

<sup>62</sup>The trust instrument clearly required that accumulations not become part of the corpus of the trust. *Id.* at 8863-32.

<sup>63</sup>Indeed, this is a distinct question because once a trustee pays over all the corpus to the income beneficiary, the income and remainder interests of the trust merge. A. SCOTT, *THE LAW OF TRUSTS*, § 341 (3d ed. 1967). Upon merger the beneficiary who holds both equitable estates can compel the termination of the trust, if its continuance will not be contrary to the settlor's intent. *Id.* There should be little question, therefore, that the accumulated income could have potentially been distributed to the income beneficiaries prior to their attaining age twenty-one, provided the parent or guardian chose to terminate the trust once the corpus had been depleted by the trustee.



opinion that one of these interests could be excluded despite the decedent's unlimited power to pay over the corpus and effectively terminate the trust. To this extent, therefore, the decision is unprecedented and should be viewed with caution.

### C. Revocable Transfers Under § 2038

Under § 2038<sup>1</sup> of the Internal Revenue Code the value of a decedent's gross estate includes the value of all transferred<sup>2</sup> property the enjoyment of which the decedent has retained the right to "alter, amend, revoke, or terminate."<sup>3</sup> The section is very broad in its application and serves to overlap frequently with § 2036(a)(2) in requiring inclusion of property for estate tax purposes.<sup>4</sup> Among the developments in 1974 dealing specifically with § 2038<sup>5</sup> was a revenue ruling which serves to clarify the applicability of § 2038 by providing an unusually narrow view of the term "transfer."

In Revenue Ruling 74-556<sup>6</sup> the IRS ruled that a wife who is treated as having made a transfer for gift tax purposes under § 2513<sup>7</sup> will not be deemed to have made a transfer for purposes of § 2038. The decedent's husband had transferred some individually owned securities to himself as custodian for the benefit of his minor daughter under the Uniform Gifts to Minors Act.<sup>8</sup> He filed a gift tax return and in doing

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<sup>1</sup>INT. REV. CODE OF 1954, § 2038.

<sup>2</sup>Transferred property means property transferred during the lifetime of the decedent. Compare INT. REV. CODE OF 1954, §§ 2035, 2036, 2037.

<sup>3</sup>INT. REV. CODE OF 1954, § 2038. The power may be exercisable either alone or in conjunction with any other person. *Id.*

<sup>4</sup> See Part II, B(2) of this survey and cases *supra*.

<sup>5</sup>In 1974 three decisions were rendered with respect to § 2038: *Mathey v. United States*, 74-1 U.S. Tax Cas. ¶ 12,975, at 84,342 (3d Cir. 1974) (decedent could name self trustee and New York law permitted her to terminate; held included); *Third Nat'l Bank v. United States*, 74-1 U.S. Tax Cas. ¶ 12,989, at 84,396 (M.D. Tenn. 1974) (Tenn. law prohibited revocation of trust and thus no inclusion); *Armata v. United States*, 74-1 U.S. Tax Cas. ¶ 12,998, at 84,423 (Ct. Cl. 1974) (decedent's incompetence no bar to operation of § 2038); *Estate of Aris Carpousis*, 43 P-H Tax Ct. Mem. 1064 (1974) (decedent as trustee held powers under § 2038; included).

An important Ninth Circuit decision, *Leopold v. United States*, 75-1 U.S. Tax Cas. ¶ 13,053, at 88,633 (1975), which considered § 2038 as well as § 2036(a)(2), is discussed in Part II, B(2) of this survey, *supra*.

<sup>6</sup>Rev. Rul 74-556, 1974 INT. REV. BULL. No. 46, at 8.

<sup>7</sup>INT. REV. CODE OF 1954, § 2513. Should a wife consent under § 2513, a gift by the husband will be deemed made one-half by the wife.

<sup>8</sup>UNIFORM GIFT TO MINORS ACT, §§ 2, 3.

so, with the decedent's consent, utilized § 2513 to have the gifts treated as being made one-half by decedent. After serving as custodian for a period, the husband resigned and the decedent succeeded to the position. At her death she was still serving in this capacity.

Since a 1959 revenue ruling,<sup>9</sup> § 2038 has required that when a decedent who appoints himself custodian under the Uniform Gift to Minors Act dies in that capacity, his estate shall include under § 2038 the value of the property he transferred under the Act. However, the IRS chose not to treat the § 2513 gift tax transfer by the non-owner of the property as a transfer under § 2038. In so choosing, the Government relied on two propositions. First, reference was made to the fact that § 2513 was enacted solely to equalize the gift tax treatment of transfers by married donors in community and common law property estates.<sup>10</sup> Second, although the IRS conceded that §§ 2035-2038 were intended to apply to property interests transferred by a decedent, the property also must have been owned by the decedent before the transfer.<sup>11</sup> Since a federal district court<sup>12</sup> had made these same observations in holding that a husband's estate should bear the burden for the full value of property transferred in contemplation of death despite § 2513 treatment for gift tax purposes, the Government apparently decided that its decision to adopt a narrow definition of transfer was sound.

A literal reading of Revenue Ruling 74-556 would make the IRS's statements applicable to §§ 2035-2038. The Government's position will obviously serve to encourage naming the parent who had no ownership rights before the transfer as custodian under the Uniform Gifts to Minors Act. The funding parent can, therefore, retain de facto control despite the absence of legal control of the assets. An additional effect of this ruling, however, is to facilitate the funding of the inter vivos trust, a frequently used estate planning device.<sup>13</sup> Utilization of § 2513 to split the gifts that fund the trust will not raise any potential inclusion problems under § 2036(a)(1) should the non-

<sup>9</sup>Rev. Rul. 357, 1959-2 CUM. BULL. 212.

<sup>10</sup>Rev. Rul. 74-556, 1974 INT. REV. BULL. No. 46, at 9.

<sup>11</sup>*Id.*

<sup>12</sup>English v. United States, 284 F. Supp. 256 (N.D. Fla. 1968).

<sup>13</sup>The inter vivos trust is used to transfer a certain percentage of an individual's property out of his estate to reduce estate taxation. Generally, the trust contains insurance policies or is funded during the life of the decedent with liquid assets. The trust usually provides the decedent's wife with a life estate only, so as to provide financial benefits and yet avoid estate taxation under § 2041 at her death. Such a trust preserves as much of the trust property as possible for the children of the decedent and spouse by avoiding estate taxation at both the decedent's and the wife's death.