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Taxation Of Life Tenants As Trustees

The last obstacle which a court would have to overcome in applying section 170 instead of section 404 would be the apparent overlap between section 404 specifically relating to pension trusts and section 170 which relates to charitable trusts generally. It is arguable that the passage of a specific statute excludes the application of a general one, but Congress is silent as to its intent in this regard. In light of the decisions in *General Shoe* and *Freighting,* to argue along these lines while litigating the same problem might be more profitable than pursuing the traditional line of reasoning which has already been rejected in two circuits.

The conclusions that may be drawn from the decision rendered in the *General Shoe* case are both philosophical and practical. Federal courts have once again asserted that the taxation laws are not a dead collection of words capable of only a single esoteric meaning, but they are a living institution which must grow and mature with the economic system they were designed to accommodate. If the members of the legislative branch of the government feel that the court was incorrect in its approach to this particular problem, then an amendment may be enacted to clarify the Congressional intent. From this case corporations which have valuable property with a comparatively low basis are made to realize that they may not avoid the taxation of the appreciated value of that property and benefit their own employees at the same time.

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TAXATION OF LIFE TENANTS AS TRUSTEES

The word "trust" as used in the Internal Revenue Code does not comprehend every instance in which a trust is recognized in chancery.[1] The rule has been stated that, "if no recognizable trust is impressed on property left a decedent or purportedly set over in trust, there is nothing to which the statute relating to taxation of trust income can be applied."[2] In *United States v. DeBonchamps,*[3] however, a life

[1]Constructive trusts and resulting trusts do not come within the scope of the Internal Revenue statutes. 6 Mertens, Taxation § 36.22 (1957). See Wilcox v. Nelson, 227 Minn. 545, 35 N.W.2d 741 (1949) (defining a constructive trust); Jankowski v. Delfert, 356 Mo. 184, 201 S.W.2d 331 (1947) (discussing situations in which chancery courts will find a resulting trust).

[2]6 Mertens, Taxation § 36.22 (1957).

[3]278 F.2d 127 (9th Cir. 1960). This case was one of three cases decided in the same opinion in which the same principles were involved.

tenant was taxed as a trustee for the remaindermen, though it is doubtful that an equity court would have enforced the obligations of a true trustee against the taxpaying life tenant.

Mrs. DeBonchamps received a devise of a life estate with broad powers to consume the corpus for her needs, maintenance and comfort, and the remainder was devised to the donor's living children. Gains were realized by sales of the estate's assets by the life tenant who paid the tax thereon as owner.[4] She then filed for a refund, and the government defended by asserting that the taxpayer was liable under section 641(a) because of the fiduciary relationship of a life tenant to a remainderman.[5] The Federal District Court for California[6] rendered summary judgment for the taxpayer, and the Court of Appeals for the Ninth Circuit reversed, holding that the relationship between remaindermen and a life tenant with power of consumption had the characteristics of a trust, and the capital gains realized from sales of portions of the corpus were taxable to the life tenant as a quasi-trustee or fiduciary for the estate.

In its decision in the principal case, the Ninth Circuit expressly overruled its 1955 decision in *United States v. Cooke*,[7] wherein it was held that a life tenant was not taxable as either owner of the estate or as trustee for the remaindermen. In that case the life tenant was held not to be the owner of the corpus since she did not have the unfettered right to use it for her own benefit. In deciding that the life tenant was not a fiduciary for the remaindermen, the *Cooke* decision was based upon the rationale that the relationship between life tenant and remaindermen does not fall within the scope of Treasury Regulation 118, section 3797-3 which defines the term "ordinary trust" as "one . . . in which the trustee . . . takes title to the property for the purpose of protecting or conserving it as customarily required

[4]Int. Rev. Code of 1954, § 1201 (pertaining to the taxation of capital gains). Unless this gain is taxed in the year of sale by the life tenant, it escapes taxation altogether in the following situations: (1) where the remainderman never sells or exchanges the property after he acquires it because upon his death the original basis of the gift terminates, and his heirs' basis in the property becomes its value on the death of the remainderman. Int. Rev. Code of 1954, § 1014; (2) where the life tenant wastes the property and it is worthless when remainder vests; (3) where the gain is not realized until the remainder vests, and the remainderman may have capital losses that offset the capital gain. Int. Rev. Code of 1954, § 1201.

[5]If the defendant were found to be an owner of the property in question, she would be liable for $6,622.17 but as a fiduciary she is only liable for $3,806.07. United States v. DeBonchamps, 278 F.2d 127, 128 (9th Cir. 1960).

[6]CCH 1958 Stand. Fed. Tax Rep. (58-1 U.S. Tax Cas.) ¶9325 (N.D. Cal. 1958).

[7]228 F.2d 667 (9th Cir. 1955), affirming 115 F. Supp. 830 (D. Hawaii 1953).

under ordinary rules applied in chancery and probate courts."[8] The court held that the life tenant was under no fiduciary duty to conserve the corpus in an equity sense, and therefore was not a trustee. The Court of Appeals in the principal case held that the Treasury Regulation upon which *Cooke* was based was "an effort to distinguish the so-called business trust from the ordinary type of trust.... It does not exclude property from taxation; rather, it aids in the determining of whether a taxable entity should be taxed as a trust or as a corporation."[9] The court based this holding upon the reasoning that a tax regulation should never be construed to exclude property from taxation unless this intention is expressly stated;[10] in this instance, such an express exemption was not present.

In most cases with facts similar to those of the instant case, two theories have been used; (1) the life tenant is owner of the income, and (2) the life tenant is a fiduciary of the estate for the remaindermen. Of course, if neither of these theories is applicable, there should be no tax upon the sale.

With reference to the first contention, the government generally argues that the legislature in seeking proper subjects of taxation will not be bound by traditional classifications of interests and estates, but "it may tax not only ownership, but any right or privilege that is a constituent of ownership."[11] A life tenant with power to consume possesses some of these privileges of ownership, *i.e.*, the power to dispose of the corpus and the right to receive income therefrom. Therefore, the government argues that one whose power of consumption is limited solely by such indefinite standards as needs, maintenance and comfort in reality has an unfettered right to take and enjoy the

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[8]Treas. Reg. 118, § 39.3797-3 (1939). The term "trust" was used for the first time in reference to a taxable entity in Smietanka v. First Trust & Sav. Bank, 257 U.S. 602, 607 (1922). The regulation itself did not appear until years later at a time when the problem of separating business associations from trusts for tax purposes received widespread attention. Morrissey v. Commissioner, 296 U.S. 344 (1935). An analysis of the entire regulation indicates that the Treasury Department was endeavoring in that particular section to clarify the distinctions between taxable groups. The reasoning of the principal case on this point appears to stand on better authority than the reasoning on the same point propounded by United States v. Cooke, 228 F.2d 667 (9th Cir. 1955).

[9]United States v. DeBonchamps, supra note 3 at 132.

[10]The basis for this statement is the Supreme Court's mandate that the legislative purpose of the revenue acts is "to reach all gain constitutionally taxable unless specifically excluded." General Am. Investors Co. v. Commissioner, 348 U.S. 434, 436 (1955); Irwin v. Gavit, 268 U.S. 161, 166 (1925); Security-First Nat'l Bank v. United States, 181 F. Supp. 911, 918 (S.D. Cal. 1960).

[11]Burnet v. Wells, 289 U.S. 670, 678 (1933).

corpus as well as the income, and is an owner in all but name.[12] This argument has not prevailed.[13] Where the life tenant's powers are narrower than those granted to Mrs. DeBonchamps, it has been summarily held that it would be unjust to tax as owner one who will never own the property.[14] On the other hand, the government's case becomes stronger when the life tenant has more privileges, including the right to consume. In *Smith v. United States*[15] the life tenant had the power to convey, encumber or consume the estate without limitation, and was held to be taxable as owner of the estate. The situation presented in *Smith* is rarely found because in most cases there are some limitations upon the life tenant's powers and even if none are expressed, some are implied.[16] The limitations or standards are usually rather vague words or phrases, such as "for his needs," or "for needs, maintenance and comfort," or "for support." Even these seemingly nebulous limitations have generally been sustained as sufficiently clear boundaries to constitute real limitations upon the life tenant's powers.[17] Whether the standard of use will suffice as a real restriction

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[12]Corliss v. Bowers, 281 U.S. 376 (1930), wherein the court stated, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Id. at 378.

[13]In Mercer, 7 T.C. 834 (1946), a life tenant with powers similar to those of the defendant in DeBonchamps was held to be the owner of the property and not a trustee. However, this case appears to stand alone, and the government did not cite it as authority for its position, relying rather on Helvering v. Clifford, 309 U.S. 331 (1940) and Helvering v. Horst, 311 U.S. 112 (1940).

[14]Gaskill v. United States, CCH 1960 Stand. Fed. Tax Rep. (60-2 U.S. Tax Cas.) ¶ 9692 (N.D. Tex. 1960).

[15]265 F.2d 834 (5th Cir. 1959). Here it was held that a life tenant, having unrestricted control of the income of the corpus, is taxable upon the entire income whether or not he actually takes or uses it since in reality he is the owner of the income. See also Flato v. Commissioner, 195 F.2d 580 (5th Cir. 1952); Spies v. United States, 180 F.2d 336 (8th Cir. 1950); Grant v. Commissioner, 174 F.2d 891 (5th Cir. 1949); Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945); Jergens v. Commissioner. 136 F.2d 497 (5th Cir. 1943); Irish v. Commissioner, 129 F.2d 468 (3d Cir. 1942); Richardson v. Commissioner, 121 F.2d 1 (2d Cir. 1941).

[16]Johnson v. Johnson, 51 Ohio St. 446, 38 N.E. 61 (1894). A duty to use good faith in regard to a remainderman was implied against a life tenant given the power to consume the corpus for her support.

"Even though power to consume is given in relatively broad terms, there is a strong tendency for courts to require good faith exercise of the power." 4 Simes & Smith, Future Interests § 1716 (1956).

[17]Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950); Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952); King v. Hawley, 113 Cal. App. 2d 534, 248 P.2d 491 (Dist. Ct. App. 1952); Shedd's Adm'r v. Gayle, 288 Ky. 466, 156 S.W.2d 490 (1941); In re Gile's Estate, 95 N.H. 270, 61 A.2d 798 (1948); Seaward v. Davis, 198 N.Y. 415, 91 N.E. 1107 (1910); Johnson v. Johnson, 51 Ohio St. 446, 38 N.E. 61 (1894); In re Powell's Estate, 340 Pa. 404, 17 A.2d 391 (1941); Collins v. Hartford Acc. & Indem. Co., 178 Va. 501, 17 S.E.2d 413 (1941).

upon the life tenant's rights is a question of judicial construction, and only if the standard is so vague that there is no basis for limiting his powers will the life tenant be held to be the owner of the property.[18]

The government's second contention in cases like *DeBonchamps* is that the corpus of the estate should be recognized as property held in trust by the life tenant as trustee.[19] This means that under section 641(a) of the Internal Revenue Code the life tenant is taxable as a trustee for capital gains realized by the estate. In order to sustain this contention, the court must find that the life tenant is a fiduciary for the remaindermen. At common law an ordinary life tenant owed certain duties to his remaindermen, *e.g.*, to refrain from waste or unreasonable use of the property, to pay current taxes and to keep down interest on the property.[20] Because of these duties, a majority of courts hold that there is a weak relationship of fiduciary or quasi-trustee between a life tenant and his remaindermen.[21] The basis for this holding appears to be two fold: (1) These successive interests in the same thing give the two a common purpose; and (2) a life tenant in possession has the physical power to affect the interest of the remaindermen in a manner comparable to the power of a trustee over the interests of a beneficiary. Both Scott[22] and Bogert[23] have criticized the majority rule, asserting that at best there is only a weak confidential relationship between the parties. Therefore, they say that if the testator in creating a life estate and a remainder appoints the life tenant as trustee, but gives him no duties, he will have created nothing more than a mere life tenancy and the words of trust will be

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[18]Compare Smith v. United States, 265 F.2d 834 (5th Cir. 1959) with Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950) and Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952). See also, Note, 60 Yale L.J. 1426 (1951).

[19]This proposition was recently accepted in Security-First Nat'l Bank v. United States, 181 F. Supp. 911 (S.D. Cal. 1960) and Weil v. United States, 180 F. Supp. 407 (Ct. Cl. 1960). But see Gaskill v. United States, CCH 1960 Stand. Fed. Tax Rep. (60-2 U.S. Tax Cas.) ¶ 9692 (N.D. Tex. 1960) and United States v. National City Bank, 21 F. Supp. 791 (S.D.N.Y 1937) where the court appointed a trustee to pay the capital gains tax involved

[20]1 Tiffany, Real Property § 63 (3d ed. 1939).

[21]Bell v. Killian, 266 Ala. 12, 93 So. 2d 769 (1957); Wagner v. Mosley, 104 So. 2d 86 (Dist. Ct. App. Fla. 1958); Burlington County Nat'l Bank v. Braddock, 24 N.J. Super. 462, 94 A.2d 868 (Super. Ct. 1953); In re Reckford's Will, 307 N.Y. 165, 120 N.E.2d 696 (1954); In re Estate of Kyle, 106 Ohio App. 502, 155 N.E.2d 498 (1958); Commercial & Sav. Bank v. Burton, 185 Va. 133, 31 S.E.2d 289 (1944). See also Annot., 137 A.L.R. 1054 (1942); Pa. Stat. Ann. tit. 20, § 301.13 (1950) (changing the relationship between life tenants and remaindermen to one of fiduciary rather than that of debtor-creditor).

[22]1 Scott, Trusts § 24.1 (2d ed. 1956).

[23]1 Bogert, Trusts and Trustees § 27 (1951).

treated as surplusage. This principle was stated in *Schaefer v. Schaefer*[24] as follows:

> "A trusteeship cannot be predicated of [sic] one who holds for life only, and for his or her own sole use or benefit, and the instrument which gives the life estate also gives the remainder to others in their own right, and no duty, other than those that grow out of this legal relation, is imposed upon the life tenant."[25]

Bogert argues that " the status of life tenant and remainderman lacks both the kind of division of ownership found in trust and the broad fiduciary nature of the latter relationship."[26] A fiduciary relationship has been defined as one whose characteristics are "analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. Thus, a person is a fiduciary who is invested with rights and powers to be exercised for the benefit of another person."[27] It would be preferable if the majority of courts would label the life tenant a partial fiduciary but not a trustee for the remaindermen, since he may deal with the remaindermen at arms length in purchasing or acquiring their interest.[28]

When the life tenant is given powers additional to those he possesses as an ordinary life tenant, such as the power to consume, a majority of jurisdictions[29] still treat him as a quasi-trustee or a fiduciary, and California designates the relationship involved as one "in the nature of a trust."[30] It would seem that the arguments against the treatment of ordinary life tenants as fiduciaries would apply with equal force here. Moreover, in the instant case the so-called trustee is given the individual right of possession and consumption of the trust res which is contrary to all common-law concepts of trusts and trust relationships.[31] Even in the light of this logic the courts in tax cases may be said to have accepted the difficulties inherent in the majority rule in order to reach the desired result.

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[24]141 Ill. 337, 31 N.E. 136 (1892). See also, Thompson v. Adams, 205 Ill. 552, 69 N.E. 1 (1903).

[25]Schaefer v. Schaefer, 141 Ill. 337, 31 N.E. 136 (1892).

[26]Note 23 supra at 218.

[27]Black, Law Dictionary (4th ed. 1951) (quoting definition of "fiduciary").

[28]Warfield v. Bixby, 51 F.2d 210 (8th Cir. 1931); Mallett v. Hall, 129 Me. 148, 150 Atl. 531 (1930).

[29]Cf. authorities cited note 21 supra. The courts apparently do not distinguish between ordinary life tenants and life tenants with additional powers in applying the majority rule which designates a life tenant to be a fiduciary for the remaindermen.

[30]King v. Hawley, 113 Cal. App. 2d 534, 248 P.2d 491, 494 (Dist. Ct. App. 1952).

[31]In re Walsh's Estate, 239 Pa. 616, 86 Atl. 1091 (1913).

After finding the life tenant to be a fiduciary, the Court of Appeals in the principal case held the tenant taxable under section 641(a) of the Internal Revenue Code which applies to estates and trusts, including "income accumulated in trust for the benefit of unborn or unascertained person or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust...."[32] The court then designated this weak fiduciary a trustee by use of section 7701(6) which defines a fiduciary as "a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in a fiduciary capacity for any person."[33]

Essentially a trust involves divided ownership of property, with the trustee holding legal title and the cestui que trust having the equitable interest.[34] It is obvious that there is not such a split ownership between the life tenant and remainderman because both hold legal estates.[35] Also implicit in the trust concept is the close confidential relationship between the trustee and the beneficiary.[36] The highest degree of good faith is required of the trustee in acting for the best interests of the cestui que trust. However, in *DeBonchamps* and similar cases the courts have forgotten established principles by labeling a life tenant as a trustee because they are in effect saying that one with the power to consume the res and deal with the beneficiary at arms length is a trustee.[37]

From the foregoing it is obvious that the term "trust" is given a different construction in chancery than in tax proceedings. This specific instance evidences the supposition that legal relationships bind-

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[32]Int. Rev. Code of 1954, § 641(a).

[33]Int. Rev. Code of 1954, § 7701(6).

[34]54 Am. Jur. Trusts § 4 (1954).

[35]Note 23 supra at 218.

[36]"A trustee must act in good faith in the administration of the trust, and this requirement means that he must act honestly and with the finest and undivided loyalty to the trust, not merely with the standards of honor required of men dealing at arm's length in the workaday world, but with a punctilio of honor of the most sensitive." 54 Am. Jur. Trusts § 311 (1954).

[37]Some further difference between the duties of a life tenant toward his remainderman and those of a trustee in regard to the cestui que trust are: (1) A life tenant is only required to deal with the property as he normally would if he was the owner of the fee. Therefore, the life tenant's duty to the remainderman is purely negative, e.g., not to injure the remainderman's interest, while the trustee has the affirmative duty to devote his best efforts for the benefit of the beneficiary. Restatement, Property § 204 (1936); (2) While the trustee cannot relieve himself of obligations merely by transfer or abandonment of the trust res, a life tenant can substitute another for himself by selling his interest. Loring, A Trustee's Handbook § 8 (1940); (3) While a life tenant has a beneficial interest in the property as well as control of it, the trustee merely manages the property for the benefit of others. Restatement, Property § 204(a) (1936).