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Untaxed Retention of Broad Managerial Control

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sympathetic consideration to the solutions of the many problems concerning the plight of the sometimes "forgotten man" in the criminally insane wards of our mental institutions.

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UNTAXED RETENTION OF BROAD MANAGERIAL CONTROL

Decedent gratuitously transferred the voting common stock of three closely-held family corporations to an inter-vivos trust, the stock constituting the principal trust property. He retained the powers (1) to vote the stock held by the trust, (2) to appoint a successor corporate trustee, and (3) to veto the transfer of any trust assets by the trustee. The Commissioner determined that the stock was includable in decedent's gross estate;[1] the estate paid the alleged deficiency and sued for refund. The United States Supreme Court *held* that decedent's retained right to vote the common stock of a small corporation held in trust, which, combined with decedent's own stock, gave him voting control of the corporation, and the retained right to veto any transfers of that stock constituted neither retention of (a) the enjoyment of or right to income from the stock, nor (b) the right to determine the persons who may enjoy the property in the trust, either of which would make the stock includable in the gross estate of decedent for estate tax computation. *United States v. Byrum*, 92 S. Ct. 2382 (1972).

The Internal Revenue Code includes in a gross estate the value of transfers made during the lifetime of the transferor, either when such transfers are not complete at the time they are made, or when they are deemed essentially testamentary.[2] Prior to 1931, some such incomplete transfers were considered taxable as transfers intended to take effect (in possession or enjoyment) at or after death.[3] However, in that year the Supreme Court in *May v. Heiner*,[4] emphasizing the technical pass-

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1. INT. REV. CODE of 1954, § 2036(a)(1), (2).
2. Section 2037 taxes certain transfers where the decedent reserved a "reversionary interest," and § 2038 taxes transfers in which he maintained the power to alter, amend, revoke, or terminate interests in the property transferred. Transfers made in contemplation of death are regulated by § 2035.
3. Revenue Act of 1926, ch. 27, § 302, 44 Stat. 70.
4. 281 U.S. 238 (1930).

ing of title to the property in trust, held that where title had actually passed, a possible reversionary interest did not make the transfer includable in the gross estate of the transferor. This broad holding was affirmed in three per curiam decisions[5] which prompted enactment of provisions substantially identical to § 2036 of the 1954 Code.[6]

There are essentially two types of incomplete transfers taxed by § 2036: transfers in which the transferor himself retains an interest, and transfers over which the transferor retains a right to control the disposition. First, the transfer is incomplete and taxable under § 2036(a)(1) if the transferor retained for himself any "possession or enjoyment of, or the right to the income from the property." In applying this section, the courts have held that the transfer is taxable as part of the transferor's estate where the transferor was to receive any of the income from the property, or the use of real property transferred, or where income from the property was to be used to pay the transferor's legal obligation.[7] If the act of transfer did not expressly provide that the settlor was to receive the income from the trust, but there was an "understanding" that he would, the property was also includable.[8] When there was no such "understanding" but the transferor did in fact receive some income from the property, the decisions were not consistent.[9] Transfers of stock in closely-

5. McCormick v. Burnet, 283 U.S. 784 (1931); Morsman v. Burnet, 283 U.S. 783 (1931); Burnet v. Northern Trust Co., 283 U.S. 782 (1931).

6. On March 2, 1931, Acting Secretary of the Treasury Ogden Mills wrote the Speaker of the House of Representatives commenting on the Supreme Court decisions. The letter is reproduced in BNA TAX MANAGEMENT, EST., GIFT & TRUSTS Portfolio No. 133, at B-15 (1967). On March 3, 1931, the House passed House Joint Resolution 529, to insure that the Treasury would not miss such a lucrative source of income.

7. United States v. Estate of Grace, 395 U.S. 316 (1969); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Guynn v. United States, 437 F.2d 1148 (4th Cir. 1971); Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959); Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Estate of Holland v. Commissioner, 1 T.C. 564 (1943); Hooper v. Commissioner, 41 B.T.A. 114 (1940); Treas. Reg. § 20.2036-1(b)(2) (1960).

8. Estate of Skinner v. United States, 316 F.2d 517 (3d Cir. 1963); Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir. 1959); Atkinson v. United States, 231 F. Supp. 933 (E.D.S.C. 1964); Fitzsimmons v. United States, 222 F. Supp. 140 (E.D. Wash. 1963); Estate of Nicol v. Commissioner, 56 T.C. 179 (1971); Treas. Reg. § 20.2036-1(a) (1960).

9. Not taxable: 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); Uhl's Estate v. Commissioner, 241 F.2d 867 (7th Cir. 1957); Stephenson v. United States, 238 F. Supp. 660 (W.D. Va. 1965). Taxable: Skinner's Estate v. United States, 316 F.2d 517 (3d Cir. 1963); Carpenter v. United States, 243 F. Supp. 993 (W.D. Okla. 1965).

held family corporations have caused special problems under § 2036(a)(1). The Commissioner has argued that a transferor's continued employment in a family corporation constitutes "enjoyment and income" from the property transferred. In *Estate of Holland v. Commissioner*,[10] where the employment was passive, the voting rights were retained by the transferor, and the "salary" was designed to and did exceed the annual income of the corporation, the Tax Court agreed that the transfer was includable because the transferor continued to have a right to the enjoyment and income. But, in two cases where the transferor did not retain voting rights and his salary was reasonable, the stock was held not includable in the gross estate.[11]

Under the second provision of § 2036, the property transferred inter vivos is nevertheless includable in the gross estate if the transferor has retained the right, either alone or in conjunction with any person to designate the persons (other than himself) who shall possess or enjoy the property or the income therefrom.[12] This includes those trusts in which the right to designate the beneficiary is held in a fiduciary capacity by the transferor (whether as trustee or otherwise) if there is no external, objective standard under which the discretion of the transferor is limited.[13] It also includes those transfers in which the decedent had the unfettered right or power to designate the beneficiary, even if there was little likelihood that the transferor would use the power and he never actually did so.[14]

However, where the discretionary powers of the decedent as trustee to designate the principal or income beneficiaries were limited in the trust instrument by enforceable external stan-

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10. 1 T.C. 564 (1943), *supplementing the original decision* at 47 B.T.A. 807 (1942).

11. Estate of Belknap v. Commissioner, 10 CCH Tax Ct. Mem. 769 (1951); Estate of Hofford v. Commissioner, 4 T.C. 790 (1945).

12. The problem usually arises when decedent has created a trust, appointed himself as a trustee, and the trust instrument has allowed the trustees a great deal of discretion in deciding to pay income or add it to the trust corpus.

13. Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947); Du Charme's Estate v. Commissioner, 164 F.2d 959 (6th Cir. 1947); Estate of Budlong v. Commissioner, 7 T.C. 756, *modified*, 8 T.C. 284 (1947).

14. Round v. Commissioner, 332 F.2d 590 (1st Cir. 1964); Hurd v. Commissioner, 160 F.2d 610 (1st Cir. 1947); Biscoe v. United States, 148 F. Supp. 224 (D. Mass. 1957). Where the decedent's right was limited to powers of broad managerial control, the result was different. *See* text at note 15 *infra*.

dards,[15] the transfer was found not taxable under § 2036(a)(2).[16] Several courts have held that when the transferor named himself as a trustee, a discretionary power on the part of the trustee to pay or withhold, *i.e.*, distribute or accumulate income, or to add that income to the trust corpus, was the right to determine who would enjoy the property or the income therefrom.[17] Again, inclusion of an adequate objective standard made the trust non-taxable under this section, even if the transferor was a trustee, because the transferor's whim was limited by the requirement that he act in a fiduciary capacity.[18]

In Revenue Ruling 67-54,[19] the Commissioner ruled that the transferor's retention of a controlling interest in a corporation's voting stock made non-voting stock transferred to a trust includable in the transferor's gross estate where (1) the transferor was a trustee of the trust at his death, or (2) the trustee (other than the transferor) was restricted in any way in his power to dispose of the stock in trust. The ruling stated that control of the dividends from the transferred property was retention of "the right to designate the persons who shall possess or enjoy the property or the income therefrom." The Commissioner reasoned, as he argued in the instant case, that power to declare dividends was inherent in control of a corporation and that power to declare dividends was power to regulate trust income.

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15. Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947). In *Jennings*, for example, decedent settlor, together with two other trustees, had authority to pay income or add it to the trust corpus. Their discretion was limited by the requirement that the income from the trust res be paid only if the beneficiary needed it "for maintenance of a proper standard of living." The trustees could invade the corpus in cases of "prolonged illness or extraordinary financial misfortune."

16. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Rudin v. United States, 285 F. Supp. 901 (E.D. Pa. 1968); Estate of Budd v. Commissioner, 49 T.C. 468 (1968); Estate of Pardee v. Commissioner, 49 T.C. 140 (1967).

17. United States v. O'Malley, 383 U.S. 627 (1966); Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947); Biscoe v. United States, 148 F. Supp. 224 (D. Mass. 1957). Even when the beneficiary of income was also the remainderman, by reserving the power to accumulate income the settlor could make the beneficiary's right to receive income contingent on the beneficiary's outliving the trust and thus possibly shift enjoyment to the income beneficiary's heirs. Joy v. United States, 404 F.2d 419 (6th Cir. 1968).

18. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929); Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970); United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

19. Rev. Rul. 67-54, 1967-1 CUM. BULL. 269.

The courts, however, did not agree. In *Yeazel v. Coyle*,[20] the district court held that where the transferor named herself as trustee and transferred to the trust about one-half of the stock of a company in which she owned the other half of the stock, the stock was not taxable under § 2036 because the transferor had retained no present economic benefit and had retained only powers of broad management of trust assets, exercisable in a fiduciary capacity, under an externally determinable standard.[21]

In *Estate of Beckwith v. Commissioner*,[22] decedent owned 37% of the stock of a corporation and regularly received the trustee's proxy to vote the shares held in trust, an additional 39% of the stock. In holding that the transferred stock was not includable in decedent's gross estate under § 2036, the Tax Court emphasized the fact that the trustees had the ability either to sell the stock in the trust and thus remove the influence of decedent, or alternatively to withhold the proxy.[23]

In the instant case, the Commissioner contended that the stock transferred to the trust was taxable because decedent had retained the right to vote the shares and the right to prevent the trustee from transferring the stock, thus retaining control of the corporation. This, the government alleged, was per se a substantial economic benefit to the decedent and assured another economic benefit, continued remunerative employment with the corporation. Moreover, maintaining control of the corporation was alleged to be enjoyment of the property in trust, or a right to that enjoyment, because it allowed decedent to determine whether the corporation might be liquidated or merged.[24]

Alternatively, the Commissioner contended that the transferred stock was includable in decedent's gross estate because

20. 68-1 U.S. Tax Cas. 87, 384 (1968).

21. The factual situation in *Yeazel* was slightly different from the instant case in that the settlor retained the power to vote the shares held in trust as trustee, whereas in the instant case the trustee was a corporation and settlor retained the power to vote the shares by a clause in the trust instrument. In addition, the settlor in the instant case retained the right to veto transfers of shares held in trust.

22. 55 T.C. 242 (1970).

23. In the instant case, the settlor could veto the transfer of shares of stock held in trust and the trustee could not withhold the settlor's power to vote the shares.

24. The assets of the trust would have been taxed as part of decedent's estate if the Commissioner had prevailed on either argument. INT. REV. CODE of 1954, § 2036(a)(1), (2).

decedent maintained control of the voting stock; thus he could elect the board of directors; the board determined dividend policies; the dividend policies of the corporation determined the income of the trust; therefore, decedent controlled payments to the income beneficiaries since he controlled income to the trust.[25] This ability to declare dividends (or alternatively to retain earnings and swell stock values) was alleged to constitute reservation of the right to designate the persons who would enjoy the property or income in the trust by favoring either income or principal beneficiaries.[26]

The Supreme Court rejected both contentions. In deciding that the decedent had not retained the "possession or enjoyment of, nor the right to the income from the property," the Court affirmed two principles found in earlier cases. First, the term "enjoyment," as used in estate tax status, means "substantial present economic benefit."[27] According to the Court, there was no retention of "substantial present economic benefit" because decedent had retained no interest in the income of the trust itself. Any economic benefit to Byrum would be received from the corporation. As to the power to determine liquidation or merger, the Court viewed this as no more than a future and contingent economic benefit.[28] Second, with respect to his control of the corporation, Byrum's fiduciary obligations (enforceable objective standards), limited much of the "enjoyment" alleged by the Commissioner. For example, the decedent's power to determine liquidation or merger was limited by rights of minority stockholders. These minority stockholders could sue to have decedent's continued employment terminated if that employment proved detrimental to the best interests of the corporation.[29]

25. The dissent noted that Byrum controlled the "spigot" of income to the trust; *i.e.*, he could start, stop, and control the rate of income to the trust. In this way, the dissent maintained, he could determine income to the income beneficiaries and designate who would have enjoyment of the trust property.

26. *See* text at note 19 *supra*.

27. 92 S. Ct. at 2395. The court was quoting with approval from Commissioner v. Estate of Holmes, 326 U.S. 480, 486 (1946), and cited 26 C.F.R. § 20.2036-1(b)(2) (1972). 92 S. Ct. at 2395 n.28.

28. The court also reasoned that decedent's "control" of the corporation was not continued enjoyment of transferred property because decedent had not transferred the *control* of the corporation but had transferred part of the stock of the corporation. Thus, he was not enjoying that which he had transferred to the trust. 92 S. Ct. at 2396.

29. The corporate directors were vulnerable to derivative suits for unreasonable compensation or improper retention of Byrum as an employee. Unreasonable compensation would also not be deductible from the corporate income tax. INT. REV. CODE of 1954, § 162.

In deciding that the decedent had not retained the right to designate the persons who would possess or enjoy the property, or the income therefrom, the Court pointed to four considerations. First, reservation of broad managerial control over trust assets does not make the trust corpus taxable[30] under § 2036.[31] Second, decedent had no discretionary ability to cause the directors of the corporation to declare dividends. Regardless of Byrum's influence over the directors he selected, those directors were themselves under a fiduciary obligation to all stockholders and to the corporation; minority stockholders could enforce their rights to impartial management through a derivative action.[32] Third, the statute includes inter vivos transfers in the transferor's gross estate if the transferor has retained the *right* to determine distributions *from the trust.* "Right" in tax statutes means "an ascertainable and legally enforceable power";[33] Byrum's "power" over dividends was neither, because corporate dividend policy is determined more by legal and economic factors than by the preferences of corporate directors.[34] Fourth, notwithstanding the above conclusions, decedent simply did not control all of the factors which ultimately determined the size of dividends paid to the trust. Small businesses are particularly susceptible to economic vicissitudes, which have such great influence on corporate income that decedent's power could not be decisive of the size of dividends paid.[35]

30. The court relied primarily on Reinecke v. Northern Trust Co., 278 U.S. 339 (1929); also Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Helvering v. Duke, 290 U.S. 591 (1933); McCormick v. Burnet, 283 U.S. 784 (1931).

31. *Estate of Chalmers*, CCH 1972 TAX CT. REP. No. 31, 473(M) (31 Tax Ct. Mem.), followed *Byrum* and the Tax Court held that mere retention of the power to manage trust property does not make the trust assets includable in the gross estate of the settlor. The court said that although the *Chalmers* facts were different from those in *Byrum*, the issue was well settled in *Byrum* and therefore not open to question.

32. The Supreme Court found that Ohio law imposed this duty on corporate directors. The Louisiana situation is analogous; *see* LA. R.S. 12:91 (Supp. 1968).

33. 92 S. Ct. 2382, 2390 (1972).

34. In addition to fiduciary duties to *all* stockholders, the majority decision noted that corporate directors must consider limited flexibility of small corporations in utilization of retained earnings and a penalty tax on accumulated earnings (INT. REV. CODE of 1954, §§ 531-37), limited access to capital markets, and maintaining reserves for replacement and modernization of plant and equipment, for growth and for expansion. 92 S. Ct. at 2392.

35. The Court noted that macroeconomic expansion and recession, "[b]ad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy—prevent any certainty or predictability as to earnings or dividends." 92 S. Ct. at 2392.

The dissent took a more pragmatic approach to statutory interpretation, contending that retention of a salaried position and maintenance of control of a corporation are quite definitely "possession, enjoyment, or right to income." As the dissenters saw it, control over dividend policy constitutes control over income to the trust, and in small corporations the majority stockholder can effectively determine these dividends. Finally, the dissent noted that the predecessor of § 2036 was hastily prepared as a reaction to *May v. Heiner*[36] and that the word "right" was meant to expand the coverage of the statute. Consequently, possession of the "power" to designate the persons who would enjoy the property is within the scope of the statute.[37]

The majority's decision that the transfer in the instant case did not involve the retention of the right to designate the persons who would possess or enjoy the property seems clearly justified. Although a majority stockholder can certainly influence dividend policies, his ability to allocate enjoyment by electing directors, who declare dividends, which constitute trust income, which is distributed by trustees, is simply too remote.[38] It seems especially remote considering the economic realities mentioned by the majority which may cause net losses and thereby preclude dividends or result in large profits which would practically necessitate dividends.

Moreover, a decision that a controlling stockholder of a corporation had the right to allocate corporate earnings between income and principal beneficiaries of the stock in trust would be inequitable and difficult to apply. Such a proposition would

36. 281 U.S. 238 (1930).

37. The dissent noted that the majority decision seemed to indicate a "technical passing of title" approach which supported the discredited *May v. Heiner* decision. *See* text at note 4 *supra*. The dissent further contended that since the Heiner decision and subsequent amendment of estate tax statutes, the courts have for the most part overlooked the technical provisions in a trust or other transfers and looked to the substance of the transaction.

38. The "remote" criteria was emphasized in *Hays' Estate v. Commissioner*, 181 F.2d 169 (5th Cir. 1950). In that case, decedent transferred immovable property incumbered by a mortgage to a trust and the trust undertook to pay the indebtedness on the land. The Commissioner contended that income from the trust was used to pay decedent's legal obligations (*see* note 7 *supra*). The Fifth Circuit held for the estate, noting that decedent's obligation was remote (*i.e.*, if the income from the land did not satisfy the payments *and* if the land was then sold for less than the remaining indebtedness, then, and only then, would decedent have to pay the remainder.)

be inequitable because stock of closely-held corporations placed in trust would always be included in the transferor's gross estate as long as his voting control continued; widely-held stocks would not be so taxed. It would be difficult to apply because a court would have to determine when a single stockholder had sufficient "control" to effect the right in question.[39]

The Court's rejection of the Commissioner's argument that decedent retained the possession or enjoyment of, or the right to the income from, the stock is a desirable result because it allows stock of closely-held corporations to be treated equally with stock of "publicly-held" corporations. However, it is unrealistic to maintain that control of a corporation is not an economic benefit per se. Consistent with his fiduciary obligations, the decedent assured himself of lifetime employment;[40] but even if he had not, he maintained "control" by virtue of voting the shares in trust. The fair market value of controlling shares (as pointed out by the dissent) is often greater than the value of such shares without control. Therefore Byrum's shares were more valuable *to him* because he had power to vote the shares in trust, together with his own shares, giving him control.

Three factors were particularly prominent in this case and any variation might have altered the result. First, Byrum was not the sole stockholder; there were apparently unrelated minority stockholders in each of the corporations.[41] Second, applicable state law created objective standards for decedent's exercise of his retained power by recognizing that the controlling stockholder and the corporate directors were under fiduciary obligations to minority stockholders. Third, there was no showing of decedent's abuse of his powers.

Louisiana recognizes by statute the fiduciary responsibility of corporate directors to the corporation and to the stockhold-

39. United States v. Byrum, 92 S. Ct. 2382, 2391 n.13 (1972).

40. The Tax Court has twice held that employment per se is not enjoyment and right to income. *See* note 11 *supra*. It was important in those cases that the rate of remuneration was reasonable in the circumstances and it should be remembered that where the "salary" was unreasonable the estate was taxed.

41. But the majority intimated that the trustee, as a stockholder, would be under a duty to bring suit to prevent abuse of fiduciary duties, and thus protect the beneficiaries. "Although Byrum had reserved the right to remove the trustee, he would have been imprudent to do this when confronted by the trustee's complaint against his conduct." 92 S. Ct. at 2393.

ers;[42] there are cases recognizing the duty morally and ethically[43] as well. However, there does not seem to be an established fiduciary responsibility on the part of majority stockholders toward the corporation, or toward the minority,[44] as was described by the court in the instant case.[45] A Louisiana transferor *might* be able to create a Byrum-type trust and escape taxation under § 2036; however, absence of a fiduciary obligation on the part of the majority stockholder would make the Commissioner's argument stronger.

The instant case has evoked considerable response from tax practitioners,[46] but the majority relied on so many bases for its opinion that the significance of each, individually, is largely uncertain. The *approach* taken by the majority, therefore, may be more important than its specific holding. The dissent characterized the majority's approach as a return to *May v. Heiner*, but saw its own position as looking beyond the form of the transaction to its substance. This criticism is not well founded. While the dissent noted the substance of the powers retained by Byrum, it failed to appreciate the substantial limitations on those powers. The majority opinion was not a return to the "technical passing of title" of *May v. Heiner*, but rather a recognition of legal and practical limits on economic power.

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42. LA. R.S. 12:91 (Supp. 1968).

43. Williams v. Fredericks, 187 La. 987, 175 So. 642 (1937): "The directors of a corporation occupy a fiduciary relation to the stockholders generally, not only to stockholders who elect them, but to all of the stockholders; and this fiduciary relation to the stockholders forbids a director to bind himself or use his official authority or prerogative for the personal benefit of any one." *See also* Mansfield Hardwood Lmbr. Co. v. Johnson, 263 F.2d 748, *on rehearing*, 268 F.2d 317 (5th Cir. 1959). *Accord*: Roussel Pump & Elec. Co. v. Sanderson, 216 So.2d 650 (La. App. 4th Cir. 1968); House of Campbell, Inc. v. Campbell, 172 So.2d 727 (La. App. 4th Cir. 1965); Bolding v. Eason Oil Co., 170 So.2d 883 (La. App. 4th Cir.), *aff'd*, 248 La. 269, 178 So.2d 246 (1965).

44. *But see* Funderburk v. Magnolia Sugar Co-op, Inc., 8 So.2d 374 (La. App. 1st Cir. 1942).

45. United States v. Byrum, 92 S. Ct. 2382, 2391 n.11 (1972). *See also* André, *Close Corporations in Louisiana*, 45 TUL. L. REV. 259 (1971).

46. Casey, *Living (and Dying) with Byrum: The Estate Planner's Dilemma*, 20 LA. B.J. 133 (1972); Newman & Kalter, *Transfers of Corporate Securities by Persons in Control of Corporate Policy: Byrum Revisited*, 111 TRUSTS & ESTATES 710 (1972); Newman & Kalter, *Transfers of Corporate Securities by Persons in Control of Corporate Policy*, 111 TRUSTS & ESTATES 118 (1972).