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# Estate Tax-§ 2036 Transfers with a Retained Life Interest

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plaintiff rejected the vehicle upon delivery at the showroom, certainly no duty to bear any depreciation would have attached. In *Tiger Motor Co. v. McMurtry*,<sup>21</sup> the vendor's assertion of a right to setoff the use value of vendee's possession for 344 days was held to be without basis in light of section 2-608 of the Code. Such a result is consistent with Florida's posture in regard to total restoration of consideration upon rescission.<sup>22</sup> The immediate effect of this portion of the decision in *Dade County Dairies* is to allow the defendant to benefit from his breach at the expense of the injured party.

The subject matter of the instant case makes this decision an important one. As a case of first impression, the theories behind the decision will have a strong effect on the development of Code case law in Florida. Unfortunately, while perhaps a just result was reached, the setoff of depreciation and the "conspicuousness" requirement for limiting remedies were questionable holdings; additionally, an important express warranty aspect was neglected. Finally, to stay within the framework of the Code, revocation of acceptance, rather than common law rescission, should have been awarded. The court did, however, establish valid law in noting that, had the disclaimers of warranty been valid, rescission would still lie for failure to measure up to the remaining warranties. Additionally, the court properly balanced the vendor's right to cure before the time for performance has expired with a requirement that such cure be effected within a reasonable time of notification.

*Dade County Dairies* may well be the first step towards an effective and persuasive use of the Uniform Commercial Code as a consumer protection tool.

DAVID A. WOLFSON

## ESTATE TAX—§ 2036 TRANSFERS WITH A RETAINED LIFE INTEREST

Decedent transferred stock in three unlisted corporations to an irrevocable trust for the benefit of his children, retaining the right to vote the transferred stock, to veto any disposition of such stock by the trustee, a bank, and to remove the trustee and appoint another corporate trustee as successor. The retained voting rights coupled with the vote of the shares owned by the decedent individually at the time of his death gave him a majority vote in each of the corporations. The Commissioner of Internal Revenue determined that the value of the shares so transferred was includable in the decedent's gross estate under the provisions of

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21. 284 Ala. 238, 224 So.2d 638 (1969).

22. See, e.g., *Singleton v. Foreman*, 435 F.2d 962 (5th Cir. 1970), for a discussion of Florida decisions on this point.

§ 2036(a) of the Internal Revenue Code of 1954.<sup>1</sup> The Commissioner argued that the retained powers had enabled the decedent to shift trust income between the life tenants and the remaindermen, thereby constituting a retention of "the right . . . to designate." Consequently, the Commissioner required the inclusion of the trust assets in the gross estate as prescribed by § 2036(a)(2). Alternatively, the Commissioner argued that the decedent, by virtue of his control posture, had maintained himself in a position as a salaried officer of the companies and had thereby retained the "enjoyment" of the property transferred. Pursuant to the provisions of § 2036(a)(1), as an alternative ground, the Commissioner required the inclusion of the trust assets in the gross estate. In a refund action, the United States District Court for the Southern District of Ohio entered judgment for the executrix.<sup>2</sup> On appeal to the United States Court of Appeals for the Sixth Circuit the case was affirmed.<sup>3</sup> On writ of certiorari to the United States Supreme Court, *held*, affirmed: The decedent had not retained the "right to designate" within the meaning of § 2036(a)(2), nor did the retained voting rights constitute retention of "enjoyment" of the property transferred within the meaning of § 2036(a)(1). *United States v. Byrum*, 92 S. Ct. 2382 (1972).<sup>4</sup>

Generally, § 2036(a) requires that the gross estate include the value of the entire property transferred by the decedent with respect to which he has retained or reserved possession, enjoyment, the right to income, or the right to designate the persons who shall possess or enjoy the property or the income therefrom.<sup>5</sup> The Government, basing its primary argument on § 2036(a)(2), relied heavily on *United States v. O'Malley*.<sup>6</sup> In *O'Malley*, the settlor of an *inter vivos* trust had named himself as one of the trustees. The trustees were empowered, in their "sole discretion," to either pay out or accumulate trust income. Any income so accumulated would become part of the trust corpus, accruing to the benefit of the remaindermen. The Government contended that this provision gave the settlor, in conjunction with the other trustees, the right to designate who, as between the income beneficiaries and the remaindermen, would enjoy the income from the transferred property.

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1. Hereinafter cited as § 2036(a).

2. *Byrum v. United States*, 331 F. Supp. 892 (S.D. Ohio 1970).

3. *Byrum v. United States*, 440 F.2d 949 (6th Cir. 1971).

4. *Petition for rehearing denied*, *United States v. Byrum*, 93 S. Ct. 94 (1972).

5. § 2036 in pertinent parts is as follows:

§ 2036. TRANSFERS WITH RETAINED LIFE ESTATE

(a) General Rule—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(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.

6. 383 U.S. 627 (1966).

The Government contended that Byrum, by retaining control in the corporation,<sup>7</sup> had "retained the right to designate the persons who shall enjoy the income from the transferred property."<sup>8</sup> This "retained right," the Government argued, was embodied in Byrum's ability to select the corporate directors, and then, exerting his influence over such directors, to control corporate dividend policies.<sup>9</sup> The logical result of the foregoing would be an effective control of the flow of income into the trust. Thus, according to the Government, Byrum had retained the "right to designate" in that he had the power to either ensure payments to the income beneficiaries by causing dividend payouts or to increase the value of the trust estate for the remaindermen by restricting corporate disbursements. By accumulating the income in the corporations, and thereby increasing their net worth, the value of the stock would increase, such increase accruing to the benefit of the remaindermen.<sup>10</sup> The net effect was that Byrum could effectively shift the beneficial enjoyment of the trust income between the income beneficiaries and the remaindermen. Thus, according to the Government's position, such powers were tantamount to a settlor-trustee's power to accumulate income in the trust,<sup>11</sup> which had been recognized as a tainted power by the Court in *O'Malley*.

While the Court readily agreed that *O'Malley* clearly fell within the ambit of § 2036(a)(2), rather than examining the substance of the transactions involved, the majority attempted to distinguish *O'Malley* based on a semantic difference between a "right" and a "power."<sup>12</sup> To the majority, a "right" constituted an ascertainable and legally enforceable power, such as a right to accumulate trust income as conferred by a trust instrument, whereas a "power" was lacking in ascertainability and enforceability.<sup>13</sup> The Court agreed that Byrum did have the "power" to regulate the flow of income into the trust through his control of the corporate dividend policies, but not the "right" within the meaning of § 2036(a)(2), since the above mentioned elements were lacking.<sup>14</sup> In

7. The actual proportions after the creation of the trust were:

Corporation	Trust	Percentages Owned by:	
		Decedent	Combined
Byrum Lithographing Co., Inc.	12	59	71
Graphic Realty, Inc.	48	35	83
Bychrome Co.	46	42	88

United States v. Byrum, 92 S. Ct. 2382, 2387 n.2 (1972).

8. *Id.* at 2388.

9. *Id.*

10. See Yeazel v. Coyle, 21 Am. Fed. Tax R.2d 1681, 68-1 U.S. Tax Cas. ¶ 12,524 (N.D. Ill. 1968).

11. United States v. Byrum, 92 S. Ct. 2382, 2388 (1972).

12. *Id.* at 2390.

13. *Id.*

14. Such careful analysis on the majority's part presupposed a careful and painstaking drafting of the statute. The dissent was quick to note the actual circumstances surrounding the enactment of the predecessor of § 2036(a)(2):

This argument conjures up an image of congressional care in the articulation of [the predecessor of] § 2036(a)(2) which is entirely at odds with the circumstances of its passage. The 1931 Revenue Act which first enacted [the predecessor of]

addition to the foregoing semantic distinctions drawn by the Court, Byrum's retained powers were promptly classified as managerial powers, as opposed to dispositive powers, the majority noting that retention of the former by a settlor had never caused the value of an *inter vivos* trust to be included in the settlor's estate.<sup>15</sup> The First Circuit, in *Old Colony Trust Co. v. United States*,<sup>16</sup> had ruled, with respect to such retained managerial powers: "[N]o aggregation of purely administrative powers can meet the government's amorphous test of 'sufficient dominion and control' so as to be equated with [retained] ownership."<sup>17</sup> The decision of the Supreme Court in *Byrum* leaves this rule undisturbed.

Moreover, the Court buttressed its decision that retention of such powers would not require the inclusion of the value of the trust assets in the gross estate by observing that under Ohio law a majority shareholder and the directors have fiduciary obligations both to the minority interests and to the corporation itself.<sup>18</sup>

Such fiduciary obligations subjected Byrum's conduct and the director's conduct to an external ascertainable standard, and their actions were thus reviewable in a court of equity.<sup>19</sup> Thus, this situation is analogous to cases<sup>20</sup> in which there had been a direct retention of power limited by an ascertainable external standard, the existence of which was sufficient to exclude the assets from the settlor's gross estate. Apparently, the fact that Byrum's retained powers could *indirectly* rather than directly affect trust income, in addition to being circumscribed by an external standard, made it easier for the Court to exclude the stock from his estate.<sup>21</sup> Moreover, the Court noted, unreasonable accumulations of corporate earnings would be subject to the accumulated earnings tax,<sup>22</sup> which would serve as an additional deterrent to excessive earnings accumulations by the directors. A further circumscription of an arbitrary exercise of Byrum's influence over the corporate directors was to be found in the vicissitudes and exigencies commonly associated with corporate life at the small business level: bad years, product obsolescence, new competition,

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§ 2036(a)(2) in language unamended since that date, passed both houses of Congress in one day -- the last day of the session.

*Id.* at 2402 (dissenting opinion).

15. To support its observation, the Court cited *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929). The dissent pointed out that the rationale of *Northern Trust* was adopted by the Court in *May v. Heiner*, 281 U.S. 238 (1930), a decision, the affirmance of which, in three later cases, prompted Congress to pass the predecessor of § 2036(a) in one day.

16. 423 F.2d 601 (1st Cir. 1970).

17. *Id.* at 603.

18. *United States v. Byrum*, 92 S. Ct. 2382, 2391 nn.11-12 (1972).

19. *Estate of Budd*, 49 T.C. 468 (1968); *Estate of King*, 37 T.C. 973 (1962). *Cf.*, e.g., *State Street Trust Co. v. United States*, 263 F.2d 635 (1st Cir. 1959); *Jennings v. Smith*, 161 F.2d 73 (2d Cir. 1947).

20. *Estate of Budd*, 49 T.C. 468 (1968); *Estate of King*, 37 T.C. 973 (1962); *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); *DeLancey v. United States*, 264 F. Supp. 904 (W.D. Ark. 1967).

21. *See Byrum v. United States*, 311 F. Supp. 892 (S.D. Ohio 1970).

22. INT. REV. CODE OF 1954, §§ 531-37.

disastrous litigation, restrictive government regulation, etc.<sup>23</sup> The Court indicated that such factors, over which Byrum had little or no control, would certainly tend to limit the effect of any influence he might choose to exert over the directors with respect to dividend policy.<sup>24</sup>

In summary, the Court's position with respect to the Government's § 2036(a)(2) argument was as follows: the decedent did not have an unfettered *de facto* power to regulate the flow of dividends to the trust, such "power" being circumscribed by a two level fiduciary obligation, subject to the scrutiny of a court of equity: 1) The majority shareholder's obligation to the minority interests; and 2) the director's obligations to both the minority interests and the corporations. Byrum's ability to *affect*, but not *control* trust income was merely a "power" and not a "right," the former not legally enforceable, and thus qualitatively distinguishable from the settlor's power in *O'Malley*.<sup>25</sup>

The Government's secondary attack rested on § 2036(a)(1). The argument was that Byrum, by retaining effective control over the three corporations, could assure himself of a continued salaried position or positions as he chose, as well as other benefits. He had thus retained or reserved to himself for his lifetime the "enjoyment" of the property transferred into the trust.<sup>26</sup> The Court, conceding that Byrum had retained control, found the Government's argument to be "conceptually unsound" in addition to being *contra* to the weight of authority (although no cases were cited as representing the "weight of authority").<sup>27</sup> The majority discovered some mystical dichotomy between a transfer of the stock certificates and a transfer of control. Byrum had certainly irrevocably transferred the physical shares of stock, but had never transferred the control of the corporations:

The only property transferred was corporate stock. He did not transfer "control" (in the sense used by the Government) as the trust never owned as much as 50% of the stock of any corporation.<sup>28</sup>

The point is intricate: Byrum had not transferred to the trust more than 48% of the outstanding stock of any of the three companies, and thus, had not transferred "control" of any of the companies to the trust. Accordingly, the fact that Byrum had retained "control" was of little or no consequence, since it was not retained as an attribute of the property transferred. The Court went on to hold that even if Byrum had transferred a controlling interest to the trust, the same result would obtain.<sup>29</sup> The

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23. *United States v. Byrum*, 92 S. Ct. 2382, 2392 (1972).

24. *Id.*

25. *Id.* at 2394.

26. *Id.* at 2395.

27. *Id.* at 2396.

28. *Id.*

29. *Id.* at 2397.

fact that Byrum could retain his position as a salaried officer was not substantial "enjoyment" of the transferred property, since it was likely that an "active and productive" dominant shareholder in a closely-held corporation would retain such a position anyway. Furthermore, the decedent's "power" to cause the liquidation or merger of any of the companies (alleged by the Government to be a right which added to Byrum's "enjoyment" of the property) was merely a speculative benefit and not a retention of a "substantial present economic benefit," the presence of which would be required to cause the trust assets to be included in the gross estate.<sup>30</sup> The Court thus concluded that Byrum's retention of voting control was not a retention of the enjoyment of the property transferred.<sup>31</sup>

Mr. Justice White, joined by Justices Brennan and Blackmun in the dissent, pulled no punches in piercing gaping holes in the rationalizations advanced by the majority in support of its decision. Examining the *substance* of Byrum's arrangement, the dissent maintained that *O'Malley* should have controlled in the instant case, there being no basis for distinguishing between the power to allocate or accumulate income within a trust, and the power to achieve the same end through control of corporate dividend policy.<sup>32</sup>

After proceeding in a similar manner to refute the fine points of the majority opinion, Justice White attempted to illustrate the Government's § 2036(a)(2) contentions ("the right to designate" through control of the flow of income into the trust) by noting that during Byrum's lifetime, the trust had only received \$339 in dividends from the \$89,000 worth of stock which he had transferred to it.<sup>33</sup> The major point was that the year following Byrum's death, on the same shares of stock, the trust received \$1,498 in dividends,<sup>34</sup> thus suggesting that Byrum had actually controlled the corporate dividend policies during his lifetime and had accordingly retained "the right to designate" within the meaning of § 2036(a)(2).

In making this point, however, the dissent did not compare the corporate earnings records of the lean dividend years with such records for the post-death period. Such a comparison would have been useful, for without it the above-mentioned dividend figures tend to be meaningless.

Summing up, Mr. Justice White stated that the majority had erred in "every substantial respect."<sup>35</sup> As he viewed the law, § 2036(a) required an absolute and total *inter vivos* surrender of one's interest in transferred

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30. See *Commissioner v. Estate of Holmes*, 326 U.S. 480 (1946); *Estate of McNichol v. Commissioner*, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959).

31. *United States v. Byrum*, 92 S. Ct. 2382, 2397-98 (1972).

32. *Id.* at 2400.

33. *Id.* at 2398.

34. *Id.*

35. *Id.* at 2406.

property if inclusion in the gross estate is to be avoided, and Byrum simply had not achieved this requirement.<sup>36</sup>

While the realization of the full import of this decision must await subsequent actions, some observations may be made at this time. The Majority, in its opinion, did not consider Revenue Ruling 67-54.<sup>37</sup> That ruling holds that the value of *non-voting* stock transferred in trust is includable in the settlor's gross estate under § 2036(a) if the settlor retains control of the voting stock of the corporation, either in the capacity of a trustee or by restrictions upon the trustee with respect to the disposition of such non-voting stock during the term of the trust. Since this ruling has been consistently distinguished,<sup>38</sup> disregarded,<sup>39</sup> and rejected<sup>40</sup> by the courts, it may well have been laid to rest by this decision, albeit indirectly. While the Court did not dwell on the fact that a substantial proportion of the minority interests in each of the three corporations were held by unrelated persons,<sup>41</sup> at least one authority believes the case should be limited to its facts, primarily because of the unrelated shareholder minority.<sup>42</sup> Other authorities feel that the decision will have a broader effect<sup>43</sup> and will severely limit the use of § 2036(a) as a "taxing tool" in similar cases.<sup>44</sup>

In either case, if the Government is unable to use § 2036(a) to cause inclusion of the value of the transferred shares, it may employ an approach analogous to that used in *United States v. Parker*:<sup>45</sup> the allocation of a proportionately greater value to the unrestricted shares retained by the settlor-decedent, and, accordingly, a proportionate devaluation of the shares held in trust because of the restrictions placed on them. Thus, the issue of whether such shares will or will not be included in the gross estate may well become moot.

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36. *Id.* at 2398.

37. 1967-1 CUM. BULL. 269.

38. *Yeazel v. Coyle*, 21 Am. Fed. Tax R.2d 1681, 68-1 U.S. Tax Cas. ¶ 12,524 (N.D. Ill. 1968).

39. *Estate of Harry H. Beckwith*, 55 T.C. 242 (1970), *acquiesced*, in 1971 INT. REV. BULL. No. 9, at 6.

40. *Byrum v. United States*, 440 F.2d 949 (6th Cir. 1971).

41. The actual figures were:

<i>Corporation</i>	<i>Number of Minority Shareholders</i>	<i>Number of Shareholders Unrelated</i>
Byrum Lithographing Co., Inc.	11	11
Graphic Realty, Inc.	14	11
Bychrome Co.	8	5

42. 47 Miami Review and Daily Record No. 34, § A at 1 (July 28, 1972).

43. Newman and Kalter, *Transfers of Corporate Securities by Person in Control of Corporate Policy*, 111 TRUSTS & ESTATES 118 (Feb. 1972).

44. Comment, 37 J. TAX 138 (Sept. 1972).

45. 376 F.2d 402 (5th Cir. 1967). The Court, in *Parker*, reasoned that the value of unrestricted shares is increased by restrictions placed on other shares (of the same class) with respect to their disposition for purposes of the "more than 80% in value" requirement of § 1239 of the Internal Revenue Code of 1954. *See also* Note, 35 J. TAX 110, 111 (Aug. 1971).