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TAXABLE ENJOYMENTS UNDER THE CHURCH AND SPIEGEL DECISIONS

Since 1916 the Federal estate tax has included in the gross estate of a decedent gifts which he made during his lifetime "intended to take effect in possession or enjoyment at or after his death."[1] This phraseology, borrowed from State statutes[2] where it had enjoyed a quiet existence, has become a battleground of incredible carnage both financial and intellectual.[3] After thirty-three years of controversy over the meaning of these thirteen words, now found in Section 811(c) of the Code, the Supreme Court has undertaken to clear away the smoke in two recent decisions. In *Commissioner v. Church*[4] the Court held that a decedent who had created a trust in 1924, reserving to himself the income for life, was taxable on the value of the trust corpus at his death in 1939. The Court squarely overruled *May v. Heiner,* decided in 1930, which held that the same statutory words did not tax trusts with reserved life estates.[5] The fall of *May v. Heiner* did not come as a surprise,[6] but whether the uprooting of this landmark was necessary is another question. Inasmuch as the reserved life estate has been expressly taxable by statute since 1931, the immediate effect of the decision affects only trusts created in the period from 1916 to 1931.

[1] Revenue Act of 1916, Sec. 202(b), 39 Stat. 777; Revenue Act of 1918, Sec. 402(c), 40 Stat. 1097; Revenue Act of 1921, Sec. 402(c), 42 Stat. 278; Revenue Act of 1924, Sec. 302(c), 43 Stat. 304; Revenue Act of 1926, Sec. 302(c), 44 Stat. 70, amended by Joint Resolution of March 3, 1931, 46 Stat. 1516; Revenue Act of 1932, Sec. 803(a), 47 Stat. 278; Int. Rev. Code, Sec. 811(c).

[2] "Origin Of The Phrase, Intended To Take Effect In Possession Or Enjoyment At Or After. . . . Death (Section 811(c), Int. Rev. Code)," 56 Yale L. J. 176(1946).

[3] The decision of May v. Heiner, 281 U.S. 238 (1930) holding the reserved life estate not taxable threatened a loss to the Treasury in excess of one-third of the revenue derived from the federal estate tax, with anticipated refunds in excess of $25,000,000. 74 Cong. Rec. 7198, 7199 (1931). In Spiegel v. Commissioner (U.S. Supreme Court, No. 3, January 17, 1949) the settlor's reversion had a value of $70 at the time of death. The decision included in his gross estate trust assets valued at $1,140,000 involving approximate taxes of $450,000. On the intellectual side see Eisenstein, "The Hallock Problem," 58 Harv. L. Rev. 1141 (1945); Alexander, "Possibilities of Reacquisition and the Federal Estate Tax," 1 Tax L. Rev. 291 (1946); Eisenstein, "Another Glance at the Hallock Problem," 1 Tax L. Rev. 430 (1946).

[4] U.S. Supreme Court, No. 5, January 17, 1949.

[5] *Supra,* note 3.

[6] The Tax Court had premonitions of disaster for the May v. Heiner doctrine in 1941, Estate of Mary H. Hughes, 44 B.T.A. 1196 (1941), but regained confidence in Estate of Edward E. Bradley, 1 T.C. 518 (1943), aff'd Helvering v. Proctor, 140 F.2d 87 (C.C.A. 2d, 1944). As a matter of state law interpretation of the same thirteen words, it was said: ". . . a situation which is universally held to involve a transfer intended, etc., under state inheritance tax statutes . . . is the case in which the grantor creates a remainder on a life estate limited to himself, or transfers property in trust to pay the income to himself for life with remainders over." Rottschaefer, "Transfers Taking Effect At Grantor's Death," 26 Iowa L. Rev. 514, 516 (1941).

Presumably *Nichols v. Coolidge*[7] is still law, and reserved life estate trusts created before 1916 are within the protection of the due process clause.

In its second decision, *Spiegel v. Commissioner*,[8] the Court resolved nine years of lower court confusion over the meaning and application of the doctrine in the *Hallock* case,[9] holding that the estate tax applies to any inter vivos trust transfer where the settlor has a possible reversionary interest, express or by operation of law, however remote and regardless of his intention to reserve the interest.[10] On the facts of the *Spiegel* case two dissenting Justices had serious doubts that the trust limitations to the taxpayer's children created contingent rather than vested remainders under Illinois law,[11] and Mr. Justice Frankfurter

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[7] 274 U.S. 531 (1927).

[8] *Supra*, note 3.

[9] 309 U.S. 106 (1940). The doctrine of the Hallock case may be explained in this way: in May v. Heiner, *supra*, note 3, the Court held the reserved life estate trust not taxable because there had been a complete inter vivos disposition of the legal title, that is, the interests of the remaindermen were all definitely fixed by the trust grant as a matter of title. In Klein v. United States, 283 U.S. 231 (1931) the decedent had made an inter vivos conveyance of a common law life estate to his wife, expressly reserving to himself the reversion, and limiting a remainder interest to his wife only if she survived him. The Court held the gift includible in the gross estate because there was an incomplete disposition of legal title, but also indicating as a ground for its decision the factual contingency in the disposition regardless of the niceties of the art of conveyancing. In Helvering v. St. Louis Trust Co., 296 U.S. 39 (1935) the Court seized on the legal title theory to the exclusion of the broader aspects of the Klein case, holding the decedent not taxable on an inter vivos trust grant which gave the remaindermen a vested remainder subject to being divested if the grantor survived the life tenant. The Court reasoned that legal title was fixed and completely disposed of in the trust and in no way affected by the grantor's death. His possibility of reverter merely became an impossibility. The Hallock case was essentially a reconsideration and overruling of the St. Louis Trust case. The Court held the express reverter taxable regardless of whether the remainder interests were vested subject to being divested or contingent, returning to the broad interpretation of the Klein decision. The Hallock doctrine precipitated the fall of May v. Heiner.

[10] The problems of the lower courts in applying the Hallock doctrine are discussed and summarized in Paul, Federal Estate and Gift Taxation, 1946 Supplement, Sec. 7.23. At one time or another the following limitations on the Hallock doctrine were raised: (1) that the possibility of reverter must not be too remote; (2) that the reverter must be express and not one arising by operation of law; (3) that the settlor must have intended to reserve the interest. All of these limitations have been swept aside by the Spiegel case. See Corbett, 12 T.C. (No. 22) (1949).

[11] The remainder limitations in the Spiegel case were as follows: "Upon my death, the said Trustees, and the survivor of them, or any successor Trustee, shall divide said trust fund and any accumulated income thereon then in the hands of said Trustees, equally among my said three (3) children, and if any of my said children shall have died, leaving any child or children surviving, then the child or children of such deceased child of mine shall receive the share of said trust fund to which its or their parent would have been entitled, and if any of my said three (3) children shall have died without leaving any child or children him or her surviving, then the share to which such deceased child of mine would have been entitled shall go to my remaining children, and the descendants of any deceased child of mine per stirpes and not per capita." The Circuit Court of Appeals held that these interests did

objected that an estate tax liability should hang on such a "gossamer thread", and a doubtful one at that. Thus, the unwitty diversities of common law conveyancing have been unleashed on the taxpayer, leaving him to the perils of State law interpretations of future interests.[12] Lawyers have been advised to consider the "awfulness" of this decision in its effect on trust dispositions, and one reputable tax authority suggests an ultimate limitation to the United States government in all trusts.[13] The *Spiegel* doctrine does not justify taxing the decedent, however, merely because he would take from the remaindermen by inheritance.[14]

Beyond the present impact of these decisions lies the question of their ultimate effect on Section 811(c) and related problems. If the Court means what it said in the *Church* case, the way is logically open for an integration of the income, gift and estate taxes along the lines of retained economic enjoyment that has flourished in the income tax field. The mandate of the *Church* decision is that the taxpayer rid himself of "all title, and all possession and all enjoyment." The scope of taxable enjoyments is apparently beyond the Commissioner's fondest expectations, starting with the "unbreakable cable" of the reserved life estate in the *Church* case and extending to the "gossamer thread" of a lurking reverter in the *Spiegel* case. The inscrutable Clifford regulations have never gone so far in their definition of taxable enjoyments for income tax purposes.[15] It would also seem that the gift tax must yield,

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not vest upon the execution of the trust, and were therefore contingent upon survival. 159 F.2d 257, 259. Mr. Justice Burton felt that the remainders were vested, and since Illinois law requires literal compliance with the divesting conditions before a vested remainder can be divested, the settlor had no possible interest. Presumably the interest of the last to survive would not divest upon his death because the conditions for divestment would not be present.

[12] The Spiegel decision makes it clear that state law controls. This introduces an undesirable factor into the administration of a federal tax law, to wit, the history of alimony trusts. See, "Federal Taxation of Alimony Trusts," 25 Ill. L. Rev. 332 (1940).

[13] Paul, *supra,* note 10, p. 194: "In view of the Commissioner's claim that a remainder to charity is inadequate to exclude the Hallock doctrine, the only certain escape from tax is to assign any contingent reversionary interest to the United States. It is safe to assume that Government counsel would not argue that the grantor or his estate could regain the property because the Government might collapse or disappear."

[14] It is safe to assume that the views of Mr. Justice Roberts in Goldstone v. United States, 325 U.S. 687 (1945) would prevail in this regard. Otherwise, any gift within the family is taxable at death on the theory that the donee might predecease the donor and the property pass back to the donor by intestacy. See Estate of Mabel H. Houghton, 2 T.C. 871, app. dism. C.C.A. 2, 1944.

[15] The Clifford regulations, promulgated by the Commissioner under the decision in Helvering v. Clifford, 309 U.S. 331 (1940) and found in Reg. 111, Sec. 29.22(a)-21,-22, cover taxable enjoyments for income tax purposes under I.R.C. Sec. 22(a). Three broad classifications are made: (1) reversionary interests, (2) enjoyments affecting disposition, and (3) enjoyments affecting trust administration.

abandon its property law concepts of completed transfers and join the economic approach of retained benefits. Pushed to its logical conclusion, the time is ripe for a thorough-going definition of what can and what cannot be safely retained by the taxpayer in an inter vivos gift. Once defined, the taxpayer who has failed to part with taxable enjoyments has not made a completed transfer and stands liable for income and estate taxes; more fortunate donors would pay only a gift tax.[16] The present confusion of the substantial adverse interest test and of powers outstanding in third parties could also be cleared away in the integration.

All of this has a Utopian ring, however. There are fundamental differences between an income tax and a transfer tax; there is a wealth of case and statutory development that cannot be lightly cast aside; and furthermore, it is not clear that the Supreme Court means exactly what it said. It can be safely assumed that the legal title, or property, interpretation of Section 811(c) has been abandoned in favor of an enjoyment theory. But the traditional teaching that Section 811(c) is designed to tax "testamentary gifts" has not necessarily left us.[17] After all, the thirteen words are found in juxtaposition with the statutory language taxing gifts in contemplation of death. A testamentary gift, often referred to as a substitute for a will, has a necessary relation to the disposition of property, and it may well be that the enjoyments of which the Court speaks in the *Church* case are such enjoyments as affect in fact the disposition of the gift property. This explanation would resolve the problem why a taxpayer under the *Spiegel* case is liable for estate taxes on a remote possibility of reverter by operation of law whereas the Clifford regulations would not levy an income tax for such an enjoyment.[18] The fact is that the reverter enjoyment affects the disposition of the gift property and for that reason warrants an estate tax under the theory of a testamentary gift. A similar application to the income tax problem seems unreasonable, although

[16] See Warren, "Correlation of Gift and Estate Taxes," 55 Harv. L. Rev. 1, 43 (1941).

[17] "It also taxes *inter vivos* transfers that are too much akin to testamentary dispositions not to be subjected to the same excise." Mr. Justice Frankfurter in the Hallock case, *supra*, note 9, p. 112; the section is designed to "prevent tax evasion by subjecting to the death tax, forms of gifts *inter vivos* which may be resorted to, as a substitute for a will, in making dispositions of property operative at death." Mr. Justice Stone in the St. Louis Trust case, *supra*, note 9, p. 46.

[18] The Clifford regulations, *supra*, note 15, tax the income of a trust to the grantor where he has a reversionary interest which will or may be reasonably expected to take effect in possession or enjoyment within 10 years, or within 10 to 15 years with certain other enjoyments added. The Regulations provide that the trust income is not attributable to the grantor where the reversionary interest is to take effect in possession or enjoyment at the death of the person or persons to whom the income is payable. Reg. 111, Sec. 22(a)-21(c)(2).

not to the gift tax problem on an economic approach. This suggestion may also explain why the Court failed to mention the *Clifford* case in its opinions, leading Mr. Justice Burton to conclude that the case had been left to its native soil, the income tax.[19] Also, the *Northern Trust* case,[20] where the Court first rejected the argument that an estate tax could be based on reserved powers over trust administration, still stands in contradiction to the income tax developments.[21] If the *Church* case is limited, therefore, to retained enjoyments affecting the disposition of the transferred property, its sweep may not be unrestricted.

An objection may be raised that under the facts of the *Church* case the reserved life estate in no way affected the ultimate disposition of the property. This is to ignore the fact that the grantor's life was the measuring stick, operating much like a power of termination in the acceleration of remainder interests under the *Holmes* case.[22] The reserved life estate is an enjoyment which by its nature affects the "when" of the enjoyment. It is not believed, however, that the mere fact that remainder interests vest at the grantor's death is sufficient to sustain the tax without the retained enjoyment. The *Northern Trust* decision should remain the law on this point, not because the effect on the remainder interests is not parallel but because the *Church* case calls for a retained enjoyment of some kind.[23]

The effect of the *Church* and *Spiegel* pronouncements on the Commissioner's Hallock regulations[24] should be interesting. The regulations have required the presence of two elements in the transfer: (1) possession or enjoyment of the transferred interest can be obtained

[19] Dissenting opinion of Mr. Justice Burton in Spiegel case, discussion of second proposal.

[20] Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). In this important case the Court considered, among other problems, the inclusion in the decedent's gross estate of the corpus of five trusts where he had reserved to himself the power to supervise the reinvestment of trust funds, to require the trustee to execute proxies to his nominee, to vote any share of stock held by the trustee, to control all leases executed by the trustee and to appoint successor trustees. In rejecting these enjoyments as a ground for taxability, the Court said: "Nor did the reserved powers of management of the trusts save to decedent any control over the economic benefits or enjoyment of the property . . . The shifting of the economic interest in the trust property which was the subject of the tax was thus complete as soon as the trust was made." p. 346. Even if the Court at this time was primarily concerned with the settlement of legal title, it is still sound on the theory that these enjoyments impose no factual contingency in the disposition, which is essential to a testamentary gift.

[21] Under the Clifford regulations, *supra,* note 15, an administrative control exercisable primarily for the benefit of the grantor, such as powers to vote the stock, or control investments, etc., will support the income tax. Reg. 111, Sec. 22(a)-21(e)(4).

[22] Commissioner v. Estate of Harry Holmes, 326 U.S. 480 (1946).

[23] Also, how can a living settlor shed the estate tax liability by giving away the reserved life estate if the remainder interests will vest according to the original trust grant? The problem is discussed in Rottschaefer, "Transfers Taking Effect at Grantor's Death," 26 Iowa L. Rev. 514, 526.

[24] Reg. 105, Sec. 81.17.

only by beneficiaries who must survive the decedent, and (2) the decedent or his estate must possess some right or interest in the property (whether arising by the express terms of the instrument of transfer or otherwise). Inasmuch as the Commissioner himself has not been scrupulous in the observance of the first requirement[25] its elimination as an essential test should not come as a shock. Although on the facts of both the *Church* and *Spiegel* cases the remaindermen had to survive the grantor to enjoy,[26] the Court's approach does not give this factor significance in the latter decision and in the former it merely serves to make the retained enjoyment testamentary in effect. The second requirement, without the qualification that the right or interest must inject a factual contingency into the disposition, seems incomplete unless the retained enjoyment is sufficient in itself. It is suggested that the regulations might be modified to provide one test, namely, whether the retained enjoyment or possibility of enjoyment affects in fact the disposition of the enjoyment. This would account for the distinction between the income tax field where the test is whether the benefit justifies the burden of the tax,[27] and the estate tax field where the test has been the testamentary effect of the transfer. There is the likelihood, however, that the entire emphasis in the income-gift-estate problem may be shifted to a question of ownership for tax purposes and what constitutes the transfer of that ownership.

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[25] See Eisenstein, "The Hallock Problem," 58 Harv. L. Rev. 1141, 1146, (1945). In a trust grant to B for life, C for life, remainder to C's surviving issue, the Commissioner has insisted on taxability because of the reversionary interest in spite of the fact that C's issue do not have to survive the grantor to take. See Frances Biddle Trust, 3 T.C. 832, app. dism. C.C.A. 3, 1945.

[26] The Church case was a reserved life estate; the Spiegel case was income to children for the life of the grantor and then remainders.

[27] The due process limitation which underlies the income tax developments was expressed by Mr. Justice Cardozo in Burnet v. Wells, 289 U.S. 670 (1933) at p. 678: "Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner and to tax him on that basis. A margin must be allowed for the play of legislative judgment. To overcome this statute the taxpayer must show that in attributing to him the ownership of the income of the trusts, or something fairly to be dealt with as equivalent to ownership, that the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit."

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