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Federal Estate and Gift Taxation of Reversionary Interests

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COMMENTS

FEDERAL ESTATE AND GIFT TAXATION OF REVERSIONARY INTERESTS

Section 811 of the Internal Revenue Code relating to federal estate taxes contains the following provision:

> "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property . . .
> (c) . . . To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise . . . intended to take effect in possession or enjoyment at or after death . . ."[1]

This clause has been a part of the federal estate tax law since its first enactment in 1916, but it lost much of its vitality as a source of federal estate tax revenue in 1930 when the United States Supreme Court held transfers retaining a life estate were not intended to fall within the provision.[2]

In 1940, however, the Supreme Court revitalized the provision when it decided *Helvering v. Hallock,*[3] the leading case on "possibility of reverter". In that case the decedent in 1919 created an inter vivos trust giving the trust income to his wife for life with the further provision that at her death the trust should terminate and the corpus revert to the decedent if he be still living, if not, to his daughters. It was held that the value of the corpus was includable in the decedent's gross estate under section 811 (c).[4] The possibility that the corpus might revert to the decedent in the event his wife predeceased him withheld the absolute vesting of the estate in remainder in his daughters until decedent's death, and this was held to be a transfer intended not to take effect absolutely in possession and enjoyment until at or after death as contemplated by the statute.

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[1] Sec. 811 (c), Internal Revenue Code of 1939, as amended; 26 U.S.C.A. 811 (c).

[2] May v. Heiner, 281 U. S. 238, 74 L. Ed. 826, 50 S. Ct. 286 (1930); Burnet v. Northern Trust Co., 283 U.S. 782, 75 L. Ed. 1412, 51 S. Ct. 343 (1931). Most of the state courts, however, had construed their respective inheritance tax acts containing similar provisions as including transfers retaining a life interest, and the United States Supreme Court sustained such constructions as not violating the Fourteenth Amendment of the Federal Constitution. Guaranty Trust Co. v. Blodgett, 287 U. S. 509, 77 L. Ed. 463, 53 S. Ct. 244 (1933); Matter of Brandreth, 169 N. Y. 437, 62 N. E. 563 (1902); Matter of Green, 153 N. Y. 223, 47 N. E. 292, (1897); In re Estate of Rising, 186 Minn. 56, 242 N. W. 459 (1932); 75 U. of Pa. L. Rev. 168 (1926); 38 Yale L. J. 657 (1929); 49 A. L. R. 874, 878 (1927); 67 A. L. R. 1247 (1930). In 1931 a Joint Resolution of Congress amended the estate tax law to include transfers wherein a life interest is retained. Fn. 1, Supra.

[3] Helvering v. Hallock, 309 U. S. 106, 84 L. Ed. 604, 60 S. Ct. 444 (1940).

[4] Sec. 811 (c) of the present I.R.C. was referred to in the opinion as Sec. 302 (c), its designation in the Revenue Act of 1926.

The Court, in 1931, had sustained a similar application of the statute in the *Klein* case[5] where the language of the instrument of transfer retained the remainder interest in the decedent, transferring it only upon the happening of the condition precedent that he predecease the life tenant. The problem resolved by the *Hallock* case arose when the *St. Louis Trust* cases[6] were decided in 1935. In those two cases the Court refused to allow the tax because the trust deeds effecting the transfer in question were so worded as to *presently* transfer the remainders, subject to being divested later if the person receiving the income should predecease the grantor, in which case the corpus would revert to the grantor. In the *Hallock* case, the Court recognized that in substance the difference between the instrument of transfer in the *Klein* case and the trust deeds in the *St. Louis Trust* cases amounted to "a mere difference in phrasing the circumstance by which identic interests in property were brought into being . . ."[7] The *St. Louis Trust* cases were overruled, and the rule established that if, in substance, a "possibility of reverter"[8] is retained, the transfer is one intended to take effect at or after death of the grantor, regardless of where the verbiage of the instrument places it under property law classifications.

The doctrine of the *Hallock* case was followed in three principle cases; viz, *Fidelity-Philadelphia Trust Company v. Rothensies, Commissioner v. Estate of Field,* and *Goldstone v. United States.*[9] In the *Rothensies* case the doctrine was applied to a retained possibility of a power of appointment. In the *Field* case it was applied to a transfer in trust, income to the grantor during the lives of two nieces, with reverter of the corpus to the grantor if he should survive the nieces. In the *Goldstone* case it was applied to a possibility of reverter of interest in insurance contracts.

In these cases a serious question was raised as to the scope of *Helvering v. Hallock* in that the Court used language which seems to sweep into the provision all possibilities of reverter existing at the time of death, no matter how remote, and regardless of whether or

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[5] Klein v. United States, 283 U. S. 231, 75 L. Ed. 996, 51 S. Ct. 398 (1931).

[6] Helvering v. St. Louis Union Trust Co., 296 U. S. 39, 80 L. Ed. 29, 56 S. Ct. 74 (1935); Becker v. St. Louis Trust Co., 296 U. S. 48, 80 L. Ed. 35, 56 S. Ct. 78 (1935).

[7] Helvering v. Hallock, Fn. 3, supra, 309 U. S. 106, pg. 114.

[8] The phrase "possibility of reverter" has frequently been used in writings on the *Hallock* doctrine, and is so used herein, as including all reversionary interests. Technically, a possibility of reverter is only that type of reversionary interest subject to a condition precedent. Restatement of the Law of property, Sec. 154 (1)e.

[9] Fidelity-Philadelphia Trust Co. v. Rothensies, 324 U. S. 108, 89 L. Ed. 782, 65 S. Ct. 508 (1945); Commissioner of Internal Revenue v. Estate of Field, 324 U. S. 113, 89 L. Ed. 786, 65 S. Ct. 511 (1945); Goldstone v. United States, 325 U. S. 687, 89 L. Ed. 1871, 65 S. Ct. 1323 (1945).

not the interest transferred could be obtained only by beneficiaries surviving the decedent.

In *Commissioner v. Estate of Field,* the Court said,

> "It makes no difference how vested may be the remainder interests in the corpus or *how remote or uncertain may be the decedent's reversionary interest.*[10] If the corpus does not shed the possibility of reversion until at or after the decedent's death, the value of the entire corpus on the date of death is taxable."[11]

While this was mere dictum as to the point in question in the case, the language raises a serious doubt as to just how far the doctrine of the *Hallock* case might be extended. It was unquestionably broad enough to include any transfer under which the decedent has a possibility of reaquisition, whether the grantor intended the grantee to *survive* him before acquiring full dominion of the property or not.

That the Court went just that far seems clear from a consideration of *Goldstone v. United States.* That case involved a transfer by a decedent to his wife of all the powers of ownership in two paid up insurance contracts, the decedent being the insured and his wife and daughters the primary and secondary beneficiaries, respectively. The contracts contained a provision that if the wife predeceased the decedent, all the aforementioned powers of ownership would return to the decedent; and if both wife and daughters predecease him, the proceeds would be payable to his estate. Upon this latter provision the application of the doctrine of the *Hallock* case was based. In commenting on the wife's complete power to destroy the decedent's reverter interest by assignment or surrender of the contracts, the Court said,

> "The indefeasability of that interest prior to death or the decedent's possession of other powers of ownership is *unnecessary and indecisive of estate tax liability.*"[12]

Justice Roberts saw the implications of such an extensive application of the *Hallock* doctrine to what he was convinced was a complete gift, when he said in his vigorous dissent,

> "I think it demonstrable that the transaction as respects the beneficiary, his wife, was no different in substance or effect than an outright gift of money or property to her. I cannot distinguish this case from one in which a husband, not in contemplation of death, conveys money or property, real or personal, in fee simple to his wife or to any other relative. For, in such case, all, or a portion of the property, may, upon death

[10] Italics the writer's.

[11] Commissioner of Internal Revenue v. Estate of Field, Fn. 9, supra, 324 U. S. 113, Pg. 116.

[12] Goldstone v. United States, Fn 9, supra, 325 U.S. 687, pg. 692. Italics the writer's.

of the donee, descend to the donor under the intestate laws, and both parties to the transaction know this to be the fact. Notwithstanding then that, under the law, the wife may, until her death, spend, convey, mortgage, or dispose of the property, I suppose it will be held that, inasmuch as all or some of it will descend to him if she omits so to do, he will be held, within the meaning of the statute, to have made a conveyance to take effect at his death because the only way he can avoid inheriting it from the donee is to die . . .

"The so-called 'string' which he retained upon the property need not have the quality of a tie that binds."[13]

The unsettled state of the law and confusion resulting from the broad language quoted above has now been dispelled by a clear cut amendatory regulation promulgated by the Treasury Department on May 1, 1946[14] which reads, in part, as follows:

"The value of such property interests [i.e. property transferred inter vivos, by trust or otherwise, subject to a possibility of reverter][15] is includible in his gross estate, if

(1) possession or enjoyment of the transferred interest can be obtained only by beneficiaries who must survive the decedent, and

(2) the decedent or his estate possesses any right or interest in the property (whether arising by the express terms of the instrument of transfer or otherwise)."

This regulation clearly places a limitation on how far the above noted decisions will be carried. The doctrine of the *Hallock* case may only be applied when the beneficiary is required to *survive* the decedent to obtain possession and enjoyment. Suvirvorship is the test and not merely that the possibility of reverter is not snuffed out until at or after death.

The regulation states eight hypothetical applications of the test, the eighth example indicating that the result of the *Goldstone* case would no longer obtain. The illustration is of a transfer in trust retaining a possibility of reverter in the settlor if the beneficiaries fail to survive him. It was further provided, however, that the settlor's wife would have the unrestricted power to alter, amend, or revoke the trust. In reference to the new regulation's provision requiring survivorship, it is stated that,

"the first requirement is not satisfied, since the wife can obtain possession or enjoyment of the property during the decedent's lifetime through the exercise of her power to alter,

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[13] Goldstone v. United States, Fn. 9, supra, 325 U. S. 687, pg. 694.

[14] Regulations 105, Section 81.17, as amended by Treasury Decision 5512, (May 1, 1946).

[15] Comment in brackets supplied by writer.

amend, or revoke. No part of the property is, therefore, includible in the decedent's gross estate."[16]

No distinction is perceived between these powers and those given the decedent's wife in the *Goldstone* case. It appears that the construction contended for by Justice Roberts' dissent would now be reached under the new regulation, except when the person possessing absolute power to cut off a transferor's possibility of reverter dies without exercising the power, and the remaining beneficiaries are required to survive the transferor to prevent a reversion, "survivorship" again being controlling.

While the new regulation settles the question as to survivorship, it leaves open the question of remoteness of the possibility of reverter. The problem may be made clearer by an illustration. Let us suppose that a transfer in trust is made by A at ninety years of age, income for life to B who is fifty years of age, remainedr to C, twenty-five years of age, if he survives A, if not, to D, two years of age, if he survives A, if not, trust to terminate and the corpus to revert to A if he be still living, or, if not living, to his heirs at law. The only way the trust corpus could revert to A under the above situation would be if A should survive B, C, and D, a highly improbable result. Yet, assuming that the transfer escapes taxation under the "contemplation of death" clause,[17] it would be taxable under the decisions and the regulations as they now stand.[18]

Legislative action may be taken to prevent the result illustrated above. H.R. 5358, now introduced in Congress,[19] would require the inclusion of a transferred property interest in the gross estate only if it might have reverted to the decedent "in the normal course of events."[20] Such a provision in the statute would raise other questions requiring further interpretation as to just where the line should be drawn, but it certainly would prevent taxability in the not too uncommon instance illustrated.

The problem of the gift tax in "possibility of reverter" cases remains for consideration. Many tax-payers will want to dispose of retained possibilities of reverter and the question arises — will such disposition subject them to a gift tax?

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[16] Fn. 14, supra, Example (8).

[17] Fn. 1, supra.

[18] "It makes no difference . . . how remote . . . may be the decedent's reversionary interest." Commissioner of Internal Revenue v. Estate of Field, Fn. 9, supra, 324 U. S. 113, pg. 116.

[19] Introduced Feb. 4, 1946 in the House of Representatives and referred to the Ways and Means Committee; Alexander Tax News Letter #31, February 9, 1946.

[20] Ibid.

Upon the strength of *Estate of Sanford v. Commissioner,*[21] which strongly intimated that estate taxes and gift taxes were mutually exclusive except in cases of gifts in contemplation of death, it was for a time generally believed that no gift tax was payable on the original transfer in cases where possibilities of reverter were retained. However the decisions in *Smith v. Shaughnessy*[22] and *Robinette v Helvering*[23] dispelled any such belief. In these two cases it was held that the gift taxes and estate taxes were *not* mutually exclusive in cases of possibility of reverter. The gift tax was payable on the original transfer, *but the value of the transferred property was to be diminished by the value of the retained interest* because the gift was complete *except* for the retained possibility of reverter.[24]

It would seem to follow, therefore, that the gift tax will be payable on relinquishment of a possibility of reverter, it being an interest in property of value, and that the method of valuation will be the actuarial measure employed in these cases.

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[21] 308 U. S. 39, 84 L. Ed. 20, 60 S. Ct. 51 (1939).
[22] 318 U. S. 176, 87 L. Ed. 690, 63 S. Ct. 545 (1943).
[23] 318 U. S. 184, 87 L. Ed. 700, 63 S. Ct. 540 (1943).
[24] "We conclude that under the present statute, Congress has provided as it's plan for integrating the estate and gift taxes this system of secured payments on gifts which will later be subject to the estate tax." Smith v. Shaughnessy, 318 U. S. 176, pg. 179.