Michigan Law Review

Volume 38 | Issue 6

1940

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Recommended Citation
Robert M. Warren, *TAXATION - INCOME TAX - LIABILITY OF SETTLORS OF IRREVOCABLE SHORT TERM TRUSTS*, 38 MICH. L. REV. 885 (1940).
Available at: https://repository.law.umich.edu/mlr/vol38/iss6/8

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TAXATION — INCOME TAX — LIABILITY OF SETTLORS OF IRREVOCABLE SHORT TERM TRUSTS — In a recent significant decision[1] the Supreme Court of the United States has declared that, under certain circumstances, income from irrevocable short-term trusts may be taxed to the settlor. This conclusion is contrary to the previously accepted notion that there was no authority for such a tax under existing provisions of the Revenue Act. In the light of this and other recent decisions the matter of taxation of income from short-term trusts assumes renewed significance.

1.

As a general rule, trusts have been treated as separate entities for income tax purposes. In the ordinary case, the income from property held in trust is taxable to the trustee or to the beneficiaries rather than to the settlor.[2] This fact forms the basis for the employment of the trust device as a means of escaping high surtaxes. The special utility of this device is that it allows the settlor to retain varying degrees of control over the trust property and its income, perhaps even enjoy its economic benefit, although he has ostensibly parted with title and ownership. It is easily understood why the history of the taxation of trust income has been described as an unending struggle between taxpayers and the government.[3] Taxpayers and their counsel are continually seeking devices which, while permitting escape from surtaxes, will yet allow the settlor maximum control over the trust property. The treasury department, on the other hand, in seeking to close all avenues of escape, believes it proper to tax settlors who retain control over and receive the benefits from trust property. In certain cases, the treasury's strategy has been to disregard the trust as a separate entity for tax purposes. This nullifies the tax avoidance purpose by making the trust income taxable to the settlor, contrary to the usual rule.

2.

Prior to 1924, an important means of retaining control was the reservation by the settlor of a power to revoke the trust. So frequently

[1] Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504, 60 S. Ct. 554.

[2] Trust income is ordinarily taxable to the trustee, unless it is distributed currently to the beneficiaries, in which case it is payable by them. Revenue Act of 1938, 52 Stat. L. 519, § 162 (b), (c). Similar provisions were embodied in the previous revenue acts, see 26 U. S. C. A. (Supp. 1939), § 162, note, and in the Revenue Act of 1939, 53 Stat. L. 66.

[3] Clapp v. Heiner, (C. C. A. 3d, 1931) 51 F. (2d) 224. See also, Maxeiner, "Reservation of Control by the Settlor of a Private Trust as Affected by Federal Tax Legislation," 21 ST. LOUIS L. REV. 275 (1936); Paul, "The Background of the Revenue Act of 1937," 5 UNIV. CHI. L. REV. 41 (1937); Warren, "The Reduction of Income Taxes Through the Use of Trusts," 34 MICH. L. REV. 809 (1936); Buck, "Income Tax Evasion and Avoidance: The Deflection of Income," 23 VA. L. REV. 107 (1936), 265 (1937); and Sutter and Owen, "Federal Taxation of Settlors of Trusts," 33 MICH. L. REV. 1169 (1935).

was this method resorted to that it became clear that unless this means of escape were closed the surtax would lose much of its effectiveness.[4] An attempt to close the door was made by a provision in the Revenue Act of 1924,[5] which has been repeated in subsequent acts, taxing the settlor on income from trusts over which he reserved a power to revest title in himself. However, the wording of the original provision left an obvious loophole,[6] and not until amendment in 1934[7] was the gap effectively closed. As presently worded, section 166 goes far towards placing the incidence of the tax on settlors whose control consists of a power to revoke.

But a high degree of dominion can be exercised on the part of settlors without reserving a power of revocation. This is so where the settlor is himself the trustee, or where the settlor has reserved the power to direct the management and investment of the trust. And, if the period for which the trust is created is short, the settlor will soon reacquire the trust property.

3.

The treasury has for some time sought to tax the settlor on income from irrevocable short-term trusts. It has contended that section 166 provided sufficient authority for such a tax, because there is "no practical difference between a revocable trust and one certain to be terminated soon."[8] That the language of section 166 does not expressly

[4] "If income-producing estates could be parceled out among donees having incomes, in such a way that the donor paid no tax, although he retained full powers of control and recapture, the surtax would be deprived of efficacy. . . ." Judge Mack in Corliss v. Bowers, (D. C. N. Y. 1929) 30 F. (2d) 135 at 136.

[5] 43 Stat. L. 277, § 219 (g) (1924), reenacted in Revenue Act of 1926, 44 Stat. L. 34, § 219 (g), and Revenue Act of 1928, 45 Stat. L. 840, § 166. A similar provision was contained in the Revenue Act of 1932, 47 Stat. L. 221. This provision was amended in 1934 and since then has been reenacted without change. Revenue Act of 1934, 48 Stat. L. 729; Revenue Act of 1936, 49 Stat. L. 1707; Revenue Act of 1938, 52 Stat. L. 519; Revenue Act of 1939, 53 Stat. L. 68.

[6] Prior to 1934 the tax was imposed upon the grantor where he had power to revest title in himself "at any time during the taxable year." Statutes cited in note 5, supra. This opened the door to avoidance of the tax by the so-called "year-and-a-day" trusts. Thus where the power of revocation was conditioned upon notice given a year and a day precedent to revocation, it was held that the requisite power did not exist "at any time during the taxable year." Lewis v. White, (D. C. Mass. 1932) 56 F. (2d) 390; Langley v. Commissioner, (C. C. A. 2d, 1932) 61 F. (2d) 796.

[7] The words "during the taxable year" were eliminated by the Revenue Act of 1934. Since then (statutes cited note 5, supra), sec. 166 provides: "Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor."

[8] Helvering v. Wood, (U. S. 1940) 84 L. Ed. 511 at 512, 60 S. Ct. 551.

refer to reversions was conceded, but a practical construction of the language was sought. In *Helvering v. Wood*,[9] the commissioner argued "that it would not be sensible to impute to Congress a purpose to impose the tax when the grantor has an executory power to revest title in himself but to withhold the tax when the grantor, by provisions in the trust deed, has already exercised that power."[10] Furthermore, the existing income tax regulations under section 166 provide that a grantor will be taxable on trust income whenever he may be regarded as "in substance the owner of the corpus"; and he may be so regarded where "in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitely with the substantial incidents of ownership in the corpus."[11] The following example is given:

> "A grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John, (A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment. . . ."[12]

Helvering v. Wood involved a trust in which the grantor declared himself trustee of securities for the benefit of his wife. As trustee, he was empowered to hold, invest, or reinvest the securities and to collect the income. On termination, which was to be in three years, or earlier in case of the death of either the settlor or his wife, all property then held in trust was to go to the settlor. No power of revocation was reserved. The commissioner claimed that section 166 would support taxing the income to the settlor. But the Supreme Court affirmed the decisions of the board of tax appeals[13] and the Circuit Court of Appeals of the Second Circuit[14] holding that the settlor could not be taxed under section 166. In the opinion of the Supreme Court it was recognized that a reversion and a power to revoke may be equivalent in "economic fact," but it was concluded that Congress intended to preserve the distinction between reversions and powers to revoke which exists in the law of estates.[15] Section 166 was confined to a special class of trusts—

[9] (U. S. 1940) 84 L. Ed. 511, 60 S. Ct. 551.

[10] Ibid., 84 L. Ed. 511 at 512-513.

[11] TREAS. REGS. 101, art. 166-1 (b) (1939).

[12] Ibid.

[13] Wood v. Commissioner, 37 B. T. A. 1065 (1938).

[14] Commissioner v. Wood, (C. C. A. 2d, 1939) 104 F. (2d) 1013.

[15] The court cited 1 TIFFANY, REAL PROPERTY, 2d ed., 1049 (1920). See also, United States v. First Nat. Bank of Birmingham, (C. C. A. 5th, 1934) 74 F. (2d) 360.

those in which a power to revest was expressly reserved.[16] Thus, in construing the scope of a specific provision taxing a particular type of trust, no reason was found for an interpretation based on "a broader purpose than that expressed."[17] Regard was had for technical considerations, and the Court looked to the law of trusts and conveyances to determine the meaning of the language used by Congress.

4.

Since the possibility of taxing settlors on income from irrevocable short-term trusts under section 166 was thus foreclosed, the question remained whether any other statutory provision would provide authority for such a tax. In *Helvering v. Clifford*,[18] the settlor set up a five-year trust of securities for the benefit of his wife in which the settlor was trustee. The powers retained by the settlor-trustee were substantially the same as those in *Helvering v. Wood*. As in the *Wood* case, no power of revocation was reserved. The board of tax appeals[19] sustained the commissioner's finding that the income was taxable to the settlor, but this decision was reversed by the Circuit Court of Appeals of the Eighth Circuit.[20] On certiorari, the Supreme Court[21] reversed the circuit court of appeals and upheld the tax under section 22(a) of the Revenue Act of 1934.[22] The Court concluded that section 22(a) provided sufficient authority to tax the grantor on some short-term trusts, thus making more specific authority unnecessary. The "broad and sweeping" language of that section indicated to the Court that Congress there intended "to use the full measure of its taxing power within those definable categories."[23] In order to reach a construction

[16] Helvering v. Wood, (U. S. 1940) 84 L. Ed. 511 at 513. See Warren, "The Reduction of Income Taxes Through the Use of Trusts," 34 MICH. L. REV. 809 at 817-820 (1936), for discussion of the inapplicability of section 166 to term trusts.

[17] Helvering v. Wood, (U. S. 1940) 84 L. Ed. 511 at 513.

[18] (U. S. 1940) 84 L. Ed. 504.

[19] Clifford v. Commissioner, 38 B. T. A. 1532 (1938).

[20] Clifford v. Helvering, (C. C. A. 8th, 1939) 105 F. (2d) 586.

[21] The opinion was written by Justice Douglas. Justice Roberts, with whom concurred Justice McReynolds, delivered a dissenting opinion.

[22] Sec. 22(a) of the Revenue Act of 1934, 48 Stat. L. 686, includes among "gross income" all "gains, profits, and income derived . . . from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." The same provision was reenacted in 49 Stat. L. 1657 (1936), 52 Stat. L. 457 (1938), 53 Stat. L. 9 (1939). In its argument before the Supreme Court in Helvering v. Wood, the government contended that sec. 22(a) would be likewise applicable to the trust set up in that case. This contention was denied, because the commissioner had failed to preserve this ground in his appeal. Helvering v. Wood, (U. S. 1940) 84 L. Ed. 511 at 513-514.

[23] Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 506.

in consonance with that purpose, the Court brushed aside technical considerations so as not to obscure the basic issue.[24] That issue was whether the grantor could still be treated as the owner of the corpus, in spite of the existence of the trust. According to the Court, the trust device will be ignored and the settlor will be treated as owner for the purposes of section 22(a), whenever the terms of the trust and circumstances surrounding its operation show that the creation of the trust did not effect any substantial change in the dominion and control of the settlor. No one fact is decisive, but the following are deemed relevant to support a finding that the settlor is to be treated as owner for tax purposes: a trust of short duration[25] for the benefit of the settlor's wife or close relative,[26] in which the right of ultimate enjoyment is reserved to the settlor, and in which the settlor is trustee with broad powers of investment and reinvestment.[27]

In exposing family trusts to scrutiny, the court does not intend to confine itself to an examination of "strictly legal rights." To determine the extent of the settlor's control, account must be taken of the indirect benefits accruing to the settlor by reason of the "intimacy of the familial relationship."[28] If the settlor, by reason of these indirect benefits and the practical control which the head of the household may exercise, remains in substantially the same financial position after the trust as before, he will be taxed as owner.[29] The Court thus recognizes that practical control and indirect benefits may, at times, mean as much as legal title.

[24] Ibid., 84 L. Ed. 504 at 506.

[25] The problem is one of degree: "the income of a long term irrevocable trust which committed the possession and control of the corpus to an independent trustee *would not likely* be taxed to the settlor merely because of a reversionary interest." From a portion of the commissioner's brief quoted in Justice Roberts' dissenting opinion, Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 510, italics supplied by Justice Roberts. See DuPont v. Commissioner, 289 U. S. 685 at 688-689, 53 S. Ct. 766 (1933), where Justice Cardozo discusses the element of short duration as bearing on the settlor's control.

[26] "To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements." Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 507.

[27] Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 506.

[28] Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 507. The Court continued, "where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as it stays in the family group."

[29] Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 507. The Court cited DuPont v. Commissioner, 289 U. S. 685 at 689, 53 S. Ct. 766 (1933), where it is said: "One who retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as owner altogether."

The *Clifford* decision will doubtless come as a surprise to those who believed that specific legislation was necessary before irrevocable short-term trusts could be taxed to the settlor. Such a belief was fortified by the treasury's unsuccessful attempt to achieve specific legislation on this matter.[80] According to the dissenting opinion, what the treasury failed to achieve by application to Congress, it gained by this decision. But in the view of the majority, no additional authority beyond what is now in section 22(a) is needed to tax some short-term trusts to the settlor.[81]

5.

Helvering v. Clifford can be looked upon as an extension of the doctrine of prior decisions whereby the trust entity has been disregarded for tax purposes when the settlor has retained such general powers of control that the trust property may be used for his own benefit.[82] Irrespective of whether the trust was revocable or irrevocable, the income therefrom has been taxed to the settlor where he has retained the "substance of enjoyment."[83] By the doctrine of constructive receipt, it has been declared that a settlor may be taxed when he enjoys the benefit of the income through the liquidation of a legal obligation;[84] and it is believed that this doctrine will support taxing the settlor even though the obligation is not legally enforceable.[85] These conclusions are said to be justified on the basis of congressional intent.

[80] Among the recommendations for legislation made by the treasury to the House Ways and Means Committee when that committee was considering the Revenue Act of 1934 was the following: "(6) The income from short-term trusts and trusts which are revocable by the creator at the expiration of a short period after notice by him should be made taxable to the creator of the trust." Congress adopted the recommendation as to revocable trusts (sec. 166), but did not accept the recommendation concerning short-term trusts. HEARINGS ON H. R. 7835, 73d Cong., 2d sess., p. 151 (1934); H. REP. 1385, 73d Cong., 2d sess., p. 24 (1934). "It appears that the Treasury Department not only considered legislation as necessary to tax the income of a trust for a term of years, but it likewise appears that Congress refused to adopt the suggestion." Clifford v. Helvering, (C. C. A. 8th, 1939) 105 F. (2d) 586 at 591-592.

[81] "We should add that liability under § 22(a) is not foreclosed by reason of the fact that Congress made specific provision in § 166 for revocable trusts, but failed to adopt the Treasury recommendation in 1934 . . . that similar specific treatment should be accorded income from short term trusts. Such choice, while relevant to the scope of § 166 . . . cannot be said to have subtracted from § 22(a) what was already there. Rather, on this evidence it must be assumed that the choice was between a generalized treatment under § 22(a) or specific treatment under a separate provision (such as was accorded revocable trusts under § 166 . . .); not between taxing or not taxing grantors of short term trusts." Helvering v. Clifford, (U. S. 1940) 84 L. Ed. 504 at 507-508.

[82] Wollman v. Commissioner, 31 B. T. A. 37 (1934); Rands v. Commissioner, 34 B. T. A. 1107 (1936); O'Laughlin v. Commissioner, 38 B. T. A. 1120 (1938).

[83] Burnet v. Wells, 289 U. S. 670 at 677, 53 S. Ct. 761 (1933).

[84] Old Colony Trust Co. v. Commissioner, 279 U. S. 716, 49 S. Ct. 499 (1929); United States v. Boston & Maine R. R., 279 U. S. 732, 49 S. Ct. 505 (1929).

[85] Douglas v. Willcuts, 296 U. S. 1, 56 S. Ct. 59 (1935) (trust for the payment of alimony); Helvering v. Schweitzer, 296 U. S. 551, 56 S. Ct. 304 (1935), per

6.

The construction given section 22(a) in *Helvering v. Clifford* emphasized substance rather than form, practical considerations rather than refinements of title.[86] In this decision, the Court deemed the purpose and policy of Congress to be the guideposts of construction. Attention is called to four recent decisions of the Supreme Court in which similar construction has been given tax statutes.[87] In the past, technical construction and judicial exclusion have left loopholes which threatened to undermine the effectiveness of the acts. To close these gaps required legislative action, and the estate and income tax statutes were subjected to constant piecemeal amendment in order to meet each new tax avoidance plan. Many of these amendments could have been avoided had the courts construed the statutes in the light of the purpose of Congress and the apparent intention to prevent tax avoidance.

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curiam opinion reversing Schweitzer v. Commissioner, (C. C. A. 7th, 1935) 75 F. (2d) 702 (trust for the support of the settlor's children).

[86] See Burnet v. Wells, 289 U. S. 670 at 681-682, 53 S. Ct. 761 (1933). Also, Maxeiner, "Reservation of Control by the Settlor of a Private Trust as Affected by Federal Tax Legislation," 21 ST. LOUIS L. REV. 275 at 292-293 (1936).

[87] "But 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." Justice Holmes in Corliss v. Bowers, 281 U. S. 376 at 378, 50 S. Ct. 336 (1930). See Justice Frankfurter's remarks upon the conflict between practical considerations and the "niceties of the art of conveyancing" in Helvering v. Hallock, (U. S. 1940) 60 S. Ct. 444 at 448. It is there said that the Supreme Court has "refused to subordinate the plain purposes of a modern fiscal measure to the wholly unrelated origins of the recondite learning of ancient property law."

[88] In Pearson v. McGraw, 308 U. S. 313, 60 S. Ct. 211 (1939), the state of Oregon was held to have jurisdiction over the subject of a gift consummated in contemplation of death by a sequence of interrelated transactions in Illinois which the Court looked upon as an integrated plan to achieve a single purpose. The Court stated, "to hold that there is a constitutional barrier . . . would be to make a fetish of form." 60 S. Ct. at 213.

Griffiths v. Helvering, (U. S. 1939) 60 S. Ct. 277, involved taxation of the proceeds of a sale of stock which were routed through a corporation created by the petitioner for this purpose. In upholding taxation of the petitioner the Court characterized the scheme as the "maintenance of effective benefit through the interposition of a subservient agency." 60 S. Ct. at 278.

In Higgins v. Smith, (U. S. 1940) 60 S. Ct. 355 at 357, the Court denied deductions by a taxpayer for losses on sale of securities to his wholly owned corporation: "transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration."

Helvering v. Hallock, (U. S. 1940) 60 S. Ct. 444 at 451, upheld the inclusion in gross estate, under sec. 302(c) of the estate tax, of a transfer in which the decedent had reserved a contingent remainder: "Distinctions which originated under a feudal economy . . . are peculiarly irrelevant in the application of tax measures. . . ." This case is noted in 53 HARV. L. REV. 884 (1940).