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WHEN REVOCABLE TRUSTS ARE SUBJECT TO AN INHERITANCE TAX

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A settlor transferred property to trustees upon trust to pay the income to himself during life and after his death to his children and, ultimately, to divide the principal. The settlor reserved a power to revoke the trust and also to change its terms. Subsequently a law was passed taxing successions, i.e., all transfers by will or *inter vivos*, "made or intended to take effect in possession or enjoyment after the death of the grantor or donor."

Held, that the trust estate was subject to the tax at the death of the settlor.[1]

Trusts created by will are subject to an inheritance tax upon the death of the settlor because the trustee succeeds to the property by virtue of the will.[2] Trusts created by a transfer *inter vivos* or by declaration, if complete and valid, are not subject to an inheritance tax upon the death of the settlor[3] unless made in contemplation of death under the usual type of inheritance tax statute making transfers *inter vivos* made in contemplation of death and without consideration subject to the tax upon the death of the donor. The settlor, however, may fail to create a valid trust during his life. Just what constitutes a valid trust is a large and intricate problem involving a large portion of the law of trusts and is beyond the scope of this inquiry. To suggest a few of the elements which, if lacking, will cause the trust to fail, it may be said that the trust may fail because the purpose of the trust and the duties of the trustee are not made clear, or there are no definite or determinable beneficiaries, or the settlor has not clearly indicated an intention to create a trust, or

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[1]Saltonstall v. Treasurer and Receiver General (Mass. 1926) 153 N. E. 4.

[2]Gleason and Otis on Inheritance Taxation, 4th ed. p. 324.

[3]This is the general rule. People v. Kelley, 218 Ill., 509, 75 N. E. 1038; In re Taxation of Masebury Estate, 159 N. Y. 532, 53 N. E. 1127. Spangler's Estate, 281 Penn. St. 118, 126 Atl. 252; Dexter v. Treasurer and Receiver General, 243 Mass. 523, 137 N. E. 877.

where it is intended to make a third party a trustee there has been no valid transfer or gift to the trustee. If there is no valid trust created during the life of the settlor, still he may complete it and supply the missing elements in his will. In this case, the trust is said to be testamentary. If the will which supplies the missing elements complies with the statute of wills and is valid, the trust is then created and valid, but it would then be subject to the inheritance tax. If the statute of wills were not complied with, then there would be no valid trust and the property would pass by intestate succession and would, of course, be subject to the tax.

What is the effect of the settlor's reserving powers to himself upon the validity of the trust? There are three kinds of powers which may thus be reserved: 1. A power to revoke the trust. 2. A power to change the beneficiaries and the purpose of the trust. 3. A power to direct the management and investment of the corpus and to direct the payment of a part or all of it to himself.

If the trust is otherwise valid and created *in praesenti,* the only possibility of its being held testamentary on account of the powers reserved is in cases where they indicate an intention on the part of the settlor that the transferee shall be merely his agent in dealing with the property and that because there was no intention to create a trust the trust fails.[4]

The fact that the settlor reserves to himself the right to revoke the trust does not make the disposition testamentary or the trust invalid.[5]

The power to change beneficiaries would not seem contrary to an intention to create a trust. The complete power of control indicated in the third type of power to direct the investment and payment of the corpus, however, indicates an intention to establish the

[4]McEvoy v. Boston Five Cents Savings Bank, 201 Mass. 50, 87 N. E. 465. Note the analogy in the principle which determines the distinction between a Massachusetts trust and a corporation. When the certificate holders have the power to meet, elect trustees, determine policies or otherwise exercise control over the trustees, the relation is one of agency and the organization is a corporation and not a valid trust. Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N. E. 355.

[5]Stone v. Hackett, 12 Gray (Mass.) 227; Kelley v. Snow, 185 Mass. 228. 70 N. E. 89; SCOTT'S CASES ON TRUSTS, 215n.

relationship of principal and agent and not an intention to create a trust and will defeat the trust.[6] By these principles then the trust in the principal case was not testamentary and was valid.

The courts have had some difficulty in dealing with this problem, either because they have not recognized it as purely a trust problem or because, recognizing it as such, they have been content to rely solely upon tax cases as precedents. The result is that they have frequently gone astray. A line of cases in New York is worth noting. The first of the cases was *Matter of Bostwick*.[7] In that case very complete powers were reserved to the settlor, i.e., to direct the payment of the income to himself or anyone else during his life, to withdraw the securities constituting the trust fund and to substitute others, to alter and amend the trust, and to terminate the same. The court held that these reservations indicated an intention of the donor to keep such a control of the property that no gift was effected during his life. The court then used these words, "an intention on his part that the beneficial enjoyment of the property * * * was not to take effect until after his death." These words and the fact that the tax was imposed upon the beneficiaries lead to a belief that the court held the trust to be valid upon the death of the settlor: but that question was not raised, since there was no other claimant for this property.

In *Matter of Dana Co.*,[8] the solution of the problem before the court would have been easy had it held the trust invalid, but it professed to be following the *Bostwick* case and said, "There was no element of finality about the instrument during the donor's lifetime, for it was just as capable of revocation as a will would have been. Under these circumstances it was a transfer of a testamentary nature, and must be regarded as speaking from the time when it became effective by reason of the death of the party who executed it." Finally, in *Matter of Schmidlapp*,[8] in which the grantor reserved the right to control and direct all investments and reinvestments, to

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[6]McEvoy v. Boston Five Cents Savings Bk., *supra;* Matter of Schmidlapp, 236 N. Y. 278, 140 N. E. 697. Matter of Dana Co., 215 N. Y. 461, 109 N. E. 557.

[7]160 N. Y. 489, 55 N. E. 208.

[8]*Supra.*

modify, alter, or revoke in whole or in part, the court held that the trust was not valid and had no effect *until the death of the settlor.* The case was distinguished from the *Masebury* case[9] on the ground, that the settlor was to receive the income for life in addition to having a power to revoke. This, however, should make no difference, as we shall see in the next paragraph.

The two later cases, instead of holding the trusts invalid as they should have, held that they became valid upon the death of the settlor and were subject to the tax. The death of the settlor could in no way make the trust valid unless by will he changed the relationship from one of agency to one of trust, which was not done in these two cases. This is a common error and many of these cases are cited as authority for the proposition that when a settlor reserves income to himself for life the trust is subject to a tax at his death.

In considering our first problem, i.e., the validity of the trust, it becomes necessary to consider the effect of another factor which intrudes itself and causes no end of confusion. This factor is the reservation of income to the donor during his lifetime. Courts have thought that this subjected the beneficiaries to a tax upon the death of the donor and have given five reasons for assessing the tax:

(1) That no estate vested in the beneficiary during the donor's life;[10] (2) That this would permit an evasion of the inheritance tax;[11] (3) That the reservation of income indicated an intention on the part of the donor to make a gift *causa mortis;* (4) That this was conclusive evidence that the transfer was made in contemplation of death;[12] and (5) That the tax was assessed upon the coming into possession or enjoyment of the property by the remainderman and not upon the property vesting in him.[13]

These reasons must be considered.

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[9]In re Taxation of Masebury's Estate, *supra.*

[10]In re Schermerhorn's Estate, 149 N. Y. Supp. 95.

[11]Appeal of Seibert, 110 Penn. St. 329, 1 Atl. 346.

[12]In re Hoyt's Estate, 149 N. Y. Supp. 91.

[13]Douglas Co. v. Kountze, 84 Neb. 506, 121 N. W. 593; Lamb v. Morrow, 140 Iowa, 89, 117 N. W. 1118; Massachusetts and Pennsylvania cases are discussed *post.*

Only the first has to do with the validity of the trust. By accepted trust law, the fact that the settlor reserves the income to himself for life does not make the disposition testamentary or the trust invalid.[14] The trust being valid, the interests of the beneficiaries vest at once, even though their enjoyment is postponed.[15] Therefore, it cannot be said that the estate is subject to the tax because the interests of the beneficiaries did not vest until the death of the settlor.

Nor would such a provision be an evasion of the inheritance tax law. In the words of Justice Holmes in *Bullen v. State of Wisconsin,*[16] "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits." The statutes tax transfers by will and interstate law or *inter vivos,* when made in contemplation of death. The valid trust, which has been created long before death was felt to be imminent, is none of these. If the legislature wants the tax to be levied upon transfers *inter vivos* or trusts, let it so declare. For the court to do so is judicial legislation.

The third and fourth arguments may be considered together. A gift *causa mortis* is one which is made in contemplation of death, and which may be revoked, if the donor recovers. The important point to note here is that it is made in contemplation of death. But the fact that the income is reserved to the donor for life does not mean that the transfer was made in contemplation of death; for contemplation of death does not mean that the donor expects some time to die, but that death is so imminent that the donor feels he must act or it will be too late to effectuate his wishes. Of course, if the transfer were made in contemplation of death, the transfer would be subject to the tax, but this is not the usual case.

Finally, may the tax be assessed upon the remaindermen beneficiaries, upon their coming into possession and enjoyment of the

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[14]Lewis v. Curnutt, 130 Iowa 423, 106 N. W. 914; Scrivens v. North Easton Savings Bank, 166 Mass. 255, 44 N. E. 251. See also Stone v. Hackett, Kelley v. Snow, SCOTT'S CASES ON TRUSTS, *supra.*

[15]1 Perry on Trusts, 6th ed. p. 116 n.

[16]240 U. S. 625, 630.

property, even though their property interests vested at the time the trust was created?[17] The rule, in the majority of the states, is that the right of the state to assess the tax arises at the moment that the interests of the beneficiaries vest in them.[18] As a matter of convenience in administering the tax, the state may postpone assessing it until the beneficiaries come into the actual possession of the property or beneficially receive the income;[19] but, if the interests of the beneficiaries vested prior to the passage of the taxing act, no tax may be imposed without violating the constitution.[20] For a long time the rule in Massachusetts was that, even though the interests of the beneficiaries vested prior to the passage of the taxing statute, yet, they are subject to the tax upon coming into the actual possession of the property or the beneficial enjoyment of the income and this was not contrary to the state constitution.[21] Since there is this conflict of authority, it becomes necessary to consider the problem on principle. The reasons for the majority view are sound and are best set forth in *Matter of Seaman*.[22] The tax is not upon the property, but upon the right of succession which passes to the successor. The beneficiarv of the trust succeeds to the property when the trust is created and his interest vests. If that vesting is prior to the passage of the tax statute, the act of succeeding to the property is complete. A tax upon the beneficiary when he came into actual possession of the property would not be a tax upon the succession, but a tax upon the property which had vested prior to the act. Such a tax would be unconstitutional. A further argument in favor of the majority rule is that, in cases where no trust is involved, a remainderman is not taxed upon coming into actual possession and enjoyment where his interest vested

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[17]Statutes in all the states are worded to tax transfers by will, or intestate succession, or by deed, grant or gift, except those for full consideration, "made or intended to take effect in possession or enjoyment after the death of the grantor or donor." See General Laws of Mass., C 85, par. 1.

[18]Matter of Seaman, 147 N. Y. 69, 41 N. E. 401; People v. Kelley, *supra;* Spangler's Estate, *supra.*

[19]GLEASON AND OTIS' INHERITANCE TAXATION, 4th ed. p. 508.

[20]Matter of Lansing, 182 N. Y. 238, 74 N. E. 882; Spangler's Estate, *supra.*

[21]Crocker v. Shaw, 174 Mass. 266, 54 N. E. 549; see discussion of Massachusetts cases, *post.*

[22]*Supra.*

prior to the taxing statute.[23] There are a great many cases which contain dicta to the effect that the vested remainder may be taxed upon the beneficiary coming into actual possession or enjoyment. Most of these cases are, however, cases where there was no valid transfer to the trustee, or where the trust was testamentary, or where the trust was created in contemplation of death. Thus, the early decisions in Pennsylvania contain dicta that the trust was subject to a tax upon the beneficiary's coming into actual possession of the property, or enjoyment of the income. *Reish v. Pennsylvania*[24] was a case where the donor conveyed, while suffering from his last sickness. The transfer was therefore made in contemplation of death. In *Appeal of Seibert*[25] the trustees were to receive the income to their own use during the life of the donor, and upon his death to apply the property to the uses and purposes designated in his will already executed and on deposit with a bank.. The court spoke of this as an attempt to evade the tax, and said that the transfer of property did not take effect in enjoyment until the death of the donor. But the reason that it did not take effect in enjoyment must have been that the trust, depending for its completion as to purpose and beneficiaries upon the will, did not come into existence until the death of the donor. In *Du Bois Appeal*,[26] the trust was testamentary, since the trustee was obliged to pay out of the corpus of the trust any liabilities, either *ex contractu*, or *ex delicto*, incurred by the donor. In *Line's Estate*,[27] the donor reserved the income for life and a power to change the beneficiaries. The court, in an incoherent opinion, said that while the legal title was in the trustee, it was the merest shadow, and the property must be regarded as in the donor until his death. The property does not actually pass, nor is it intended to pass, to the collateral beneficiaries until his death. All this simply shows that the court did not understand its trust law and not that, had the interests of the beneficiaries vested, they would

[23]Matter of Pell, 171 N. Y. 48, 63 N. E. 789; Matter of Chapman, 196 N. Y. 561, 90 N. E. 1157; Dexter v. Treasurer and Receiver General, *supra;* GLEASON AND OTIS' ON INHERITANCE TAXATION, 4th ed. p. 507.

[24]106 Penn. St. 521.

[25]*Supra.*

[26]121 Penn. St. 368, 15 Atl. 641.

[27]155 Penn. St. 378, 26 Atl. 728.

be subject to a tax upon coming into possession or enjoyment. Finally a case arose[28] in which the court was confronted with the constitutional problem of a valid trust created prior to the enactment of the inheritance tax law. It overruled the dicta of the preceding cases and squarely held that, where there was a bona fide and unconditional transfer by deed or gift, which had been fully consummated by conveyance of the title and absolute and exclusive possession of the property taken by the transferee, the transfer was not subject to a tax. The court discussed *Line's Estate,* said that the reservation of power to change the beneficiaries did not make the transfer taxable at any time, but thought that the reservation of income to the donor there was what made the transfer subject to a tax, apparently holding the erroneous view that such a reservation prevented a transfer until the donor's death.

An examination of the Massachusetts decisions shows that the doctrine, that a vested remainderman is subject to a tax upon coming into actual possession of the property or enjoyment of the income, was based upon a misapprehension of the New York cases, and has since been overruled. The doctrine first arose in *Crocker v. Shaw,*[29] where the settlor reserved income for life and power to appoint the beneficiaries to whom the corpus should be paid upon her death. The trust was created prior to the passage of the inheritance tax act. The court held it subject to the tax, upon the ground that the transfer did not take effect in possession or enjoyment until the death of the settlor. The court professed to be following *In re Seaman*[30] and *In re Green,*[31] but misapplied the New York cases. The principle announced in those cases was that the beneficiary came into possession and enjoyment when his interest vested.

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[28]Spangler's Estate, *supra.*
[29]*Supra.*
[30]*Supra.*
[31]153 N. Y. 223, 47 N. E. 292.

The next three cases[32] applied the doctrine announced in *Crocker v. Shaw.* In *Minot v. Treasurer and Receiver General*[33] there was a power reserved in the settlor to appoint by will the persons to receive the corpus upon her death. The trust was held subject to a tax on the erroneous ground that the power prevented the interests of the beneficiaries vesting, and also on the ground that the power was automatically exercised by death, subjecting the trust to a tax as the property of the donee of the power. In *Attorney General v. Stone*[34] the court said, "The New York decisions relied on by defendant have not commanded assent in this court." *Burnham v. Treasurer and Receiver General*[35] was the same on its facts as *Minot v. Treasurer and Receiver General.* The court said that no estate vested in the beneficiaries, and also affirmed the doctrine we are here discussing.[36] *Dexter v. Treasurer and Receiver General*[37] overruled these cases and established the New York rule in Massachusetts. The case was one of a trust to pay the income to the children of the settlor and, upon the settlor's death, to divide the corpus among the members of a designated class then living. The right to change the beneficiaries was reserved. The court said that the transfer was not one intended to take effect in possession or enjoyment at the death of the donor because the property vested at the time of the delivery of the deed. "They were from that date in possession and enjoyment of the property and such possession and enjoyment were not in any way contingent on the donor's death." *Crocker v. Shaw, New England Trust Co.,* and *State Street Trust Co. v. Treasurer and Receiver General*[38] were distinguished on the ground that there the vesting was deferred until the death of the grantor. The court

[32]Stevens v. Bradford, 185 Mass. 439, 70 N. E. 425; New England Trust Co. v. Abbott, 205 Mass. 279, 91 N. E. 379; State Street Trust Co. v. Treas. & Rec'r General, 209 Mass. 373, 95 N. E. 851; See also Gardiner v. Treasurer and Receiver General, 225 Mass. 355, 114 N. E. 617, where the power of appointment ground was alone relied upon.

[33]207 Mass. 588, 93 N. E. 973.

[34]209 Mass. 186, 95 N. E. 395.

[35]212 Mass. 165, 98 N. E. 603.

[36]Milton v. Treasurer & Receiver General, 229 Mass. 140, 118 N. E. 274, also affirmed the doctrine.

[37]*Supra.*

[38]*Supra.*

cited *In re Taxation of Masebury's Estate, Matter of Bostwick*[39] and *People v. Northern Trust Co.*[40]

Applying this to the principal case, we see that the reservation of income to the settlor did not make the trust invalid, nor did it subject it to a tax as a transfer intended to take effect in possession or enjoyment upon the death of the donor or for any other reason. The court thought that the trust was subject to the tax as a transfer intended to take effect in possession or enjoyment upon the death of the settlor, citing *Crocker v. Shaw*[41] and the early cases[42] and not mentioning, perhaps because not called to its attention, *Dexter v. Treasurer and Receiver General.*[43] The court also cited *Pratt v. Dean,*[44] a case which came after the *Dexter* case, but *Pratt v. Dean* affirmed the rule announced in the *Dexter* case, saying that it did not apply because no interest vested in the beneficiaries until the death of the settlor, the court, it is submitted, again erring in its trust law.

In pursuing our inquiry as to when a valid trust with reserved powers to revoke or change the beneficiaries is nevertheless subject to an inheritance tax, it next becomes necessary to consider the proposition of the court that these powers are powers of appointment. The application of the law of powers to this class of cases is of long standing in Massachusetts, but seems not to have been applied in the taxation of trusts in other states. The first case[45] and succeeding cases[46] were trusts to pay the income during the settlor's life or some other life, and upon his death to divide the corpus as he should by will appoint. These cases are somewhat easier than the principal case, where the trust deed contains a power to revoke and to change beneficiaries. The usual form of common law power of appointment was the creation of an estate in A for life with a power to appoint by will the person who should take the remainder

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[39]*Supra.*

[40]289 Ill. 475, 124 N. E. 662.

[41]*Supra.*

[42]Minot v. Treasurer & Rec'r General, *supra;* Burnham v. Treasurer & Receiver General, *supra.*

[43]*Supra.*

[44]246 Mass. 300, 140 N. E. 924.

[45]Minot v. Treas. & Rec'r General, *supra.*

[46]Gardner v. Treas. and Rec'r General, 225 Mass. 355, 114 N. E. 617; Minot v. Paine, 230 Mass. 514, 120 N. E. 167.

with, perhaps, the designation of those who should take in case the power were not exercised. Such a case was *Minot v. Paine* except that the estates were equitable. In the other two cases the trusts were created *inter vivos* instead of by will and in one of them[47] the life estate in the income was in the donor. The powers reserved in both cases, however, were true powers of appointment for when exercised they divested the interests of those who would have taken but for its exercise and vested the interest in those appointed. An exercise of a power to revoke or to change beneficiaries would have the same effect. "A power is defined as a liberty or authority reserved by, or limited to, a person to dispose of real or personal property for his own benefit, or for the benefit of others, and operating on an estate or interest, vested either in himself or some other person; the liberty or authority, however, not being derived out of such estate or interest but overreaching or superseding it either wholly or partially."[48] A power has also been defined as an authority enabling one person to dispose of the interest which is vested in another.[49] Thus, there may be a power to appoint an interest in personal property, the interest may be equitable, and the power may be to appoint to the donor's own benefit. Thus, a power to revoke, or to change beneficiaries is included within the terms of the definition. Furthermore, powers in their origin were powers to appoint the uses of an estate, the legal title of which was vested in another, to new beneficiaries. The analogy to the trust is perfect. Thus Sugden says concerning the origin of powers, "The person who had the beneficial interest, or the cestui que use, as he was then termed, answered almost precisely to the cestui que trust of the present day. Sometimes, instead of declaring the trusts at the time of the feoffment the estate was conveyed to the feoffee upon such trusts as the feoffor or even a stranger should subsequently appoint; or if the uses were designated, yet a right was reserved to the feoffor or a stranger to revoke them either wholly or partially. Thus powers arose, for although it was repugnant to a feoffment at common law that a power should be reserved to revoke it, yet there was no such

[47]Minot v. Treasurer and Receiver General, *supra*.
[48]Maryland Mut. Benev. Soc. v. Clendinen, 44 Md. 429.
[49]Burleigh v. Clough, 52 N. H. 267; RULING CASE LAW, vol. 21, p. 772.

repugnancy as to trusts, which were simple declarations or directions to the person seized of the legal estate in what manner and to whom he should convey the estate. And for the same reason the owner might direct the trustee to convey as a stranger should appoint, * * * . A use which was raised by a simple declaration could be made to cease by a like declaration."[50]

Massachusetts, New York and a number of other states have statutes declaring that the tax should be imposed upon the exercise of the power in the same way as though the property belonged absolutely to the donee of the power.[51] These statutes, then, become applicable, and the trust becomes subject to a tax upon the exercise of the power of appointment by will or intestate law or in contemplation of death, because the effect of the statute was held to change the time of vesting for purposes of taxation to the time when the power was exercised.[52] Suppose, however, the power is not exercised? New York holds that, if the power is not exercised, the interest passes by the original will (or deed), and is not subject to a tax.[53] Massachusetts holds that the death of the donee of the power without exercising the power is an exercise of the power on the erroneous theory that it is only then that the interests vest.[54] In the principal case, therefore, although the power was not exercised, the trust was taxed as if it had been.

The final question to be considered is the constitutionality of the tax. We need not consider the cases where the trust is invalid, or testamentary, or made in contemplation of death, for the same principles would apply as apply to the deceased's other property. In fact, there is no problem of any considerable importance left because, if the trust is valid, and not made in contemplation of death, it is not subject to a tax except in the case where a power of appointment (including power to revoke, or to change beneficiaries) is exercised by will or in contemplation of death.

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[50]SUGDEN ON POWERS, 8th ed. p. 4.
[51]For typical statute see G. L. of Mass. 1921, c. 65, par. 2.
[52]GLEASON AND OTIS' INHERITANCE TAXATION 4th ed. pp. 348-352.
[53]Matter of Lansing, *supra*.
[54]Minot v. Treas. & Rec'r General, *supra*.

However, because of the early interpretation of the words "taking effect in possession or enjoyment" by Massachusetts and Pennsylvania, and because the question is one which is not yet settled in the federal courts, it is necessary to consider constitutionality in certain situations which are on the whole exceptional. The constitutional question arises in three fact situations: (1) Where the interests of the beneficiaries vested prior to the passage of the inheritance tax law; (2) Where the trust was created in another state from that in which decedent died; (3) Where a power of appointment, including the power to revoke or change beneficiaries, has been exercised.

Where the interests of the beneficiaries vested prior to the passage of the inheritance tax law the states have held, as we have seen, that the words, "transfers taking effect in possession and enjoyment upon the death of the donor," did not refer to those transfers which created vested interests before the death of the donor and which were not made in contemplation of death. They felt that they were forced into this interpretation because they thought that, if these vested interests were subjected to taxation, interests which vested prior to the passage of the taxing statute would also be subjected to taxation. This they held to be unconstitutional[55] because, while retroactive legislation is not necessarily unconstitutional, yet where it disturbs vested rights it amounts to a taking of property without due process of law. These decisions in Massachusetts and Pennslyvania, however, are recent, and when the earlier decisions reached the Supreme Court of the United States it was held that the levy of an inheritance tax by a state upon the coming into possession or enjoyment of an interest which had vested prior to the passage of the law was not unconstitutional.[56] The reason given by the court for this result was that the state could deny the privilege of succeeding to property altogether and therefore might annex any conditions it saw fit.[57] This is analogous to the argument that, since a state might exclude foreign corporations from doing business within its borders, it might

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[55]People v. Kelley, In re Taxation of Masebury's Estate, Spangler's Estate, Dexter v. Treasurer and Receiver General, *supra*.

[56]U. S. v. Perkins, 163 U. S. 625; Cohen v. Brewster, 203 U. S. 543.

[57]U. S. v. Perkins, *supra*. Cohen v. Brewster, *supra*.

impose any condition it saw fit upon their coming in, including a tax based upon their property situated elsewhere. But in 1910 in an important line of cases[58] the Supreme Court held that although a state might exclude a foreign corporation it could not impose unconstitutional conditions upon its coming in and that such a tax was contrary to due process of law. In view of these decisions this first argument is no longer tenable, and, if the question should now arise, the Supreme Court could not base its decision on this ground.

In view of the decisions of the state courts, this question will hardly be presented to the Supreme Court from the states. The question is, however, a very live one in connection with the federal estate tax. An early decision[59] apparently held that Congress had the power to enact a retroactive inheritance tax law which would tax interests vesting prior to the passage of the act. The interests of the beneficiaries were, however, held to be contingent and not vested. Furthermore, it is to be noted that the reason given in the state inheritance tax cases would not have been good in the case of a federal inheritance tax because the United States has no power over successions and could not control or prohibit succession to property.[60] The Supreme Court has yet to pass upon this problem but the district and circuit courts have wrestled with it. The problem has come up in connection with the Federal Estate Tax Acts of 1916 and 1918, in three district courts and two circuit courts. Four of these cases[61] have either held that the statute[62] should not be interpreted

[58]Western Union v. Kansas, 216 U. S. 1; Pullman Co. v. Kansas, 216 U. S. 56; Ludwig v. Western Union Tel. Co. 216 U. S. 146; Atchison, T & S. F. Ry. Co. v. O'Connor, 223 U. S. 280; Looney v. Crane Co. 245 U. S. 178; International Paper Co. v. Mass., 246 U. S. 135; Locomobile Co. of America v. Mass. 246 U. S. 146.

[59]Wright v. Blakeslee, 101 U. S., 174.

[60]See Knowlton v. Moore, 178 U. S. 41, 58.

[61]Curley v. Tait, 276 Fed. 840; Gerard Trust Co. v. McCoughn, 3 F. (2d) 618; Coolidge v. Nichols, 4 F. (2d) 112; Frew v. Bowers, 12 F. (2d) 625.

[62]The important section of the statute involved here is Sec. 402 "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, real or personal, tangible or intangible, wherever situated." "(c) To the extent of any interest therein of which the decedent has, at any time, made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to

so as to subject vested rights to a tax, or that the provision was unconstitutional. The other case[63] held the tax constitutional *because it did not interfere with vested rights* in that the tax being upon the estate fell upon the residuary legatees and not upon the vested interest of the beneficiaries of the trust created before the statute. Suppose there had been no residuary legatees. The ground upon which the cases holding the provision unconstitutional rested was that the inclusion of property, which had already vested and in no way depended upon the death of the transferor, in measuring the tax upon the transfer at death was not a reasonable classification, was arbitrary and unconstitutional in the same way that a property tax on A measured by including the property of B would be unconstitutional.[64] This argument depended upon the doubtful interpretation of the statute that the word "interest" used therein referred to the decedent's interest at the time of his death, and since he had no interest in property which had vested in others the tax was measured by the property of others. This is hardly tenable ground because it rests upon an interpretation contrary to the obvious intention of Congress and because almost any sort of classification has been upheld in excise tax cases. It is submitted that the due process ground used by the state courts is the one which must eventually prevail.

In view of the decisions in the state courts and the tendency of the decisions in the lower federal courts, it is to be expected and hoped that when the case arises in the Supreme Court of the United States any such interference with vested rights will be held unconstitutional.[64a]

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take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this act), except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title." Comp. St. Ann. Supp. 1919, par. 6336, 3/4 C.

[63]Schwab v. Doyle, 269 Fed. 321.

[64]Frew v. Bowers, *supra;* Coolidge v. Nichols, *supra.*

[64a]See 37 HARV. L. REV. 691.

A holding that it is unconstitutional to tax where these rights vested before the enactment of the statute does not, however, necessarily require an interpretation of the words "taking effect in possession or enjoyment" to mean vesting. A trust may be created vesting interests before and independently of the death of the settlor but subsequent to the adoption of the law. If it be said that the imposition of such a tax is not a tax on the transfer, therefore contrary to the theory of an excise tax and a tax upon property and therefore one which the federal government could not make without apportionment, and arbitrary because falling on only some and not all property of the same kind, it may be answered that the tax is on certain kinds of *transfers inter vivos,* i.e., transfers in trust where the beneficiaries come into actual enjoyment at the death of the settlor, and that the tax is merely postponed until the death of the settlor. So, an interpretation that where there has been a vesting independent of the death of the settlor but subsequent to the statute a tax may be collected is possible. If Congress wanted to tax transfers *inter vivos* there is no reason why they should not have taxed them all. This would be administratively simple and avoid all the legal difficulties arising from the phrase "taking effect in possession and enjoyment." If the legislators were laboring under the misapprehension that there was some sort of a transfer when the beneficiary came into actual possession or enjoyment upon the death of the settlor; if they had realized that they were taxing the transfer *inter vivos* to the trustee; it might be doubted that they would have singled out this kind of transfer *inter vivos* only as an act to be taxed. On the other hand, they might have felt that this kind of transfer *inter vivos* was one which was being used to escape the inheritance tax; and, if so, there would be sufficient reason for putting this kind of transfer *inter vivos* in a class by itself and subjecting it to a tax. It is perfectly possible, therefore, to interpret the act as taxing trust estates when the beneficiary comes into actual possession or enjoyment at the death of the settlor. The contrary holding in the state courts was not necessitated by the holding that where the interest had vested prior to the enactment of the statute the tax was unconstitutional.

Where the trust is created in a state other than that of the settlor's domicile at the time of his death, no new problem is raised in the majority of cases because the majority of the states, as we have seen, do not subject such a trust to the tax, even if created in the state of decedent's death. Where, in the United States, the trust is created, of course, has no significance in federal inheritance taxation. The situation only creates difficulties in state inheritance taxation where the old Massachusetts rule, that the beneficiary of the trust is subject to a tax when he comes into actual possession or enjoyment of his property, prevails. In such a case the state of the settlor's domicile at the time of his death could not impose the tax unless it had jurisdiction to tax. One would expect that the tax being upon the transfer a state would have no jurisdiction to tax when the transfer occurred beyond its borders. The rule, however, is that the state of decedent's domicile may not impose the tax upon transfers of real estate or tangible personal property situated beyond its borders.[65] Thus, where the transfer occurs makes no difference, for, even if it is made in the state of decedent's domicile, it would only have jurisdiction to tax transfers of real estate or personal property situated within its boundaries, or intangible personal property.

Where a power of appointment, including the power to revoke or change beneficiaries, has been exercised, there is a constitutional question. There are two phases of this problem, (a) where the power is exercised in the state where the property is situated, (b) where the power is exercised in some other state.

(a) At common law when a power of appointment was exercised it was in legal effect merely writing the names of the appointees into the blank left by the maker of the original will (or deed of trust).[66] The appointee was in by the will (or deed of trust) and the transfer took effect at the death of the testator. If that was prior to the enactment of the inheritance tax statute, it was held that the transfer could not be taxed.[67] New York, followed by Massachusetts

[65]Frick v. Pennsylvania, 268 U. S., 473.

[66]GLEASON AND OTIS ON INHERITANCE TAXATION, 4th ed. p. 346.

[67]Matter of Harbeck, 161 N. Y. 211, 55 N. E. 850; Emmons v. Shaw, 171 Mass. 410, 50 N. E. 1033.

and other states, then passed statutes declaring that the tax should be imposed upon the exercise of the power in the same way as though the property belonged absolutely to the donee of the power.[68] The effect of these statutes was held to be to change the time of vesting, for purposes of taxation, to the time when the power was exercised.[69] Does this not permit the legislature to get around the constitutional rule against disturbing vested interests by retroactive legislation by simply changing the time of vesting for the purposes of any statute which they wish to pass?[70] It would seem so. Yet, the real reason for the decisions is that where a power of appointment is exercised it cannot logically be said that the appointee had any vested interest prior to his appointment. Furthermore, the exercise of the power is regarded as the source of title for some purposes, for example, upon the exercise of the power by the donee the property is then subject to execution by the donee's creditors. The Supreme Court of the United States, when these cases came before it, therefore held that the statute did not violate the constitution because, the state court having declared that the vesting was upon the exercise of the power, the federal court could not say it was prior to that time, since at common law the instrument creating the power was for some purposes regarded as the source of title, while for other purposes the exercise of the power was regarded as the source.[71] By some of the statutes, the power is to be regarded as exercised if the donee of the power dies without exercising it.[72] This resulted from an interpretation by the Massachusetts courts as to when a power was exercised.[73] The rule in New York is that the power is not exercised in case of the donee's death without positive action on his part. Thus, in states like Massachusetts and North Carolina our trust with reserved powers would be subjected to a tax upon the death of the settlor. No case is known[74] where this has

[68]See G. L. of Mass. 1921, c. 65, par. 2, *supra.*

[69]GLEASON AND OTIS INHERITANCE TAXATION, 4th ed. p. 348.

[70]See dissenting opinion of Justice Holmes in Chanler v. Kelsey, 205 U. S. 466, 479.

[71]Chanler v. Kelsey, *supra.* Orr v. Gilman, 183 U. S. 278.

[72]Sec. 6, c. 34, Public Laws N. C., 1921, for example.

[73]GLEASON AND OTIS INHERITANCE TAXATION, 4th ed. p. 349.

[74]Bullen v. State of Wisconsin, 240 U. S. 625, may be explained on other grounds, see *post.*

been brought before the Supreme Court of the United States. Suppose, however, that our prnicipal case were carried there. It is submitted that such an interpretation or such a statute must be declared unconstitutional. How can it be said that a power is exercised when it is not? Whether there was provision for an individual or a class to take in case of failure to exercise the power, or not, the interests of those who would take under this proviso or who would be given the property by a court of equity distributing it to the heirs or next of kin, vested at the time the trust was created, and were only subject to being divested by the exercise of the power. In no sense were these interests vested by the death of the donee of the power who had not exercised it.

(b) When the power is exercised in some other state than that in which the property is situated a constitutional problem is likewise presented. The problem is to determine whether or not the state in which the power is exercised has jurisdiction to tax. No jurisdiction is given to it because the power is exercised by will. Its authority to administer decedents' estates only extends to real estate and tangible personal property situated within the state and to intangible personal property of a decedent domiciled there at the time of his death[75] even though the conflict of laws rule is that the state of administration will look to the law of the state of domicile to determine the succession to all personal property. In *Bullen v. State of Wisconsin,*[76] the Supreme Court permitted Wisconsin, the state of domicile of the settlor at the time of his death, to place an inheritance tax upon a trust containing powers of revocation although the trust was created in Illinois. The power of revocation and to change beneficiaries was not exercised. The court said, "the Supreme Court of Wisconsin was fully justified in treating Bullen's general power of disposition as equivalent to a fee." The only possible explanation of the case is that the powers reserved to the settlor were so complete, (power to direct and control the disposition of the corpus in whole or in part in any way that he saw fit, to revoke and to appoint the principal and income to beneficiaries) that no trust was created at all and therefore the property belonged to the decedent

[75]See 24 MICH. L. REV. 556, 561. Frick v. Penn., *supra.*
[76]*Supra.*

at the time of his death.[77] If we can accept the court's finding that there was a valid trust, then the decision is perfectly supportable, Wisconsin having jurisdiction to tax because the decedent was domiciled there and the corpus of the attempted trust was intangible property, stocks, bonds and notes. Of course, the property was not the settlor's at the time of his death; but the federal court was not concerned with this since it had been his and, since the trust had not been created prior to the enactment of the inheritance tax law, there was no disturbance of vested interests.

In *Wachovia Bank and Trust Co. v. Doughton*[78] a trust was created by the will of a Massachusetts decedent placing intangible property, stocks and bonds, in trust to pay the income to a daughter during her life and giving her a power to appoint the corpus by will upon her death. She exercised the power in North Carolina. The Supreme Court held that it was unconstitutional for North Carolina to tax the exercise of the power by will, believing that, according to its decision in *Frick v. Pennsylvania,*[79] North Carolina had no jurisdiction to tax. Justices Holmes, Brandeis, and Stone dissented, believing that the decision was contrary to *Bullen v. State of Wisconsin,*[80] since the property was intangible, the court may have felt that the owner was the trustee in Massachusetts and that therefore Massachusetts had jurisdiction to tax but not North Carolina.[81] It would seem, however, that if a state may constitutionally regard the time of vesting as the time when the power is exercised[82] then, the tax falling at the exact moment when the title was passing, the recipient or appointee might equally well be regarded as the owner of this property and, being domiciled in North Carolina, could be taxed there. In fact, it would be more logical to regard him as the owner because the theory of state inheritance taxation is that the

[77]McEvoy v. Boston Five Cents Bank, *supra.*

[78]Supreme Court of the U. S., No. 49, October Term, 1926.

[79]*Supra.*

[80]*Supra.*

[81]Union Transit Co. v. Ky. 199 U. S. 194, the principles of which were extended to the field of inheritance taxation by Frick v. Penn. 268 U. S. 473, did not prevent the taxation of commercial specialties at the domicile of the owner, Hawley v. Malden, 232 U. S. 1.

[82]Chanler v. Kelsey, Orr v. Gilman, *supra.*

tax is levied upon the act of receiving property[83] and because the appointee bears the burden of the tax. If this view is accepted, then the case is wrong in holding North Carolina did not have jurisdiction to tax unless the court either intended to hold that for purposes of jurisdiction the property must be regarded as vesting by the original will or deed and the time of vesting as relating back to the original instrument, or that only the state where commercial specialties are actually kept may tax them.

From what has been said, it will be readily seen that the problem of the revocable trust in inheritance taxation is a complicated one and that the decision in any case must be made step by step; first, determining whether or not there is a valid trust; secondly, whether or not, even if there is a trust, it is subject to the tax; and thirdly, whether or not such tax or taxing statute is constitutional, the latter involving a determination, first, of whether or not there was a vesting prior to the enactment of the statute and, secondly, whether or not the state had jurisdiction to tax.

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[83]Gleason and Otis on Inheritance Taxation, 4th ed. p. 256.