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TAXATION—FEDERAL ESTATE TAX—INFERENCE OF RETAINED LIFE INTEREST UNDER SECTION 2036 (A) — In 1936 decedent established an irrevocable trust naming herself and relatives as beneficiaries. The corporate trustees were directed to pay the trust income, in the exercise of their absolute discretion, either to the settlor or to the other beneficiaries. In filing her 1936 federal gift tax return settlor attempted unsuccessfully to

exclude the value of a life estate in the trust income, allegedly retained by her. At her death, the value of the trust corpus was not included in her estate tax return. The Commissioner assessed a deficiency[1] contending that decedent-settlor had retained for her life the "possession or enjoyment" of, or the "right to income from" the trust corpus within the meaning of the forerunner of section 2036 (a) of the Internal Revenue Code of 1954.[2] Plaintiff argued that since the trust was irrevocable and the trustees were vested with absolute discretion, settlor had retained nothing which could properly be included in her estate. In an action for refund of federal estate taxes, *held,* dismissed. Although a discretionary trust is ordinarily excluded from a decedent's gross estate, where the settlor had in fact received all the income for her life and acted in the belief that she had a life interest in such income, an informal prearrangement to exercise discretion in favor of the settlor will be inferred. As such, the trust corpus must be included in the deceased settlor's estate. *Estate of Skinner v. United States,* 197 F. Supp. 726 (E.D. Pa. 1961), *appeal taken by taxpayer to Third Circuit,* CCH FED. EST. & GIFT REP. 9007.

The decision in the principal case is illustrative of the broad scope of section 2036 (a), a provision requiring inclusion in one's estate of inter vivos transfers of property in which decedent had retained "the possession or enjoyment," or, in the alternative,[3] "the right to income." Such transfers, although inter vivos, are considered, for tax purposes, as being essentially akin to testamentary dispositions. Although the provision is described as dealing with the retention of a "life interest," it has been construed to encompass more than the life estate known to property law.[4] As such, the word "enjoyment," used in the setting of section 2036 (a), connotes "substantial present economic benefit,"[5] rather than the technical vesting of title. However, since no more explicit definition of the language "possession or enjoyment" has been formulated, its use in the application of section 2036 (a) has not yielded uniform results in connection with avoidance litigation.

This problem is illustrated by the history of the section preceding the decision in the principal case. Generally it has been held that where one

1 A credit was allowed for the amount paid as a gift tax in 1936.

2 INT. REV. CODE OF 1954, § 2036 (a) (1), successor of Int. Rev. Code of 1939, § 811 (c) (1) (B) (i), under which the principal case was decided.

3 Estate of Uhl, 25 T.C. 22 (1955). See also 3 MERTENS, LAW OF FEDERAL ESTATE AND GIFT TAXATION § 24.08 (1959).

4 *E.g.,* Silverman v. McGinnes, 259 F.2d 731 (3d Cir. 1958); Wells Fargo Bank & Union Trust Co. v. United States, 80 F. Supp. 787 (N.D. Cal. 1948); Estate of Holland v. Commissioner, 47 B.T.A. 807 (1942). See generally LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES, 130-73 (1st ed. 1956). See also Covey, *Section 2036—The New Problem Child of the Federal Estate Tax,* 4 TAX COUNSELOR'S Q. 121 (1960).

5 Commissioner v. Holmes' Estate, 326 U.S. 480 (1946); Silverman v. McGinnes, 259 F.2d 731 (3d Cir. 1958).

creates an irrevocable trust vesting in the trustee absolute discretion over corpus and income, such transfer is a completed gift inter vivos and is not includible in the decedent-settlor's gross estate, although he perhaps may have received incidental benefits after the transfer.[6] However, where by the terms of the trust the exercise of discretion in favor of the settlor is governed by some external standard which a court may apply in compelling the exercise of that discretion,[7] or where the trust is created to discharge a legal obligation of support,[8] or where it can be reached by creditors,[9] it has been held that there is a retention of interest in the property sufficient to satisfy the "enjoyment" requirement of section 2036 (a).[10] In such circumstances it is obviously tempting for one to combine a transfer such as an absolute discretionary trust, complete on its face, with an informal agreement allowing the retention of benefits by the settlor in an attempt to escape the estate tax on the property held in trust.[11] In coping with this problem, courts have looked to the substance of such a transfer, its realities and not mere form, to determine its true character for tax purposes.[12] Thus, in *Estate of McNichol v. Commissioner*[13] it was held that a decedent who conveyed income-producing real estate with no reservation of rents, and simultaneously entered into oral agreements with his children under which he received rents until his death, had in fact retained the "enjoyment" of the property, and therefore, it should be included in his gross estate.

The holding in the principal case carries the proposition in *McNichol* one step further, by allowing the existence of such prearranged oral agreement to be *inferred* from the receipt of income, rather than requiring it to be established by direct proof.[14] From the standpoint of combatting

6 See, *e.g.*, *In re* Uhl's Estate, 241 F.2d 867 (7th Cir. 1957); Commissioner v. Irving Trust Co., 147 F.2d 946 (2d Cir. 1945); Commissioner v. Douglass' Estate, 143 F.2d 961 (3d Cir. 1944). See also Comment, 38 N.C.L. REV. 638 (1960).

7 Estate of Boardman, 20 T.C. 871 (1953).

8 Colonial-American Nat'l Bank v. United States, 243 F.2d 312 (4th Cir. 1957); Commissioner v. Dwight's Estate, 205 F.2d 298 (2d Cir.), *cert. denied*, 346 U.S. 871 (1953); Helvering v. Mercantile-Commerce Bank & Trust Co., 111 F.2d 224 (8th Cir. 1940); Estate of Lee, 33 T.C. 1064 (1960).

9 Commissioner v. Vander Weele, 254 F.2d 895 (6th Cir. 1958). *Cf.* Estate of Uhl, 25 T. C. 22 (1955), *rev'd and remanded*, 241 F.2d 867 (7th Cir. 1957).

10 For other illustrations of the indirect retention of income, see 3 MERTENS, *supra* note 3, at § 24.09.

11 *E.g.*, Fidelity Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Estate of Bergan, 1 T.C. 543 (1943). See also 43 MINN. L. REV. 354 (1958).

12 Commissioner v. Estate of Church, 335 U.S. 632 (1949); Commissioner v. Wilder's Estate, 118 F.2d 281 (5th Cir. 1941); Wells Fargo Bank & Union Trust Co. v. United States, 80 F. Supp. 787 (N.D. Cal. 1948); Estate of Schwartz, 9 T.C. 229 (1947); Estate of Holland v. Commissioner, 47 B.T.A. 807 (1942).

13 265 F.2d 667 (3d Cir. 1959), 19 MD. L. REV. 348. See also Covey, *supra* note 4, at 126.

14 *But cf.* Burrill v. Shaughnessy, 71 F. Supp. 99, 101 (N.D.N.Y. 1947) "To draw the

avoidance of section 2036 (a) the court's attitude is justifiable. First, in requiring the inclusion of the trust corpus in decedent's estate, the fact that settlor thought she had a life interest in the income from the trust is certainly significant, as a factual matter, to the inference of a prearrangement. Secondly, and more essential to the result, the court reasoned that since decedent-settlor had in fact received all income paid from the trust during her lifetime, she may properly be said to have retained the "enjoyment" of the property. However, the legislative history behind section 2036 (a) may subject this rationale to question; for it indicates that the language "possession or enjoyment" was intended to have reference only to a power over non-income-producing property,[15] whereas in the instant case, income-producing assets comprised the trust corpus. Such being the intent of Congress,[16] it would seem that the court should not have based taxability upon the retention of "possession or enjoyment" but rather upon the settlor's retention of the "right to income."[17] This the court refused to do, saying that the presence of an absolute discretion in the trustees necessitated the conclusion that settlor had retained no legally enforceable right. But the regulations treat a right as having been retained "if at the time of the transfer there was an understanding, express or *implied*, that the interest or right would later be conferred."[18] Moreover, the congressional reports indicate that the words "right to" merely clarify the scope of section 2036 (a) [19] and do not require a legally enforceable right for taxability.[20] Thus, although the decision did not follow congressional intent by limiting the term "possession or enjoyment" to non-income-producing

inference requested . . . is . . . to hold that the existence of a family relationship in itself is a handicap to one's right to contract or . . . express the virtue of unselfishness." See also McCullough v. Granger, 128 F. Supp. 611 (W.D. Pa. 1955).

15 H.R. REP. No. 1412, 81st Cong., 1st Sess., 5 (1949). "The income interests described in Section 2036 (a) . . . include reserved rights to the income from transferred property and rights to possess or enjoy non-income producing property." See also LOWNDES & KRAMER, *supra* note 4, at 168, "Although Section 2036 (a) (2) includes the right to designate, not only income, but also the possession or enjoyment of the property, the Regulations appear to restrict the right to 'possess or enjoy' the property to a power over non-income producing property."

16 *But see* Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir. 1959); Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955). In these cases the application of "enjoyment" was not limited to non-income-producing property, though this point was not argued.

17 See Harter v. United States, 48 Am. Fed. Tax R. 1964 (N.D. Okla. 1954).

18 Treas. Reg. § 20.2036-1-a-ii (1958).

19 The insertion of the words "right to" were intended to make it clear that the provision covered cases in which the decedent had the right to income but did not actually receive it. See S. REP. No. 665, 72d Cong., 1st Sess., 50 (1932).

20 The following cases stand for the proposition that the "right to income" provision of § 2036 (a) imposes a factual and not a legal test of liability: Estate of Shearer, 17 T.C. 304 (1951); Estate of Fry, 9 T.C. 503 (1947); Estate of Schwartz, 9 T.C. 229 (1947). *But cf.* Estate of Trafton, 27 T.C. 610 (1956).

property, it could have done so and still required the inclusion of the corpus in the gross estate.

Nevertheless, the principal case is significant in illustrating a rather unique application of section 2036 (a), and in permitting the inference of an agreement which made the "retention" here a taxable one. Although the court failed to give effect to the congressionally-proposed dichotomy between income and non-income-producing property, such a distinction will probably never be determinative, as a practical matter, of the outcome of litigation. However, when viewed from the standpoint of the desirability of maintaining the integrity of the death tax statute, the principal decision serves to check a possible means of avoidance under section 2036 (a), and, as such, seems justifiable.

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