1949

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Recommended Citation

THE FEDERAL ESTATE TAX AND INCOME ACCUMULATED IN A TRUST CREATED IN CONTEMPLATION OF DEATH, 58 YALE L.J. (1949).
Available at: https://digitalcommons.law.yale.edu/ylj/vol58/iss2/6

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NOTES

THE FEDERAL ESTATE TAX AND INCOME ACCUMULATED IN A TRUST CREATED IN CONTEMPLATION OF DEATH

The provision of the Internal Revenue Code for applying the estate tax to inter vivos transfers made "in contemplation of . . . death" was enacted in order "to reach substitutes for testamentary dispositions" which would, at the time of enactment, otherwise have gone untaxed. The mechanism adopted to implement this purpose was to include such transfers in the taxable estate "as if" the decedent had continued to own the property until his death. Where the transfer is in trust, therefore, the Commissioner of Internal Revenue applies the tax to the corpus as valued at the date of the donor's decease. But in a recent decision, Estate of James E. Frizzell, the Tax Court has imposed one restriction on what may be included in this corpus.

At the age of eighty-one, Frizzell irrevocably transferred securities in trust

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1. Int. Rev. Code § 811 provides: "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, in contemplation of or intended to take effect in possession or enjoyment at or after his death . . ."


4. There was no gift tax in effect when the contemplation-of-death provision was introduced in 1916. Today, an inter vivos transfer may be subject both to the federal gift tax and the federal estate tax. If the former has been paid, a credit is permitted against the latter. Int. Rev. Code § 813(a). The gift tax rates, however, are generally assumed to be three-quarters of the estate tax rates. 2 PAUL, op. cit. supra note 1, § 15.02. The actual gift tax on a given transfer will, in fact, frequently be much less than three-quarters of the estate tax on the same transfer, since the gift tax, unlike the estate tax, is imposed upon the net gift after deduction of the tax itself. MAGILL AND MAGUIRE, CASES ON THE LAW OF TAXATION, 624, n. 16 (4th ed. 1947).

5. See Igleheart v. Com'r, 77 F.2d 704, 711 (5th Cir. 1935); Milliken v. United States, 283 U.S. 15, 23 (1931) (underlying the statute is the policy of taxing gifts in contemplation of death "equally with testamentary dispositions").

6. U.S. Treas. Reg. 105, § 81.15 (1942) provides: "The value of transferred property includible in the gross estate is the value thereof at the date of decedent's death . . ." Valuation of trust assets at the date of death irrespective of their value at the date of gift is clearly in conformity with the requirement of the Code, note 1 supra. Estate of Addison W. Igleheart, 28 B.T.A. 888, 905-6 (1933), aff'd, 77 F.2d 704 (5th Cir. 1935).

7. 9 T.C. 979 (1947), supplemental opinion, 11 T.C. No. 69 (1948).
for his mentally incompetent son. The trustee bank was directed to pay from trust income whatever sums it considered necessary for the son's living expenses, and to encroach upon the corpus if the income proved insufficient; undistributed income was to be accumulated. Classifying the transfer as a trust in contemplation of death, the Commissioner sought to tax the value of the entire corpus as of the date of the donor's death, including income which had been accumulated. The Tax Court sustained the Commissioner's classification of the transfer, but held that, since "the taxable event is the transfer inter vivos," only the value of the original assets at the donor's death could be included in the taxable estate. Accumulated income was excluded because, unlike an increase in principal, it was "derived from the operation of the trustee, independently of the grantor."
One obstacle in the path of this holding was the rule that profits from re-investment of assets should be included in the taxable estate where a grantor has reserved powers to amend or revoke. But the court, despite the fact that such profits similarly stem directly from independent "operation of the trustee," distinguished cases applying that rule on the ground that the tax is imposed upon the property transfer, and that the transfers in those cases were not complete until the grantor's death. Frizzell, on the other hand, had renounced control completely and irrevocably when the trust was created, so that his death had no operative effect on the trust.

While completeness of transfer is characteristic of gifts in contemplation of death, the determinative force accorded to it by the court in the Frizzell case seems unjustified. The virtual identity of phrasing in the Code provisions for transfers in contemplation of death and for incomplete transfers provides a strong indication that they should be taxed identically. And even if the similarity of these provisions is disregarded, the legislative intent that trusts in contemplation of death be taxed "as if" the decedent had retained the property until his death makes it logical that income which presumably would have accrued to the grantor be taxed along with the rest of the corpus. Although on its face it may seem questionable to permit the measure of the tax on the appraised value of the corpus, the court has approved such an inclusion in some cases.

F.2d 469 (2d Cir. 1941), cert. denied, 314 U.S. 621 (1941). Its application has actually been less closely restricted. See Liebmann v. Hasset, 148 F.2d 247, 251 (1st Cir. 1945).

13. Inr. Rev. Code § 811(d) requires the inclusion in a decedent's gross estate of transfers with respect to which the decedent possessed at his death a power to alter, amend, revoke, or terminate. Holderness v. Comm'r, 89 F.2d 137 (4th Cir. 1936) (transfer of cash with directions to invest in securities, reserving power to change proportions of income passing to respective beneficiaries and to withdraw portion of corpus); Estate of Daniel Guggenheim, 39 B.T.A. 251 (1939), supplemental opinion, 40 B.T.A. 181 (1939), modified in other respects, 117 F.2d 469 (2d Cir. 1941), cert. denied, 314 U.S. 621 (1941) (grantor reserved power to distribute principal and interest as between named beneficiaries, but had no power over sales or substitutions of assets by trustee).

14. 9 T.C. 979, 988-9. On the same ground the Tax Court distinguished cases upholding taxation of the "entire corpus" where control of that corpus might conceivably have reverted to the grantor-decedent, 9 T.C. 979, 987: Fidelity-Philadelphia Trust Co. v. Rothensies, 324 U.S. 103 (1945) (possibility that corpus would revert to persons whom grantor might appoint by will); Comm'r v. Estate of Field, 324 U.S. 113 (1945) (possible reversion of corpus to grantor). Those cases held that, since the decedent retained a "string" attached to the whole corpus, the amount includible in gross estate is not the value of the reversionary interest terminated by his death but rather the value at his death of the whole property to which that interest relates. It was not indicated in those cases that the corpus included any new property or accumulations; in the Field opinion, in fact, it is stated that the assets transferred were valued at the date of death. Id. at 114-5. In Spiegel's Estate v. Comm'r, U.S. Sup. Ct., Jan. 17, 1949, 17 U.S. L. Week 4135, the Court affirmed a holding that "the value of the trust property and accumulated income" should have been included in the gross estate where the circuit court of appeals had found a possibility of reversion to the grantor by operation of law.


16. See Inr. Rev. Code § 811(e), note 1 supra, and § 811(d), note 13 supra.

17. See note 4 supra.
tax to be determined by the fortuity of the trustee’s judgment in distribution, this is in accord with the normal operation of the estate tax. A property holder, except for the contemplation-of-death situation, can always avoid the tax by giving away his property.

Even more difficult for the court to circumvent than the “incomplete transfer” cases was the decision in Estate of Addison W. Igleheart,18 upholding taxation of the entire corpus of a trust established, as in the Frizzell situation, by a completed transfer in contemplation of death. Igleheart’s taxable estate apparently included profits from reinvestment of the original assets by the trustee,19 but this issue was not discussed on appeal.20 The Tax Court, however, not only disregarded the decision as inconclusive on the question of reinvestment profits but also intimated that a rule requiring inclusion of these profits in the taxable estate would not require inclusion of accumulated income.21 Carried to its logical conclusion, this refusal to accept a uniform principle makes the taxability of an increase in the corpus dependent on the nature of that increase. Such a conclusion seems difficult to substantiate in

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18. 28 B.T.A. 888 (1933), aff’d, 77 F.2d 704 (5th Cir. 1935).
19. The Tax Court in the Frizzell opinion interpreted the findings of fact made by the Board of Tax Appeals in the Igleheart case as indicating that the trustee had reinvested part of the original trust assets. 9 T.C. 979, 986. This conclusion seems reasonably inferred from the facts that the trustee sold certain securities at a profit, 28 B.T.A. 888, 897, and that the value of the assets at the decedent’s death was greater than at the date of the transfer.20
The inclusion of trust property at its value on the date of the settlor’s death has been condemned as taxing property which the decedent never owned, in cases where Int. Rev. Code § 811(c) was held inapplicable, primarily upon other constitutional grounds. See Heiner v. Donnan, 285 U.S. 312, 327 (1932); Frew v. Bowers, 12 F.2d 625, 628 (2d Cir. 1926). That argument was urged unsuccessfully by the executor in the Igleheart case.

In Estate of B. H. Kroger, P-H 1943 TC Mem. Dec. 43,92 (1943), aff’d, 145 F.2d 901 (6th Cir. 1944), cert. denied, 324 U.S. 866 (1945), not cited in the Frizzell decision, the question of including gains from exchange of trust assets was squarely presented. The taxpayer claimed that the Commissioner erred in taxing assets substituted by the trustee, rather than the original assets as valued at the grantor’s death. But the Tax Court held that “... if property has been converted into other property the value of such other property at the date of death is the measure of the tax.” P-H 1943 TC Mem. Dec. 43,92 at 1244. A possible ground for distinction between the Kroger case and the Frizzell situation is the fact that the Kroger trustee was empowered to sell trust assets only with the decedent’s prior consent; but the Tax Court did not base the inclusion of substituted assets on this fact.

20. Igleheart v. Com’r, 77 F.2d 704 (5th Cir. 1935).
21. See 9 T.C. 979, 986: “Also, in this case, the question does not relate to reinvestments by the trustee of proceeds from the original property transferred by the grantor-decedent to a trust in contemplation of death, nor to accretions to the very property which the grantor-decedent transferred to the trust during his lifetime. We are unable to find, and neither party has cited, any authority which has considered the precise question presented in this case.” The distinction between accumulated income and reinvestment profits will often prove a difficult one to draw. Are reinvestment profits synonymous with capital gains? Into which category would fall capital gains resulting from investment of accumulated income? Accumulated income resulting from capital gains?
view of the statutory policy that a transfer in contemplation of death should be treated as non-existent for tax purposes; all undistributed increases would have added to the donor's estate regardless of their nature.

The "nature of increase" rule appears not only unjustified but also unfortunate in that its adoption would permit an event which does not affect the amount of property transmitted to vary the amount of property taxed. Thus, if no dividend had been paid on the Frizzell stock between creation of the trust and the settlor's death, undistributed earnings might have been reflected in an enhanced value of the stock, or in a profit from sale of the stock by the trustee; if so they would in effect be included in the taxable estate, whereas the fortuity of dividend payment permits the same accretion to escape that tax. Moreover, the "nature of increase" rule raises questions as to whether stock dividends and liquidating dividends would similarly be excluded from the corpus. Conversely, does the Frizzell decision presage a "nature of increase" rule results clearly required under the Tax Court's holding in the Frizzell case that "the 'property' to be included in decedent's gross estate is only the value at the date of death of the . . . stock of which the decedent made transfer during his life, rather than the value of the entire trust corpus. . . ." 9 T.C. 979, 988. In a closely held corporation controlled by persons interested in the trust or in the settlor's estate, dividend payment, under the rule of the Frizzell decision, might be far from fortuitous, for that rule provides an inducement to distribute profits rather than accumulate them in corporate surplus. This often salutary influence would not be present under a rule requiring inclusion of accumulated income in the settlor's gross estate; the effect of such a rule on the dividend policy of a closely held corporation would at least theoretically be neutral, for if the corporation accumulated its profits they would still enter into the determination of trust value through increased value of the shares. In respect to such corporations, then, the Frizzell rule would only augment the more direct encouragement to pay dividends which is provided by the additional taxes imposed on undistributed income of personal holding companies under § 500 of the Internal Revenue Code and on undistributed income of corporations shielding shareholders from surtaxes under § 102; the opposite rule would not appear to undermine the efficacy of those sections.

Similarly, under the Frizzell rule, any bond purchased at a discount, for example a United States Series E bond, would be valued at the settlor's death, with the effect of including accumulated income. On the other hand, application of the rule to a coupon bond would presumably result in the exclusion of income collected and accumulated in the trust through "operation of the trustee." Conversely, the Frizzell rule, if extended to such cases, would appear to bar inclusion of such dividends as "other property" than that originally transferred. Cf. Attorney-General v. Oldham, [1940] 1 K.B. 599, aff'd, [1940] 3 All Eng. 450 (C.A.), 54 Harv. L. Rev. 512 (1941), where a gift of stock was subject to a death tax laid on any inter vivos outright gift made within three years of death, but additional shares distributed as a stock dividend were held not taxable, because it could not be said that they were given by the donor to the donee. But in theory at least, payment of either a stock dividend or a cash liquidating dividend to the trust would occasion no change in the value of its total holdings, and would not justify limiting the tax to the now depressed value of the stock originally held. A decision permitting inclusion of the entire trust corpus in the Frizzell case, on the other hand, would pose no difficulties when applied to these situations, for it would automatically result in the inclusion of all types of dividends at whatever value, if any, they actually add to the trust property if retained until the settlor's death. In U.S. Treas. Reg. 105, § 81.11,
decrease" rule which would bar a reduction in the measure of the tax if the trust principal were invaded by the trustee for the beneficiary's support before the grantor's death? If so, the result would again represent a departure from the legislative intent to tax a trust in contemplation of death "as if" the decedent had never made the transfer, for had he retained the property he presumably would have made the same distributions free of the estate tax.\(^{24}\)

While the Frizzell opinion relies on questionable distinctions and foreshadows a "nature of increase" rule which seems highly undesirable,\(^{25}\) the decision obviates one apparent inconsistency inherent in a doctrine permitting inclusion of accumulated trust income in the gross estate. The Commissioner taxes outright gifts in contemplation of death only to the extent of the original assets as valued at the donor's death.\(^{26}\) Thus a variance within the contemplation-of-death category would result if trusts were not similarly treated. But the variance is not indicative of any underlying difference in treatment, for where transfers not in trust are in forms which make income readily traceable the rule with regard to outright gifts is abandoned in favor of a valuation which includes income which the property produces before the donor's death.\(^{27}\)

which applies to property valued on the optional date permitted under Int. Rev. Code § 811(j) and which implements the holding in Maass v. Higgins, 312 U.S. 443 (1941), supra note 12, the Treasury establishes a distinction between distributions in liquidation and distributions out of earnings. The Frizzell decision would seem to make appropriate the insertion of similar provisions in § 81.15 of the Regulations, supra note 5, which applies to transfers during life.

24. A decision permitting taxation of the entire value of the trust on the date of the settlor's death in the Frizzell situation, on the other hand, could be extended to an invasion case without doing violence to the "as if" principle, for it would result in the inclusion in gross estate of only that portion of the corpus still remaining undistributed. In a case of actual invasion, very likely the Tax Court would not feel that logical consistency with the Frizzell holding would force it to include within the gross estate property disbursed by the trustee in distributing portions of the corpus.

25. It is not surprising that the decision reached in a particular tax case may appear to entail undesirable consequences, in view of the many anomalous results which arise under the existing federal income, estate and gift tax statutes, see, e.g., Note, 57 Yale L. J. 1122, 1128, n. 24 (1948), and in view of the inherent difficulty of interpreting provisions which put inter vivos transfers into the assumed status of testamentary dispositions.

26. Montgomery and Wynn, Federal Taxes—Estates, Trusts and Gifts 567 (1947-8 ed.); Payenstedt, supra note 1, at 87-8; no cases or published rulings are cited. The procedure will not be affected by the fact that at the time of the donor's death the donee may no longer possess the original assets. This practice may be somewhat weakened by dictum in Estate of B. H. Kroger, P-H 1943 TC Mem. Dec. Serv. ¶ 43,392 (1943) at 1244, aff'd, 145 F.2d 901 (6th Cir. 1944), cert. denied, 324 U.S. 866 (1945), note 19 supra, which apparently regards the value of substituted assets at the date of death as the measure of the tax, regardless of whether the transfer is in trust or is an outright gift. But in Humphrey's Estate v. Com'r, 162 F.2d 1 (5th Cir. 1947), cert. denied, 332 U.S. 817 (1947), the administrative practice was approved, at least where there was a cash transfer and a diminution rather than an enhancement in the hands of the donee.

27. Thus, life insurance policies, when assigned in contemplation of death, are taxed to the assignor's estate at face value. Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).
The practice followed in the case of outright gifts, therefore, appears to be the exception, a concession to administrative expediency justified by the fact that it would often be impossible to trace such a gift after it is mixed with the donee's personal assets, while no such difficulty exists where there is a separate trust fund.

Under a broader view than that prompted by considerations of doctrinal consistency, the Tax Court might perhaps have felt its decision justified by fear of the pragmatic effects of an opposite holding. To the extent that a contemplation-of-death finding may be anticipated for any transfer in trust, a rule contrary to the Frizzell decision might tend to deter settlors from providing for accumulation and to deter trustees from exercising a discretion to accumulate, results which would be undesirable in circumstances where accumulations would serve a useful purpose. But fortunately these effects would be strongest where the settlor's motive in establishing the trust is avoidance of taxes, and weakest where accumulation is appropriate as a means of effecting the wisest disposition of his property. In the latter sort of case, the extent to which consciousness of tax liability will influence a settlor to forgo desired accumulations is conjectural, but it would be strongly limited by the desire to make the best provision for the special requirements of his situation and the characteristics of his beneficiaries. The effect on a trustee in such a case is also speculative,
but it seems unlikely that he would consider himself justified in permitting tax considerations to influence his accumulation policy to an extent which would frustrate the fundamental intent of the settlor or work to the detriment of any party having an interest in the trust. The relative weight of tax considerations will certainly be lessened by the fact that a contemplation-of-death finding can hardly ever be regarded as more than a possibility in advance, and the tax factor will be only a potential one. In any event, the deterrent influence on accumulation would be no greater than that which the estate tax as a whole exerts on saving by individuals, and it would be in accord with an underlying purpose of the federal estate tax, that of inhibiting large accumulations of property.

The susceptibility of a transfer to such a finding is highly unpredictable. See Atlas, Gifts in Contemplation of Death, 23 Taxes 421 (1945). The Treasury has been notably unsuccessful in this field. Of 92 cases litigated in the federal courts between January 1, 1939 and April 1, 1944, 34% of the transfers were held to be in contemplation of death. The Treasury was least successful in the Tax Court, where it won in only 23% of the transfers tried during that period, as against 46% of those tried in the other federal courts. Id. at 421.

30. Possible inclusion of accumulated income in gross estate is only one of a number of tax considerations which might enter into a trustee's determination of distribution policy to the extent that he would be influenced by such factors at all. Under § 161(a) (4) of the Code a trust is subject to the income tax on income which, in the discretion of the fiduciary, may be either distributed or accumulated; but § 162(c) allows as a deduction the amount of such income properly paid to a beneficiary under such a discretionary power, that amount then being included in computing the net income of the beneficiary. Under § 167(c), if the trustee has discretion to distribute income for the support or maintenance of a beneficiary whom the grantor is legally obligated to support, income actually so distributed will be taxable to the grantor. It is impossible to generalize as to the possible effect of these provisions upon distribution policy, for the resulting tax liabilities would depend on the relative sizes of the surtax net incomes of the trust, the grantor, and the beneficiary. If the trust has a substantially larger income than the beneficiary, as will often be the case, the trustee is acting under one encouragement to distribute income regardless of whether a possibility of estate taxation of accumulated income provides an additional encouragement. Finally, unless a local apportionment statute is applicable, the residuary estate and not the trust will bear the estate tax.

31. In support of this view, see communications to Yale Law Journal from Girard Trust Company, Philadelphia, dated December 8, 1948; from F. N. Garrett, Jr., Assistant Cashier, Chase National Bank of New York, dated December 9, 1948; and from C. L. Herterich, Vice President, Central Hanover Bank and Trust Company, New York, dated December 15, 1948; all in Yale Law Library.

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33. See, e.g., Paul, Taxation for Prosperity 308 (1947); Rudick, A Proposal for