FEDERAL ESTATE TAX—RETENTION OF ADMINISTRATIVE POWERS—CORPORATE CONTROL VIA A RIGHT TO VOTE TRANSFERRED STOCK DOES NOT OFFEND SECTION 2036

Upon the death of an owner of a close corporation, his estate is frequently caught in a cash squeeze due to the estate taxes on his stock. The lack of a ready market for closely held stock together with the possibility of passing control (or a substantial interest) into unfriendly hands, can combine to create a dilemma for the executor.[1] In many cases it would be better to pass the bulk of the stock inter vivos, taking advantage of the gift tax exemptions and favorable rates, while passing the interest to parties who will be welcome in the corporate family. At the same time, most owners will want to insure control of the corporation (or other business interest) to themselves for their own lifetimes. For these reasons *United States v. Byrum*,[2] a six to three decision rendered on June 26, 1972, represents a breakthrough for the estates of those who own controlling portions of closely held interests.

In 1958, Decedent, Milliken C. Byrum, created an inter vivos trust for his children to which he transferred stock in three corporations. The children were both the life and corpus beneficiaries. The trust agreement provided for a corporate trustee with broad administrative powers, but Decedent retained the power to (1) vote the transferred stock, (2) veto the sale of trust assets, and (3) remove the trustee. Prior to the transfer Decedent owned at least 71 per cent of the stock in each corporation, but some minority interests were owned by persons unrelated to him. The Commissioner of Internal Revenue determined that the value of the transferred stock should be included in Decedent's gross estate under Internal Revenue Code of 1954, § 2036(a)(1)[3] on the theory that reten-

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1. The cash problem is, however, alleviated to some extent by the provisions of section 6166 of the INTERNAL REVENUE CODE OF 1954 which, for qualifying closely held interests, allows the tax to be paid over a ten year period at 4 per cent interest. Buy-sell agreements are also commonly used to circumvent the difficulties of the situation.

2. 408 U.S. 125 (1972).

3. The full text of section 2036(a) provides as follows:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
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> (1) the possession or enjoyment of, or the right to the income from, the property, or

tion of control of the corporations constituted retention of enjoyment of the stock. In addition, the Commissioner sought to include the value of the stock under section 2036(a)(2)[4] by reason of the Decedent's retained power to control the dividend policies of the corporations since such control could shift the economic benefit of the stock between the life and corpus beneficial interests. The executrix paid the additional tax and sued for a refund. The district court[5] granted summary judgment for the executrix and the court of appeals[6] affirmed. On certiorari, the Supreme Court affirmed, holding that retention of stock voting rights which give the transferor majority control of the corporation, together with retention of a veto power over the sale of trust assets, constitutes a retention of neither the enjoyment of the stock within the meaning of 2036(a)(1) nor a right to designate its enjoyment within the meaning of 2036(a)(2).

The right to vote trusteed stock has generally been regarded as an administrative power properly belonging to the trustee.[7] It has long been established that a settlor may be the trustee of the property he has transferred without incurring, for that reason alone, estate tax liability.[8] The right of Byrum in the instant case to vote the stock he transferred was therefore not sufficient on its face to require inclusion of the stock in his estate. A new wrinkle appears, however, when the right to vote the stock carries with it a controlling interest in the corporation. In that event the stock's value is enhanced beyond a mere right to share in corporate income.[9] The underlying question in the *Byrum* case was whether this new aspect made any difference to the general rule that administative powers do not cause estate taxation. The answer was that it does not.

Section 2036(a)(1)

Leaving aside peripheral cases,[10] the question of whether corporate

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
[The respective subsections will hereinafter be referred to simply as 2036(a)(1) and 2036(a)(2)].

4. *Id.*
5. Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970).
6. Byrum v. United States, 440 F.2d 949 (6th Cir. 1971).
7. 2 A. SCOTT, THE LAW OF TRUSTS § 193 (2d ed. 1956).
8. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929).
9. *See* 1 F. O'NEAL, CLOSE CORPORATIONS § 107 (1971 ed.); Bayne, *The Noninvestment Value of Control Stock*, 45 IND. L. REV. 317 (1970).
10. Estate of Harry H. Beckworth, 55 T.C. 242 (1970) (decedent retained no legal right to vote shares but could remove trustees, and trustees did in fact give their proxies to him); Estate of

control equals enjoyment within the meaning of section 2036(a)(1) had been squarely faced only once prior to the instant litigation, in the case of *Yeazle v. Coyle.*[11] There, all the income from the trusteed stock was to be paid to the beneficiaries for 10 years with the corpus to be distributed to them at that time. Even though the decedent had retained control via voting rights, the district court held that the stock was not includable in her estate because she had retained no direct pecuniary benefit which was deemed a requirement under section 2036(a)(1).[12] The same approach was followed in its entirety when the *Byrum* case passed through the federal district court, while the court of appeals was satisfied to simply say that none of Byrum's three retained powers (to vote the stock, veto the sale of the stock, and remove the trustee) had per se ever caused taxation in the past.[13]

In the Supreme Court, the government pointed to several things as amounting to enjoyment of the transferred stock within section 2036(a)(1). These included Byrum's power to employ himself without possibility of losing his tenure (since the trustee could not sell the stock without Byrum's approval), his power to set, within wide limits, his own salary and fringe benefits, and the right to cause the corporations to be merged or liquidated.[14]

In answering and rejecting these allegations, the Court appeared to have considerable difficulty in finding a suitable basis upon which to rest its decision. As a threshold test, the Court said that the question of whether the retention of control constituted enjoyment under 2036(a)(1) was inappropriate because Byrum had always kept ownership of enough stock to maintain his corporate control without the retained voting

George H. Burr, 14 P-H Tax Ct. Mem. ¶ 45,364 (1945) (decedent was creditor of corporation and therefore exercised some degree of control over dividend policy); Estate of William F. Hofford, 4 T.C. 542, *modified*, 4 T.C. 790 (1945) (decedent did not retain right to vote shares but retained right to remain employed as corporate manager and to receive a set salary whether or not he was able to perform his duties); Estate of Pamelia D. Holland, 47 B.T.A. 807 (1942), *modified*, 1 T.C. 564 (1943) (decedent retained right to vote stock but also retained an annual salary equivalent to an income interest).

11. 68-1 U.S. Tax Cas. ¶ 12,524, 21 Am. Fed. Tax R.2d 1681 (N.D. Ill. 1968).

12. This proposition was extracted from Commissioner v. Estate of Holmes, 326 U.S. 480 (1945) which was decided under section 2038 rather than 2036 but which established the rule that "enjoyment" in tax statutes was not a term of art, but connoted only "substantial present economic benefit . . . ." It ought to be noted that *Holmes* was talking about "enjoyment" by the beneficiaries rather than by the settlor, and used the rule to expand the reach of section 2038. To say that it now applies to restrict the reach of section 2036 is arguably an application out of context.

13. Incredibly, the court of appeals never even mentioned Byrum's control over his corporations as a factor to be considered in relation to section 2036(a)(1), although it did cite *Yeazle*.

14. Brief for Petitioner at 23, 24.

rights.[15] The statute only deals with property transferred; and if sufficient stock is not transferred to carry control with it, then the stock is not a proper subject for taxation. This test, it should be noted, is relevant to both 2036(a)(1) and 2036(a)(2), and if the Court was correct in this, the rest of the opinion would be left as dictum only. Two things, however, militate against it. First, the Court itself was not content to rest its decision upon the argument, going on to discuss the merits of the *control* issue at great length. Second, with respect to two of his corporations, Byrum had given more stock to the trust than he retained for himself. In those cases, to say that Byrum kept control via his retained stock assumes the cooperation of minority stockholders. Not only is such an assumption unwarranted,but it is also inconsistent with the Court's position in other parts of the opinion that the minority stockholders were a bar to Byrum's complete enjoyment of his control. In sum, it would be difficult to view this part of the decision as the ratio decidendi.

A second argument advanced by the Court was that where title to personal property was irrevocably transferred, 2036(a)(1) caught only those situations where an income interest (a dividend interest for purposes of the present case) was retained. This proposition seems to be without connection to the purposes of section 2036 which was designed to catch the retained life estate without distinction as to the manner in which it is enjoyed. Indeed, as the Court itself mentioned, the retained *use* of real property, whether for income producing purposes or not, has always been held to cause inclusion.[16] Moreover, the only support cited for this principle was that all the previous cases taxing personal property under 2036(a)(1) did so as a result of retained income interests.[17] What appears to have escaped the Court altogether is the peculiar nature of corporate stock. The bundle of rights contained therein includes not only an income interest but also, in a sufficiently large aggregate, a right

15. At the time of Bryum's death the following percentages of stock were owned:

	Byrum	Trust
Byrum Lithographic Co., Inc.	59%	12%
Graphic Realty, Inc.	35%	48%
Bychrome Co.	42%	46%

16. *E.g.*, Guynn v. United States, 437 F.2d 1148 (4th Cir. 1971); and *see* Rev. Rul. 70-155, 1970-1 CUM. BULL. 189.

17. That all the cases requiring inclusion of personal property involve income interests shows more about the nature of the property than about the type of interest retained. Surely the Court would not suggest that a Rembrandt whose title was transferred but whose use for life was retained would not be taxable merely because no income interest was involved. *See* 3 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 24.07, n. 57 (1959); and *see* Estate of Pamelia D. Holland, 1 T.C. 564 (1943) where the court hints that a retention of control is within the statute.

to use the corporate power and assets for legitimate purposes. And this latter right is both ascertainable and highly merchantable.[18] Thus the Court has, on the basis of what is almost a bare assertion, given its sanction to an unwarranted and restrictive view of 2036(a)(1) and, in the process, opened the door to easy abuse. A more plausible solution would be to forthrightly recognize control as a separate asset, and to treat the retention of it as a retention of a life estate in part of the property transferred.[19] The proper amount to include under such a view would be the value, if any, which could be assigned to the control of the corporation.[20]

The Court's final reason for rejecting the government's contention was that the ability of Byrum to enjoy his voting power was restrained by fiduciary duties owed to the minority owners. These duties, plus the indirect controls of the income tax statutes,[21] were said to keep the stock out of his estate on the theory that a sufficiently limited enjoyment is no "enjoyment" within the meaning of 2036(a)(1). Although the Court made no mention of it, it seemed to have had in mind a test like that laid down in *Jennings v. Smith*;[22] if the control can only be enjoyed within judicially ascertainable limits, then it can hardly be called enjoyment at all. The Court's underlying premise was apparently that only unfettered enjoyment is really worth having or taxing. But if 2036 is supposed to catch retained life estates, then surely it ought to catch everything retained for life that has a marketable value. The fact that corporate control cannot be exercised with complete abandon does not prevent investors from paying a premium for it in commonplace transactions. Moreover, the *Jennings* type test was created to apply in situa-

18. The 2.1 million dollar premium involved in the case of Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955) is the classic example.

19. A case which has recognized the value of control as apart from the right to income is Estate of Marjorie G. Brush, 32 P-H Tax Ct. Mem. ¶ 63,186 (1963). In Estate of Robert H. Damon, 49 T.C. 108 (1967), the court discussed the possibility of control causing a higher valuation of the stock, although the stock in that particular case was not a large enough block to carry either actual or effective control with it. For a discussion of the possibilities as well as the problems of setting a value on control, *see* Note, *Inverse Blockage—Valuation of Control Blocks of Listed Securities for Federal Estate Tax Purposes*, 1 VALPARAISO L. REV. 340 (1967).

20. This approach would be consistent with the Treasury's regulations. *See* Treas. Reg. § 20.2036-(1)(a) (1958), which requires inclusion of only part of the transferred property where the retained life estate affects only part; and *see* Rev. Rul. 67-54, 1967-1 CUM. BULL. 269, which mentions the valuation of control as a separate asset.

21. Specifically the Court speaks of disallowance of deductions for unreasonable compensation under INT. REV. CODE OF 1954, § 162(a).

22. 161 F.2d 74 (2d Cir. 1947), *rev'g* 63 F. Supp. 834 (D. Conn. 1945). This is the leading case for the rule that retained powers will not cause estate taxation if they are limited by an enforceable external standard.

tions where a decedent's discretion was so circumscribed that it could not fairly be said to be a meaningful discretion at all. In applying the rule, the cases have rejected such standards as "in the beneficiary's best interests,"[23] and yet Byrum's duty, and the duty of his boards of directors, was no more than to act in the best interest of the corporation and the stockholders.[24]

In summary, the Court's decision with respect to 2036(a)(1) significantly narrows the reach of the statute and seems to be out of touch with the realities of Byrum's arrangement. On its face it provides a loophole to those who would like to keep a life estate in their non-income-producing personal property without having it taxed in their estates.

Section 2036(a)(2)

When the *Byrum* litigation reached the federal courts, the government's contention as regards section 2036(a)(2) was that Byrum's voting control gave him the power to shape the corporations' dividend policies. If the boards of directors voted dividends, the trust would have income; if corporate earnings were retained, the value of the trust corpus would increase. In this system, the Commissioner saw a power comparable to a reserved discretion to distribute or accumulate and add to corpus the trust income. As authority the government could point to a revenue ruling of 1967 which held that non-voting stock transferred in trust was includable in the transferor's estate under 2036 if he had retained both voting control and veto power over the sale of trust assets.[25]

As early as 1946, the courts began to recognize that 2036(a)(2) was applicable to cases where the decedent had retained a right to shift the beneficial interests of his gifts between the life and corpus beneficiaries.[26] It was seen at that time that he could accomplish this through an unfettered power to accumulate or distribute income, or to distribute corpus to the life tenant; the former power could completely defeat the life tenant's interest while the latter could do the same to the remainderman. The actual reach of the statute (insofar as property includable) was left a little uncertain by the fact that most of the early cases involved trusts

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23. Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970); Estate of Cyrus C. Yawkey, 12 T.C. 1164 (1949).

24. The position of corporate fiduciaries is often compared to that of trustees. *See generally* 3 W. FLETCHER, PRIVATE CORPORATIONS § 838 (1965).

25. Rev. Rul. 67-54, 1967-1 CUM. BULL. 269.

26. Estate of Milton J. Budlong, 7 T.C. 756 (1946), *modified sub nom.*, Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947).

which granted both of these powers simultaneously to the decedent.[27] But in the later case of *United States v. O'Malley*[28] this doubt was removed when a power to accumulate or distribute only the trust income was held to require inclusion of the entire corpus. In the meantime the rule solidified that where the decedent retained a power to withhold the life tenant's interest, it made no difference if the life tenant and remainderman were the same person; the question was not one of vesting but of a right to enjoyment within the decedent's lifetime.[29]

The Commissioner, however, harbored ideas that these powers should cause taxation even where they did not arise out of the trust instrument or other agreement directly, but were instead secondary and de facto results of other powers specifically granted. In 1959, he scored a striking success with this argument in *State Street Trust Co. v. United States*.[30] There the decedent, as trustee, had reserved a power both to allocate trust receipts between income and principal and to invest without regard to the legal list. This latter power's evil arose out of the decedent's ability to invest in wasting or non-income-producing assets. Both of these were normal administrative powers but the court held that they were granted in such broad fashion as to be ungovernable in a court of equity, and that they therefore amounted to an unrestricted discretion to shift the benefits. This result was short lived, however, as the courts soon began to whittle away at the doctrine. The rationale of these contrary decisions is well exemplified by *Estate of King v. Commissioner*.[31] There the Tax Court held that where the decedent retained an administrative power in the capacity of trustee, his discretion in its exercise was limited to choices commensurate with his fiduciary duties. Consequently, no ability was left to the decedent to shift the economic interests through the secondary effects of these powers. The court also held that this would be the case regardless of the breadth of the language that granted the administrative power. Eventually, the *State Street* case was overruled in *Old Colony Trust Co. v. United States*[32] upon essentially the same reasoning expounded by *Estate of King*.

27. *Id.*; Estate of Cyrus C. Yawkey, 12 T.C. 1164 (1949); Estate of James D. McDermott, 22 P-H Tax Ct. Mem. ¶ 53,154 (1953), *aff'd*, 222 F.2d 665 (7th Cir. 1955); Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955).

28. 383 U.S. 627 (1966).

29. Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955), which relied on the reasoning of Lober v. United States, 346 U.S. 335 (1953).

30. 263 F.2d 635 (1st Cir. 1959).

31. 37 T.C. 973 (1962).

32. 423 F.2d 601 (1st Cir. 1970).

With this background in mind a review of the *Byrum* decision with respect to section 2036(a)(2) is in order. The Supreme Court first recognized the government's argument as being an "accumulate or distribute" contention. The opinion then proceeded to talk in terms of retained managerial and administrative powers, citing *Reinecke v. Northern Trust Co.*[33] and the *Estate of King* case for the proposition that retention of broad administrative powers did not infect the property with an estate tax. Moving to the applicability of section 2036(a)(2), the Court laid down the rule that the term "right" in the subsection meant only "an ascertainable and legally enforceable power . . . ."[34] Byrum's power was said not to be legally enforceable because of the confinements imposed by the fiduciary duties owed to minority stockholders by both Byrum and the boards of directors. The cases involving a reserved power to accumulate or distribute income by one who is also a trustee were distinguished on the grounds that a trustee could legally enforce his right to exercise the power since it was granted directly by the trust instrument (or other agreement). Finally, the Court pointed out that Byrum's power to declare dividends or to withhold them at his pleasure was limited significantly by the practicalities of the business world. Not only did the control of dividend flow presume the existence of surplus earnings, but such things as the excess accumulated earnings tax and the possibility of derivative suits also inhibited Byrum's whimsy.

Perhaps the most significant impact of this decision beyond its immediate facts is that it defeats in the highest court a line of attack that the Commissioner has pursued for many years.[35] The Court clearly saw Byrum's power to vote trusteed stock as analogous to the administrative powers retained in the *Estate of King* case. The indorsement of *King* ought to foreclose for the future any notion that secondary effects of administrative or managerial powers are going to cause taxation under 2036(a)(2), at least where the decedent is a trustee.

But there is a problem with trying to fit the *Byrum* and *King* reasoning in the same mold. The *King* case said that taxation was avoided because of the restrictions of the fiduciary obligations owed to the beneficiaries of the trust. The *Byrum* case looked instead to the fiduciary obligations owed to minority stockholders who had no connection with the trust. The difficulty created by this approach is that if Byrum had

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33. 278 U.S. 339 (1929).

34. 408 U.S. at ___, 92 S. Ct. at 2390.

35. Aside from *State Street*, *Old Colony*, and *Estate of King*, *see* United States v. Powell, 307 F.2d 821 (10th Cir. 1962). For consequences in the area of charitable deductions, *see* Greer v. United States, 448 F.2d 937 (4th Cir. 1971).

breached his duties, the minority stockholders or the corporation could sue, but the trust beneficiaries could not. It is not hard to imagine a case where Byrum's guidance of dividend policy would not offend any of the minority stockholders but would leave the trust beneficiaries gasping for breath.[36] The crux of the problem, then, is that the fiduciary restrictions on which the *Byrum* Court rested its decision do not pit the real adversaries (insofar as the trust is concerned) in a head to head context.[37] The rights of the beneficiares are considerably less meaningful where they cannot sue to enforce them.

The Court's attempt to distinguish away Byrum's power on the ground that it was not legally enforceable is a confusing smokescreen for the real rationale of the opinion. Byrum clearly had a legal right to do something (namely, to elect the directors); so also do those decedents who retain their rights by naming them specifically in a trust instrument. The real question ought to be whether what the decedent had a right to do had the effect of enabling him to shift the beneficial interests. Of course this question is not one that can be answered in black and white terms. Under the doctrine of *Jennings v. Smith*[38] the courts have examined a wide spectrum of fetters placed upon retained powers, and have been forced into making some rather close judgments. The same would be true of the *Byrum* Court's "legally enforceable" test. All retained powers would be legally enforceable in some direction; the question is whether their legal effect results in the decedent keeping a sufficient quantum of discretion to favor one beneficiary over another. The Court's test, therefore, serves mainly to muddy the water. What the decision really relied on was the fiduciary obligations and the business realities which surrounded Byrum; and here one gets into a closer question than the majority was willing to admit. As pointed out above in the discussion of 2036(a)(1), the courts have usually not allowed to pass untaxed those situations where the decedent's power was restrained by no more than a simple requirement that it be exercised in the "best interest" of the beneficiary.[39] The problem is, of course, that it is difficult to determine what is in one's best interest by any objective standard.

36. In closely held corporations, where the stockholders are frequently interwoven with management, they might well look to their salaries as the primary return on their investments, and be more or less unconcerned with the dividend policy.

37. In Biscoe v. United States, 148 F. Supp. 224, 226 (D. Mass. 1957), the court said that for purposes of determining whether a retained discretion is sufficiently limited to avoid inclusion in the estate, if the limiting "standard is lacking in the trust instrument it cannot be supplied from external circumstances." The *Byrum* decision has altered this holding.

38. *See* note 22 *supra*.

39. *See* authority cited note 23 *supra*.

In the case of a corporation, the standards become a bit more objective but it is common knowledge that minority stockholders don't win many suits to alter the dividend policy; the legal standards governing it are too broad.[40] The Court's argument that Byrum's power was sufficiently limited by external business factors was answered in the dissenting opinion by looking at the actual payment record to his children's trusts. During the first five years, while Byrum was living, the total income of the stock was $339.[41] In the sixth year, when Byrum died, $1,498 was paid. This evidence, while circumstantial, points to a greater freedom on Byrum's part than the Court's opinion suggests.

Conclusion

The overall effect of the *Byrum* decision is certainly to allow the owners of closely held interests to pass along the value of their holdings during their lives without giving up their control. It should also make estate planners breathe a little easier about the inclusion of broad administrative powers in the trust instrument.[42] From the point of view of legal development, however, the decision in several ways takes a form-over-substance approach to 2036, interpreting it more narrowly than a fair reading of legislative policy would properly allow. One has to wish that a more encompassing statement of the statute would be forthcoming from Congress to help avoid the guesswork that still tempers the planning of estates.

G. McGREGOR JORDAN, JR.

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40. The minority in *Byrum* points this out citing W. CARY, CASES AND MATERIALS ON CORPORATIONS 1587 (4th ed. 1969).

41. 408 U.S. at ____, 92 S. Ct. at 2398.

42. In drafting such powers one might feel apprehensive about the effects of section 2038 of the Internal Revenue Code, which were neither argued by the government nor mentioned by the Court in the *Byrum* case. However, Estate of King v. Commissioner, 37 T.C. 973, 981 (1962), so prominently cited by the *Byrum* decision, refused to apply section 2038 to tax property subject only to administrative powers. It seems likely, therefore, that the Supreme Court would follow suit. *See also* Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970).