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FEDERAL ESTATE TAXATION—SECTION 2036: *Shares of Stock of Closely Held Corporation Placed in an Irrevocable Inter Vivos Trust by Decedent Were Not Includible in His Estate, Even Though He Retained the Right to Vote the Shares Transferred*

INTRODUCTION

Omnipresent among federal estate tax statutes are elusive "key words and phrases" upon which much, if not all, estate planning is based.[1] Because federal estate tax law requires the decedent to have relinquished, during his life-time, "control" of property which he desires to be excluded from his estate for estate tax purposes[2] and because most clients would rather retain such "control," the estate planner is often confronted with various sections of the Internal Revenue Code of 1954, and in particular, section 2036.[3] Such was the case in *United States v. Byrum*.[4]

Milliken C. Byrum, who owned at least 71 percent of the stock of three closely held corporations, transferred *inter vivos* a portion of these shares to an irrevocable trust with his children, or their surviving children, as beneficiaries. The corporate trustee was vested with broad and detailed powers of control and management.

> These powers were exercisable in the trustee's sole discretion, *subject to certain rights reserved by Byrum:* (i) to vote the shares of unlisted stock held in the trust estate, (ii) to disapprove the sale or transfer of any trust assets, including

1. Interpretation of such phrases as "in contemplation of death" and "to the extent of interest therein," INT. REV. CODE OF 1954, §§ 2033 & 2035 respectively, has been refined in regulations and decisions thereto. That refinement process continues.
2. INT. REV. CODE OF 1954, § 2033.
3. INT. REV. CODE OF 1954, § 2036 provides:

> (a) GENERAL RULE. 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—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (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.

4. 408 U.S. 125 (1972).
5. *Id.* at 127 (emphasis added).

the shares transferred to the trusts, (iii) to approve investments and reinvestments, (iv) to remove the trustee and 'designate another corporate Trustee to serve as successor.'[5]

Included in the trustee's broad power was the authority to pay the income and corpus to the beneficiaries for education, care, maintenance and support. When the youngest child reached majority, the trust was to be terminated and the property transferred to separate trusts for each child. The separate trusts would terminate individually when each beneficiary reached the age of 35. Although Byrum owned at his death less than 50 percent of the shares in two of the corporations and 59 percent in the other, he still retained the right to vote 71 percent of the shares because of his reserved power to vote the shares held in trust.[6]

Because of the rights reserved by Byrum and the alleged control that he had over such property, the government contended "that the transferred stock was properly included within Byrum's gross estate under section 2036(a)."[7] Accordingly, the inclusion of these shares of stock which were excluded from the original estate tax return increased Byrum's estate and resulted in additional estate tax. After the executrix paid the additional tax, a suit for a tax refund was filed in the United States District Court for the Southern District of Ohio. The executrix was granted summary judgment[8] and the Sixth Circuit affirmed.[9] The United States Supreme Court granted the commissioner's petition for certiorari.[10]

SECTION 2036(a)(2)

Decedent's Ability to Establish Dividend Policy

The major contention of the Internal Revenue Service was that because the decedent allegedly had control over the dividend policy of the three corporations, he, in effect, could designate whether the present beneficiaries or the remaindermen would enjoy the earnings of the three companies. (The present beneficiaries and remaindermen would not be synonymous if a child of Byrum died before reaching 35 and final distribution of the trust property.) Hence, the

6. *Id.* at 128-29.
7. *Id.* at 130.
8. Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970).
9. Byrum v. United States, 440 F.2d 949 (6th Cir. 1971).
10. United States v. Byrum, 404 U.S. 937 (1971).
11. *See* note 3 *supra*.

government asserted that the stock was properly included in the decedent's gross estate under section 2036(a)(2).[11] To arrive at this conclusion, the commissioner reasoned that because the decedent had retained sufficient voting power to nominate his choice of directors, he could control the pay-out pattern of the earnings of the companies. And by controlling the dividend pattern, the government contended that the decedent could determine the amount of income available for immediate distribution to the present beneficiaries. This reasoning was rejected by the Supreme Court.

In similar situations, the Court had not held property includible merely because the decedent retained powers of management over the trust, provided that there were "ascertainable external standards" upon which the settlor-decedent was required to base the management policy of the trust.[12] The primary issue was, therefore, whether Byrum had unfettered discretion in voting the transferred shares or whether an "ascertainable external standard" restrained him from voting the transferred shares as he pleased. The Court held there was such a standard. In this determination, the Court necessarily distinguished the instant case from the government's principal case—*United States v. O'Malley*.[13]

The cases were distinguished on the basis of the nature of the retained control. Pursuant to the trust instrument, the decedent in *O'Malley*, as one of three co-trustees, was given a discretionary "right" to pay the trust income to the life beneficiary or accumulate the income for the benefit of the remaindermen. Because the *O'Malley* discretionary "right" brought that case within the purview of section 2036(a)(2), "the taxpayer conceded that the *original* assets transferred into the trust were includible."[14] However, the issue in *O'Malley* was whether the *accumulated* income was to be included. The Court held that it was includible under section 2036(a)(2) for the same reason for which the original assets were included. On the other hand, Byrum's retained authority over the transferred shares was of a different nature. While the "right" in *O'Malley* was legally enforceable under a provision in the trust, the "power" in *Byrum* was

12. The taxpayers in *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929), and *Estate of King v. Comm'r.*, 37 T.C. 973 (1962), successfully argued that "wide latitudes in the exercise of discretion" did not subject the trusts to federal estate tax.

13. 383 U.S. 627 (1966).

14. *Id.* at 632 (emphasis added).

> the power to use his majority position and influence over the corporate directors to 'regulate the flow of dividends' to the trust. [It] was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.[15]

That is, O'Malley's control was derived directly from the trust instrument itself whereas Byrum's control resulted from the mere fact that he was able to vote more than 50 percent of the outstanding stock of the companies.[16] Although the distinction might be tenuous, Justice White, for the dissent, merely expressed a belief that the cases were similar without any substantial justification for this belief.[17] In contrast, the majority opinion refused to equate the distinctly separate derivations of control. The Court has been consistent with this view in other estate tax cases. For example, in *United States v. Estate of Grace*[18] where the doctrine of reciprocal trusts was applied, the Court noted that the controlling factor was the *effect* of such transfer. "The taxability of a trust corpus does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer."[19]

Effects of Fiduciary Duty on 2036(a)(2)

The fundamental dilemma throughout both the majority and dissenting opinions was that of defining the nature and extent of the fiduciary duty of a majority stockholder. The Court's application of a fiduciary duty, although not novel,[20] shed new light in the area of estate planning. It is important to note that the majority assumed a literal interpretation of "fiduciary duty,"[21] in contrast to the dissenting opinion's subjective approach.[22] The fiduciary duty of a majority stockholder, as well as the corporate directors, was not redefined here. Rather, it was simply recognized. Numerous cases cited by the majority proved the establishment of a duty of responsibility

15. 408 U.S. at 136-37.
16. *Id.* at 138.
17. *Id.* at 157.
18. 395 U.S. 316 (1969).
19. *Id.* at 323.
20. The fiduciary duty concept has traditionally been applied in stockholder suits. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Botany Worsted Mills v. United States, 278 U.S. 282 (1929); Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955).
21. 408 U.S. at 142.
22. *Id.* at 158.

towards both the minority stockholders and the corporation itself.[23]

> He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to [its] detriment and in disregard of the standards of common decency and honesty. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.[24]

It is submitted that Justice White, for the dissent, was remiss in suggesting that this fiduciary duty had no truly "restraining effect." White reached this conclusion by noting that few defendants have been found guilty of breaching their fiduciary duty. But one need only consult an executive who has been confronted with the demands of the minority stockholders at corporate annual meetings to discover management's total awareness of its responsibility.

No problems in establishing a fiduciary duty arose in *Byrum* since he retained the right to vote more than 50 percent of the voting stock in each of the three corporations. However, the majority was aptly aware that the concepts of "control" and "controlling stockholder" were "too variable and imprecise to constitute the basis per se for imposing tax liability under § 2036(a)."[25] In those instances where a stockholder owns less than 50 percent, the concept of "control" of the corporation is nebulous.[26] For example, the voting configuration of a block of stock is important to determine "control" because of the many different types of voting rights. That is, one vote may not, in fact, be equal to another. The concentration of ownership, the size of the corporation and the number of stockholders also affect "control."[27] Consequently, the majority took the more practical approach by recognizing that "control" might in fact vary from case to case.

Analysis

Although not detrimental to the fiduciary argument, the major-

23. *See* note 20 *supra*.
24. 308 U.S. at 311.
25. 408 U.S. 138 n.13.
26. *Id.*
27. *Id. See, e.g.,* L. Loss, Securities Regulation 770-83 (1961).

ity opinion contains one flaw. Justice Powell suggested that the dividends were truly "subject to business and economic variables,"[28] notwithstanding Byrum's actual ability to declare a dividend should earnings arise. This is true; but any reference to economic variables is immaterial since the applicability of section 2036(a)(2) depends not on whether income is received, but rather on the ability to control such income should it arise.[29]

The dissent unsuccessfully attempted to discredit the majority's least important argument, namely, the reliance argument. The majority was hesitant to rule otherwise in *Byrum* because of the possible invalidation of hundreds of similar *inter vivos* trusts which, like *Byrum*, were prepared in reasonable reliance on *Reinecke v. Northern Trust Co.*[30] There, the settlor had retained "broad powers of management without adverse estate-tax consequences."[31] The dissenting opinion in *Byrum* noted a distinction in the kinds of control over income retained in *Reinecke* and those retained in *Byrum*. According to the dissent, the *Reinecke* trust gave the settlor *direct* control, whereas Byrum received only *indirect* control.

> By according himself power of control the trust income by an indirect means, [Byrum] kept himself quite free of a fiduciary obligation measured by an ascertainable standard in the trust agreement.[32]

This distinction is clearly without merit because for estate tax purposes, the estate of a particular decedent is viewed fairly only by considering the entire estate.[33] So was the case in *Byrum*. Establishing a fiduciary obligation in *Byrum* independent of the trust and by way of corporate responsibility was sufficient.

SECTION 2036(a)(1)

Alternatively, the commissioner argued for inclusion under section 2036(a)(1) because Byrum allegedly had retained the "enjoyment" of the property.[34] This "enjoyment" was based on Byrum's alleged control over the corporation whereby he had supposedly

28. 408 U.S. at 140.
29. *See* note 3 *supra*.
30. 278 U.S. 339 (1929).
31. 408 U.S. at 134.
32. *Id.* at 166.
33. United States v. Estate of Grace, 395 U.S. 316 (1969).
34. *See* note 3 *supra*.

"guaranteed himself continued employment and remuneration. . . ."[35]

Briefly, the majority argument was twofold. First, the Court determined by prior case law that "enjoyment" or "substantial present economic benefit" within the meaning of section 2036(a)(1) was limited to

> retention of an attribute of the property transferred—such as a right to income, use of the property itself, or a power of appointment with respect either to income or principal.[36]

Thus, since section 2036(a)(1) had never been applied to *Byrum*-type fact situations, the Court merely stated that the statute did not apply.[37] The dissenting opinion suggested a flaw in this reasoning by stating that the "plain language of the statute" was ignored.[38] Perhaps a more forceful counterargument to the majority's position is that the meaning of a statute should not be limited exclusively to prior application; otherwise statutes would never cover changing circumstances.

The second argument, although summarily treated in the majority opinion, is fundamental to the Court's holding. A determination that Byrum had absolute discretion in setting the compensation that he himself would receive annually as chief operating officer of the three corporations would have been necessary for the Court to have found that he had retained enjoyment under section 2036(a)(1). However, directors owe a duty to the corporation and shareholders to pay the officers and employees reasonable, and not excessive, compensation.

> It is clear that extraordinary, unusual and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having no substantial relation to the measure of their services and being utterly disproportioned to their value, are not in reality payments for services, and cannot be regarded as 'ordi-

35. 408 U.S. at 145.

36. *Id.* at 149. *See also* United States v. Estate of Grace, 395 U.S. 316 (1969); Lober v. United States, 346 U.S. 335 (1953); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Helvering v. Hallock, 309 U.S. 106 (1940); Guynn v. United States, 437 F.2d 1148 (4th Cir. 1971); McNichol v. Comm'r., 265 F.2d 667 (3d Cir. 1959).

37. 408 U.S. at 150.

38. *Id.* at 154.

nary and necessary expenses' within the meaning of the section.[39]

Therefore, the Court held that since Byrum was under a duty to pay himself only a reasonable salary, he did not retain a "substantial present economic benefit."[40]

The dissenting opinion further suggested that the benefits which Byrum had retained, *i.e.*, controlling shareholder status, would have "fetched a substantial premium" in the marketplace.[41] This analysis is only partially correct. First, Byrum was not legally capable of selling his retained right to vote the shares held in trust. Second, even if he could have sold them and received a premium, the minority opinion failed to recognize that the value of the premium when sold would have been offset by the liability of the fiduciary relationship while Byrum held the controlling interest.

CONCLUSION

The forerunner of section 2036 initiated the "postponed-possession-or-enjoyment" test.[42] With the passage of section 2036, settlors were severely restricted as to the types of transfers that would qualify for exclusion from the settlor's estate for estate tax purposes. However, today's capital structure has required a slight modification in applying section 2036 in order to tax equally estates with different types of investments. To afford equal treatment, different arrangements of capital holdings require different types of rules. Two trends are currently having an effect in this area of the law.

First, many occasions arise when the sole shareholder of a family corporation is unable to market his shares even though the book value is substantial. On the other hand, a doctor or another professional who has invested his wealth in equally valuable listed securities probably is holding more marketable assets. In the family cor-

39. 278 U.S. at 292.

40. 408 U.S. at 150.

41. *Id.* at 155.

42. Historically, from 1916 to 1930, the "postponed-possession-or-enjoyment" test was thought to encompass life estates. However, the test was severely restricted in *May v. Heiner*, 281 U.S. 238 (1930), where the decedent had retained a secondary life estate without having the property included. The *May* holding was enlarged the following year to primary life estates in *Burnet v. Northern Trust Co.*, 283 U.S. 782 (1931). The day after this decision was handed down by the Supreme Court, Congress passed what is now section 2036. *See* B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 1158 (4th ed. 1972).

poration situation, if the fiduciary duty concept is not accepted, any type of transfer short of total transfer of all stock and powers to an *inter vivos* trust would be included in the decedent's estate. However, the professional could create an irrevocable trust without the necessity of retaining voting rights for either one of two reasons. First, retention of the voting rights is usually not essential to his particular type of investments. Second, he is seldom the controlling stockholder.[43] Consequently, to equate the two cases, the Court has appropriately adopted the fiduciary duty concept to allow the family corporate executive similar treatment concerning *inter vivos* trusts.

Second, in some instances the opposite is true. That is, with the advent of key-man life insurance, a share of stock of a closely held corporation can be liquid.[44] It is liquid because at the death of the shareholder, his stock is redeemed or purchased with the insurance proceeds.[45] Accordingly, middle managers and senior executives of small companies have demanded, and received, equity in these corporations.[46] Moreover, executives of small corporations are now considering the once forbidden minority share in lieu of total cash compensation. As a result, competition has required many sole shareholders to relinquish part ownership in their corporations. But, since the viability of the small business enterprise is dependent upon the ability of the owners to run the business, notice must be taken of the importance of retaining the right to vote the stocks transferred. The courts, as in the case at bar, have recognized this new trend and are properly exercising their judicial power in protecting this ever-increasing class of minority stockholders by imposing and enforcing a fiduciary duty upon the majority shareholder. Consequently, the *Byrum* holding will enable the estate planner to utilize the *inter vivos* trust technique for the shareholder of a small company who deems it necessary to retain the right to vote the shares transferred, as well as for the doctor or professional with listed securities.

Because of the otherwise inequitable treatment, the Court recognized a certain flexibility in applying section 2036. Therefore, Justice White, for the dissent, may not have been totally incorrect

43. INT. REV. CODE OF 1954, § 2036. Thus, without controlling interest, the stockholder theoretically is incapable of determining dividend policy.

44. W. BOWE, ESTATE PLANNING AND TAXATION 368 (Chartered Life Underwriter ed. 1965).

45. *Id.* at 389.

46. *Id.* at 403.

in suggesting that if past precedent had been followed, the Court would have reached a different result. However, as in Darwin's theory of the survival of the fittest, so must the courts of justice adapt to changing circumstances in the modern economic context.