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## Estate Tax—"Possession or Enjoyment" under 2036—*O'Malley v. United States* (F. Supp. 1963)

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ESTATE TAX — "Possession or Enjoyment"  
under 2036 — *O'Malley v. United States* (F. Supp. 1963)

I. THE O'MALLEY FACTS

Decedent had placed three Wisconsin farms in irrevocable trusts, naming his daughters beneficiaries and himself and two others as trustees. Decedent had then orally leased, occupied and paid rent for these three farms. While occupying these farms as a tenant he placed and maintained improvements upon them. In determining decedent's estate tax liability, the Commissioner of Internal Revenue added to the gross estate the value of the farm improvements, relying upon the wording of section 2036 (a)<sup>1</sup> of the Internal Revenue Code which states:

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 . . . 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.

The question decided by the court<sup>2</sup> was whether the decedent maintained the "possession or enjoyment" of the farm improvements as contemplated by the statute. Judge Campbell, stated that, "[Decedent] did retain possession and enjoyment of the improvements for a period which did not end before his death, and accordingly I find the Commissioner properly included the improvements in his estate."<sup>3</sup> In other portions of the opinion the court held that the improvements would also be includable in decedent's gross estate because they were trade fixtures under Wisconsin law and removable by the tenant.<sup>4</sup> Even if the fixtures had not been removable from the land, it is likely that the property would have been subject to taxation because of decedent's power to pay or

<sup>1</sup>For convenience the references in the text are to 2036 which is the present statutory number. The case was decided under INT. REV. CODE of 1939, § 811(c) which is identical to 2036. The statutes prior to 1939 were INT. REV. CODE of 1932, § 830 (a) and INT. REV. CODE of 1926, § 302(c).

<sup>2</sup>*O'Malley v. United States*, 220 F.Supp. 30 (1963) (N.D. Ill. E.D.).

<sup>3</sup>*Id.* at 35.

<sup>4</sup>*Old Line Ins. Co. of America v. Hawn*, 225 Wis. 627, 275 N.W. 542 (1937).

accumulate income which had made the underlying land subject to taxation. The difficulty of the decision rests in the breadth and consequences of the argument advanced by the Commissioner and approved by the court.

## II. POSSIBLE EFFECTS OF THE O'MALLEY INTERPRETATION

With respect to income-producing property the clause of subsection 1 of section 2036 (a) which reads "the possession or enjoyment of, or the right to the income from, the property" can mean that the retained possession or enjoyment of any property is sufficient to tax it to the decedent's estate. It can also mean that when the property is income-producing (such as the farm improvements in the instant case) the decedent must retain the right to the income thereof before it will be included in his estate for tax purposes. Under the latter view, the retention of the income would be the exclusive requisite in the case of income-producing property. The possession or enjoyment of such property will not subject it to the estate tax. The effect of such an interpretation is far-reaching. If taxable the tax is not limited to the value of the retained interest. Section 2036 subjects the value of *all* transferred property, in which the transferor has retained possession or enjoyment, to the estate tax.

The holding of *O'Malley* that the retention of possession or enjoyment of income producing property is sufficient to tax the property to the decedent's estate under section 2036 may destroy the efficacy of some estate plans. For example, a father who conveys his farm to his children and then leases it back retains the possession and enjoyment of the land. Under *O'Malley* this may be sufficient to tax the farm to his estate.

Another possible plan which is foreclosed by the decision is where Husband conveys income producing property, such as a farm, to himself and Wife as tenants in common. Although Wife as a tenant in common has a right to one-half of the income, Husband has, at least, a non-exclusive right to possess and enjoy the property. Upon Husband's death, unless Husband must have retained the right to the income from the property before it can be included in his estate, Wife's half interest may be taxed to Husband's estate under the "possession or enjoyment" part of the statute.<sup>5</sup>

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<sup>5</sup> Professor Casner states that under this arrangement the transferor will not retain "possession or enjoyment" within the meaning of 2036 since his right to possession of the whole is subject to the transferee's right of partition. CASNER, *ESTATE PLANNING* 414 n.45 (3d ed. 1961).

Another potential trouble area is where a settlor creates an irrevocable trust of income producing property with an independent trustee, giving the trustee absolute discretion to pay the income from the trust to either the settlor, his children, or any other designated persons, with the corpus to go to the children or other beneficiaries upon the death of the settlor. The trustee then pays all the income to the settlor. The settlor has retained no right to the income, but has he retained the possession or enjoyment of the property since he actually received the benefits from it? If he has, then upon his death the corpus of the trust will be taxed to his estate even though the property was irrevocably transferred and the decedent retained only a possibility of receiving any of the income from it. A finding that the receipt of income from a trust is, in the absence of any prearrangement, retained possession or enjoyment within section 2036 raises the possibility that the settlor may be considered to have retained possession and enjoyment even if the trustee does in fact pay no income to the settlor. The trustee owes a duty to all trust beneficiaries. Granting that a trustee's duty concerning discretionary payments is only to make a reasonable exercise or non-exercise of the discretion,<sup>6</sup> it is possible that either the trustee's duty to act or the possibility of income itself could constitute retained "possession or enjoyment".

Certain estate plans dealing with family corporations may also be subject to attack under this section of the statute. A father, owner of a growing corporation, may wish to convey the growth to his children while keeping the corporate control and the present corporate worth for himself. He can do this by capitalizing the present worth of the corporation into voting-preferred shares, which he retains for himself, and giving common shares, with less voting power than the preferred (or none at all), to his children. Thus the father retains the control and management and also the present value of the company through his voting-preferred stock, while the growth of the company is absorbed by the common stock of the children. Upon his death, however, the common shares held by the children may be taxed to the father's estate if the father's retention of corporate management and control is found to be a retention of "possession or enjoyment" of the corporation.<sup>7</sup>

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<sup>6</sup> *Scully v. Scully*, 162 Neb. 368, 76 N.W.2d 239 (1956).

<sup>7</sup> A variation of this problem would occur where an owner of farm land would incorporate his farms and then give a portion of the shares to his children or others while retaining majority control for himself. This arrangement would enable him to retain possession and enjoyment of the land and at the same time allow him to make a present

### III. THE HISTORY OF "RIGHT TO INCOME"

The phrase "or the right to the income from, the property" has not always been included within the statute.<sup>8</sup> Prior to 1931 the statute stated that the property would be taxed to the decedent's estate "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. . . ."<sup>9</sup> In *May v. Heiner*<sup>10</sup> the Court held that the transfer of property in trust with a reservation of a life estate in the income thereof was not a transfer intended to take effect in possession or enjoyment at or after death within the meaning of section 2036.

The next year the Court decided *Burnet v. Northern Trust Co.*,<sup>11</sup> and two companion cases,<sup>12</sup> affirming, and in fact, extending, the rule of *May v. Heiner*<sup>13</sup> that a reservation of a life estate in the income of a trust by the settlor does not make the property taxable to the settlor's estate.

Congress responded to these decisions the next day by passing a joint resolution which amended the statute to tax transfers wherein the transferor retained a life estate in the income.<sup>14</sup> This resolu-

conveyance of part of the land. The question raised here is whether such retained possession and enjoyment along with any salary the donor might receive as manager of the land will subject that portion of the land represented by the transferred shares to the estate tax upon the donor's death. Under the present interpretations of 2036 such a result is possible.

<sup>8</sup> For a detailed history of this statute see LOWNDES & KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 80-98 (2d ed. 1962).

<sup>9</sup> Int. Rev. Code of 1926, § 302(c).

<sup>10</sup> 281 U.S. 238 (1930).

<sup>11</sup> 283 U.S. 782 (1931).

<sup>12</sup> *Morsman v. Burnet*, 283 U.S. 783 (1931); *McCormick v. Burnet*, 283 U.S. 784 (1931).

<sup>13</sup> In *Northern Trust*, *Morsman*, and *McCormick*, the decedent had reserved a direct life estate to himself, while in *May v. Heiner* the decedent had reserved a secondary life estate. Apparently the government thought that the Court might distinguish a direct reservation of a life estate from the secondary reservation in *Heiner* and uphold a tax upon the former. LOWNDES & KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 86 (2d ed. 1962).

<sup>14</sup> 46 Stat. 1516 (1931). With minor changes, the resolution was incorporated into law the following year. INT. REV. CODE of 1932, § 803(a). Note this is the same as § 2036.

tion was hurriedly enacted to close a very apparent loop-hole and therefore little Congressional discussion can be found indicating the legislative intent. However, the resolution was obviously passed in response to the four decisions discussed above and some Congressional intent can be inferred from this fact alone. At the time of the passage of the resolution, Congress knew that under *May v. Heiner* and subsequent cases the phrase "possession and enjoyment" did not reach retained life estates in the income of transferred property. The phrase "income from the property" was incorporated into the resolution to tax retained life estates in the income of transferred property which *May v. Heiner* had held were not covered by the "possession and enjoyment" language of the old statute. From these facts, one can reasonably find that the "possession and enjoyment" section of the statute was intended to cover transfers of non-income producing property, while the "right to the income" section was intended to cover transfers of income producing property. Although *Commissioner v. Church's Estate*<sup>15</sup> has overruled *May v. Heiner* the meaning of the statute is to be determined in light of the law in effect at the time the statute was enacted.

Furthermore, in 1949 Congress re-enacted 2036 with some minor amendments.<sup>16</sup> One of these amendments was in response to *Church's Estate*. Under it, the law reverts to what it was before *May v. Heiner* was overruled. Prior to this 1949 re-enactment, a conference committee was formed to settle differences between the House and Senate versions of the amendments. In a subsequently issued report this committee stated:<sup>17</sup>

The income interests described by section [2036] and by similar language elsewhere in the conference amendments include reserved rights to the income from transferred property and rights to possess or enjoy non-income-producing property. Such interests also include a reserved power to designate the persons who shall, during the decedent's life or during any lesser period described in section [2036], receive the income from transferred property or who shall, during any such period, possess or enjoy non-income-producing property.

This passage indicates that Congress recognized a distinction between income and non-income producing property at a time when it was amending and re-enacting the revenue statutes.

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<sup>15</sup> 335 U.S. 632 (1949).

<sup>16</sup> 63 Stat. 891 (1949).

<sup>17</sup> H.R. Rep. No. 1412 (Conf.), 81st Cong. 1st Sess., p. 11.

The regulations to section 2036 (a) (2) also seem to recognize this dictinction stating that:<sup>18</sup>

The phrase 'right . . . to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom' includes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy non-income-producing property, during the decedent's life or during any other period described in paragraph (a) of this section. . . . The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life.

However, the regulations to section 2036 (a) (1) agree with the interpretation given it by *O'Malley*:<sup>19</sup>

The 'use, possession, right to the income, or other enjoyment of the transferred property' is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.

#### IV. JUDICIAL REACTION TO "RIGHT TO INCOME"

The first case interpreting the phrase "possession or enjoyment" after the statute was amended by the joint resolution was *McNichol v. Commissioner*.<sup>20</sup> In this case decedent had conveyed income-producing real property to his children with an oral understanding that he would receive the rentals therefrom for the remainder of his life, which rentals he then actually received. The court held that this property was properly included in his estate for tax purposes, finding that "the right to income" included the actual receipt of income without any legal right to it. Since there was an oral agreement that decedent should retain a life estate in the rental income, the decision of the court in this regard was correct. However, the court also found that the decedent "enjoyed" the property within the meaning of the "possession or enjoyment" phrase.

*Skinner v. United States*<sup>21</sup> is in accord with *McNichol*. In *Skinner* the settlor of a trust gave the trustees absolute discretion whether to pay the settlor the income of the trust. The trustees

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<sup>18</sup> 26 C.F.R. § 20.2036-1 (b) (3) (1961).

<sup>19</sup> 26 C.F.R. § 20.2036-1 (b) (2) (1961).

<sup>20</sup> 265 F.2d 667 (3d Cir. 1959), *cert. denied*, 361 U.S. 829 (1959).

<sup>21</sup> 197 F. Supp. E.D.Pa. 726 (1961), *aff'd*, 316 F.2d 517 (3d Cir. 1963).

actually paid the settlor the income during her life and from this the court inferred an oral agreement to do so. In interpreting the statute the court stated:<sup>22</sup>

It can be easily seen that this statute states three alternatives under each one of which property may be included in the gross estate: (1) if the decedent retains the 'possession' of the property transferred or (2) 'enjoyment' of the property or (3) the 'right to the income' from the property.

It was concluded that the decedent had retained the "enjoyment" of the property.

Two years before *McNichol, Uhl v. Commissioner*<sup>23</sup> was determined under the "right to the income" language of section 2036. In this case, decedent had created an irrevocable trust, retaining the right to one hundred dollars monthly from the income. The trustee had uncontrolled discretion over all other income to pay more than one hundred dollars to decedent if it deemed it advisable. That part of the corpus necessary to produce one hundred dollars per month was included in decedent's estate. The remaining part of the corpus was excluded. The court held the decedent's possibility of receiving more than one hundred dollars was not a retention of a right to the income which would tax the property to his estate. *Uhl* differs from *McNichol* and *Skinner* only in the fact that the trustee under his discretionary powers did not pay *Uhl* any of the trust income. Since in both *McNichol* and *Skinner* the court found an oral agreement that the transferor should retain the income from the transferred property, the holdings that the properties were properly taxed to the decedent's estates are correct under the "right to the income" phrase of the statute. However, the holdings that the enjoyment of the income is the enjoyment intended by Congress under the "possession or enjoyment" section of the statute seems incorrect.

If in *McNichol* there had been no oral agreement and the children had voluntarily reconveyed the rental income to their father, it would seem an injustice to include the property in the father's estate upon his death. A similar injustice would occur in *Skinner* if the court found no agreement and the trustee had an absolute and unqualified discretion to pay the income to the settlor or not as he saw fit. In both cases, although the transferor has received the benefits and enjoyment of the property, he has not "retained the income." It has been voluntarily reconveyed to

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<sup>22</sup> *Id.* at 728.

<sup>23</sup> 241 F.2d 867 (7th Cir. 1957).

him by the transferee. This voluntary reconveyance of income to the transferor seems to provide him with a "possession or enjoyment" of the property that is entirely different from the "possession or enjoyment" intended by Congress to subject the property to the estate tax. As was correctly held in *Uhl*, only that part of the corpus necessary to produce income that the decedent has retained a right to, should be taxed to the decedent's estate under 2036.

## V. CONCLUSION

As of yet the courts have not been faced squarely with the question of whether in the case of income producing property, a retained "possession or enjoyment" is enough to tax it to one's estate under 2036. Thus far there has either been no transfer of the property in question or the courts have found a retention of the "right to the income." It is inevitable, however, that the issue will one day have to be faced. The answer is not clear, but in looking at the reasons for the joint resolution that amended the statute in 1931, and the later Congressional interpretation of the statute in the conference report of 1949, the balance is on the side of recognizing a distinction between income and non-income producing property.<sup>24</sup> On the other hand, the *dicta* propounded by the courts thus far seems to find no distinction between income and non-income producing property so far as the "possession or enjoyment" section of the statute is concerned.<sup>25</sup>

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<sup>24</sup> One commentator is of the definite opinion that where there is income-producing property there must be a retention of the right to the income before the property can be taxed to the decedent's estate. Covey, *Section 2036—The New Problem Child of the Federal Estate Tax*, 4 TAX COUNSELOR'S Q. 121, 122-31 (1960).

<sup>25</sup> Indicative of the expanding use of 2036 is the Commissioner's position that gifts of the family residence from a husband to his wife remain includable in his gross estate. See A. B. A. Bull. of the Section of Taxation, July 1964, p. 130. Formerly, the husband's continued residence in the home was not considered a retention of possession or enjoyment. See LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 141 (2d ed. 1962).