

2-1950

The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death

Charles L.B. Lowndes

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vlr>



Part of the [Property Law and Real Estate Commons](#), and the [Taxation-Federal Estate and Gift Commons](#)

Recommended Citation

Charles L.B. Lowndes, The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death, 3 *Vanderbilt Law Review* 203 (1950)

Available at: <https://scholarship.law.vanderbilt.edu/vlr/vol3/iss2/12>

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

THE CONSTITUTIONALITY OF THE NEW FEDERAL ESTATE TAX DEFINITION OF A TRANSFER TAKING EFFECT AT DEATH

CHARLES L. B. LOWNDES *

The manifest reluctance in recent years on the part of the Supreme Court to declare any provision of the Federal Estate Tax unconstitutional¹ may have given rise to the assumption that there are no constitutional limitations on the transfers which Congress can tax under the estate tax. One of the 1949 amendments to the tax should test the validity of this assumption. In an effort to bring some order out of the chaos stemming mediately from *Helvering v. Hallock*,² and immediately from *Spiegel's Estate v. Commissioner*,³ Congress provided recently that a transfer after October 7, 1949, shall be deemed to be a transfer taking effect at death, even though the transferor retains no interest in the property transferred, provided that "possession or enjoyment of the property can be obtained only by surviving the decedent."⁴

Apart from any constitutional problem, the new amendment is an interesting illustration of the tail wagging the dog. After the Supreme Court held in *Helvering v. Hallock*⁵ that a transfer with a "possibility of reverter" was taxable as a transfer taking effect in possession or enjoyment at or after death, considerable confusion developed as to the precise scope of that decision. In an attempt to define the limits of the *Hallock* case, the Treasury ruled that it only applied where in addition to the transferor reserving an interest in the property transferred "possession or enjoyment of the transferred interest can be obtained only by beneficiaries who survive the decedent."⁶ The recent amendment makes the limitation on the rule the principal basis for the application of the rule by providing that survivorship alone, without any retained interest, shall be sufficient to make a transfer after October 7, 1949, taxable. In this respect, it is unusual, but not unique. A parallel situation arose in connection with the 1942 Amendments dealing with the taxation of life insurance, where

* Acting Dean, Duke University School of Law; author of numerous articles in legal periodicals, especially in the field of Federal Taxation.

1. Compare *Heiner v. Donnan*, 285 U. S. 312, 52 Sup. Ct. 358, 76 L. Ed. 772 (1932), and *Nichols v. Coolidge*, 274 U. S. 531, 47 Sup. Ct. 710, 71 L. Ed. 1184 (1927), with *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85, 56 Sup. Ct. 70, 80 L. Ed. 62 (1935), *Helvering v. Bullard*, 303 U. S. 297, 58 Sup. Ct. 565, 82 L. Ed. 840 (1938), and *United States v. Jacobs*, 306 U. S. 363, 59 Sup. Ct. 551, 83 L. Ed. 763 (1939).

2. 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. 604 (1940).

3. 335 U. S. 701, 69 Sup. Ct. 301 (1949). See also *Commissioner v. Church's Estate*, 335 U. S. 632, 69 Sup. Ct. 322 (1949).

4. INT. REV. CODE § 811 (c) (3), as amended by Pub. L. No. 378, 81st Cong., 1st Sess. § 7 (Oct. 25, 1949).

5. 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. 604 (1940).

6. U. S. Treas. Reg. 105, § 81.17, as amended by T. D. 5512, 1946-1 CUM. BULL. 264 (May 1, 1946), and T. D. 5741 (Sept. 6, 1949).

the incidents of ownership and payment of premium tests, which had been developed in order to limit the tax on insurance payable to beneficiaries other than the estate of the insured, were transmuted into the principal bases of the tax.⁷

The immediate question is not, however, how the recent statutory definition of transfers taking effect at death evolved, but whether it is constitutional, since it represents a significant departure from the past philosophy of the estate tax. The estate tax is designed primarily to tax the transmission of property at death. Since a death tax which was limited to taxing testamentary and intestate transfers would invite avoidance by means of transfers which were living in form but testamentary in substance, Congress has surrounded the tax on testate and intestate succession with a protective periphery of taxes on inter vivos transfers which might be resorted to in lieu of a will. With certain significant exceptions, however, all of the inter vivos transfers taxed under the statute have the common characteristic that they involve the transfer of some sort of interest from the decedent at his death. Thus, for example, in the case of joint estates,⁸ although the property passes to the surviving tenant under a legal fiction of survivorship which treats title to the property as having been in the survivor since the beginning of the tenancy, there is actually a transfer of substantial benefits at the decedent's death. The same thing is true of a transfer with a reservation of a life estate.⁹ Although the remainder in legal contemplation vests completely during the decedent's life, there is a transfer of possession and enjoyment at his death. This is also true of a revocable or alterable trust.¹⁰ Although title to the trust property vests during the decedent's life, there is a further transfer at his death when the powers which he has retained lapse. In all of these cases the substance of the tax is a tax upon the transfer of some interest passing from the decedent at his death, irrespective of form. In the case of a gift in contemplation of death,¹¹ a tax may be imposed although the transferor divests himself of all interest in the property transferred during his

7. INT. REV. CODE § 811(g)(2). Since 1942 the statute has explicitly provided that insurance payable to beneficiaries other than the estate of the insured shall be taxable only if (A) the insured paid the premiums or (B) had incidents of ownership.

8. INT. REV. CODE § 811(e).

9. INT. REV. CODE § 811(c)(1)(B). Section 7 of Pub. L. No. 378, 81st Cong., 1st Sess. (Oct. 25, 1949), in addition to adding a new definition for transfers taking effect at death when such transfers occur after October 7, 1949, provides that transfers before October 8, 1949, shall not be taxable as transfers taking effect at death, unless the transferor reserved some reversionary interest which at the time of his death exceeds 5% of the value of the property transferred. It is interesting to note that in the case of transfers prior to October 8, 1949, there is no mention in the statute of any requirement of survivorship. Another interesting aspect of Pub. L. No. 378 is that sections 7 and 8 in effect overrule the recent Supreme Court decision of *Commissioner v. Church's Estate*, 335 U. S. 632, 69 Sup. Ct. 322 (1949), by providing that transfers with a reservation of a life estate, which were not taxable before that decision, shall not be taxed where the transferor dies prior to 1950 and that any such reserved life estate may be released without incurring any gift tax liability until 1951.

10. INT. REV. CODE § 811(d).

11. INT. REV. CODE § 811(c)(1)(A).

life. However, the lack of a testamentary transfer is supplied by the intention of the transferor to make a living transfer which will operate in lieu of testamentary transmission.¹² Even *Helvering v. Hallock*¹³ was predicated upon a transfer with a reservation of a "possibility of reverter" and involved a tax upon a transfer from the decedent at death. As long as the tax on insurance payable to beneficiaries other than the insured was qualified by the incidents-of-ownership doctrine, the tax was limited to the testamentary transfer involved in the lapse of such incidents at the death of the insured. The present statute taxing life insurance,¹⁴ which rejects the incidents-of-ownership limitation, involves a departure from the fundamental philosophy of the statute by taxing a transfer where nothing passes from the decedent at his death. The premium test, which imposes a tax even where the insured surrenders all interest in an insurance policy during his life, appears to base the tax upon enjoyment accruing to the beneficiary at the death of the insured, rather than the transfer of any interest from the insured at that time. The new provision for taxing transfers taking effect at death is not, therefore, the first break with the past philosophy of the tax. However, the Supreme Court has yet to pass upon the constitutionality of the present system of taxing life insurance. Moreover, even if the present system of taxing insurance is constitutional, there may be significant differences between the taxation of insurance and the recent definition of gifts taking effect at death.

The distinguishing characteristic of the new definition of transfers taking effect at death is that a tax is imposed even though nothing passes at death, provided that the enjoyment of the transferee is conditioned upon surviving the transferor. The only connection between the tax and the transferor's death is that his death is the temporal point which marks the beginning of the enjoyment of the transferee. Is this a sufficient connection to justify the imposition of an estate tax?

In passing upon the constitutionality of the provisions of the Federal Estate Tax concerning inter vivos transfers, the Supreme Court has developed several tests. Under the earlier cases it was held that the estate tax was limited constitutionally to testamentary transfers.¹⁵ The concept of a testamentary transfer apparently envisions the passage of some interest from the decedent at his death. Thus, for example, in *Reinecke v. Northern Trust Company*,¹⁶ the Supreme Court held that a transfer where a decedent had parted with all of his interest in the transferred property during his life was not taxable as a transfer taking effect at death merely because the enjoyment of the property shifted from one transferee to another at his death. It is true that in this

12. *Milliken v. United States*, 283 U. S. 15, 51 Sup. Ct. 324, 75 L. Ed. 809 (1931).

13. 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. 604 (1940).

14. INT. REV. CODE § 811(g)(2).

15. *Heiner v. Donnan*, 285 U. S. 312, 52 Sup. Ct. 358, 76 L. Ed. 772 (1932).

16. 278 U. S. 339, 49 Sup. Ct. 123, 73 L. Ed. 410 (1929).

case the Court was not dealing directly with constitutionality, but with construction. However, the Court pointed out that its conclusion upon the construction of the statute was dictated by the desire to avoid the grave constitutional doubts which would be raised by a contrary construction.¹⁷ It seems apparent that these constitutional doubts were generated by the feeling that there was no testamentary transfer when nothing passed from the transferor at his death.

Although it seems clear that the present statute could not pass the testamentary transfer test, this may not be material in view of the apparent rejection of this test in recent years in favor of a more liberal "penumbra" theory.¹⁸ Under the penumbra test an estate tax may be imposed upon an inter vivos transfer, if this is a reasonable method of preventing avoidance of the tax. The constitutionality of the recent amendment to the estate tax, therefore, seems to resolve itself into the question of whether or not the tax is a reasonable method of preventing avoidance of the estate tax. It is difficult to see that it is. Under the new definition of a transfer taking effect at death, if *A* conveys property to *T* in trust to accumulate the income during *A*'s life and at *A*'s death to distribute the property to *B*, the trust would be taxable. Or if *A* conveyed the property to *T* in trust to accumulate the income for 30 years or until *A*'s death and upon the happening of the earlier event to distribute the property to *B*, the trust property would be taxable to *A*'s estate provided he died before the 30 years expired.¹⁹ What type of tax avoidance is facilitated by these transfers over and above that which may be achieved by any ordinary inter vivos gift? If *A* gives property to *T* in trust for *B* and provides that the income is to be accumulated for a term of years so far in excess of *A*'s normal life expectancy that the property probably will not vest in enjoyment until after *A*'s death, this is not a taxable transfer.²⁰ Postponement of enjoyment until after the transferor's death does not make a transfer taxable as long as the enjoyment is not conditioned upon his death. It would seem

17. "Doubts of the constitutionality of the statute, if construed as contended by the government, would require us to adopt the construction, at least reasonably possible here, which would uphold the act." 278 U. S. at 348.

18. *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85, 56 Sup. Ct. 70, 80 L. Ed. 62 (1935); *Helvering v. Bullard*, 303 U. S. 297, 58 Sup. Ct. 565, 82 L. Ed. 840 (1938). The test is frequently referred to as the "penumbra" test in deference to a figure from the dissenting opinion of Mr. Justice Holmes in *Schlesinger v. Wisconsin*, 270 U. S. 230, 241, 46 Sup. Ct. 260, 70 L. Ed. 557 (1926), where, in arguing for the constitutionality of a conclusive presumption that gifts made within six years of a decedent's death were in contemplation of death, Holmes said: "But the law allows a penumbra to be embraced that goes beyond the outline of its object in order that the object may be secured." 270 U. S. at 241.

19. The amendment provides that a transfer after October 7, 1949, shall be deemed to be a transfer taking effect at death, where the possession or enjoyment of the transferee is conditioned upon surviving the transferor, or alternatively upon surviving the earlier to occur of the transferor's death or some other event, provided that the other event did not in fact occur during the transferor's life. The statute also provides that such transfers shall not be taxable if possession or enjoyment of the property can be obtained during the grantor's life by any beneficiary through the exercise of a taxable power of appointment. Pub. L. No. 378, 81st Cong., 1st Sess. § 7 (Oct. 25, 1949).

20. *Shukert v. Allen*, 273 U. S. 545, 47 Sup. Ct. 461, 71 L. Ed. 764 (1927).

apparent that the only way in which a man can avoid an estate tax by an *inter vivos* gift, apart from a transfer in contemplation of death,²¹ is to make a gift under which he keeps some strings on the property given away until his death. If he entirely divests himself of all interest in property during his life, it is difficult to see how such a transfer can be used successfully to avoid the estate tax. The recent amendment to the estate tax which is divorced entirely from the past philosophy of a transfer at the decedent's death certainly cannot be justified as a tax upon a testamentary transfer. It is scarcely easier to sustain as a reasonable prophylactic against tax avoidance.

The only provision of the estate tax bearing any close analogy to the recent amendment taxing transfers taking effect at death are the insurance provisions.²² Under the insurance provisions if a man pays the premiums on an insurance policy on his life payable to one other than his estate, the insurance will be taxed to his estate at his death, even though he completely divests himself of all incidents of ownership during his life. This involves taxing a transfer where nothing passes from the decedent at his death. Conceding for the moment that this provision is constitutional, which is certainly arguable, is the insurance situation distinguishable from the recent amendment taxing transfers taking effect at death? There are at least two possible distinctions.

Life insurance is inherently testamentary. If a man insures his life in favor of another and divests himself of all incidents of ownership in the insurance, his death is still necessary to complete the transfer. The death of the insured does more than merely mark the point at which the beneficiary's enjoyment of the insurance proceeds commences. New and greater rights are generated by the death of the insured. The contingent liability of the insurer becomes fixed and unconditional. The inchoate right of the beneficiary becomes consummate. Speaking on a purely pedestrian plane, an insurance policy is worth much more when the insured is dead than it is when he is living. The distinction between life insurance and a transfer of property with a provision for accumulating income until the transferor's death may be fine, but it is real and substantial.

There are, moreover, practical considerations which serve to distinguish life insurance from a transfer with a provision for accumulation until the decedent's death. Unless life insurance is taxed a real gap is left in the statute. As long as the incidents-of-ownership doctrine prevailed, it was possible for

21. It might be argued that a transfer with a provision for accumulating income until the transferor's death is a transfer in contemplation of death. However, if the transfer were actuated by a "life motive" such a desire to escape income taxes, or to shift the responsibility for managing a burdensome piece of property, it could probably escape taxation on this ground. At any rate the assumption behind the new statutory definition of a transfer taking effect at death seems to be that a transfer conditioned upon surviving the transferor is not necessarily taxable as a transfer in contemplation of death.

22. INT. REV. CODE § 811(g)(2); see note 7 *supra*.

a man to build up an unlimited tax-free estate by investing in life insurance and divesting himself of all incidents of ownership in the insurance. It is difficult to see that any similar opportunity for tax avoidance has been opened up by the past omission to tax inter vivos trusts with a provision for accumulating the income until the settlor's death. The new statutory definition of transfers taking effect at death may not be unconstitutional. However, it certainly goes to the very verge of the constitutional limits marked out by the precedents defining the permissible area for the taxation of inter vivos transfers under the Federal Estate Tax.