

3-1-2016

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Recommended Citation

Davidowitz, Ronni G. and Byer, Jonathan C. (2016) "United States v. Byrum: Too Good To Be True?," *ACTEC Law Journal*: Vol. 42: No. 1, Article 18.

Available at: <https://scholarlycommons.law.hofstra.edu/actecj/vol42/iss1/18>

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United States v. Byrum: Too Good To Be True?

Ronni G. Davidowitz and Jonathan C. Byer*

The Supreme Court decision in *United States v. Byrum*¹ has profoundly influenced the tax planning strategies of stockholders of closely-held corporations and other business entities who seek to retain control over such entities while simultaneously avoiding estate tax consequences. In *Byrum*, the value of shares of closely-held corporations transferred into an irrevocable trust where the settlor retained broad managerial powers, including the right to vote shares and veto sales of shares, was held not includable in the settlor-decedent's estate under section 2036(a).² Fearing the Court's reasoning created a "tax loophole" for taxpayers to avoid estate tax inclusion of shares of closely-held corporations contributed to trusts despite retaining control over such shares, Congress enacted various preventative "anti-*Byrum*" measures.³ Because these measures only addressed corporations, the subsequent popularity of family limited partnerships and similar vehicles allowed the Court's reasoning in *Byrum* to resonate with non-corporate entities. However, despite both taxpayers and the I.R.S. championing *Byrum* in these contexts,⁴ recent decisions have begun limiting its application.⁵

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¹ 408 U.S. 125 (1972).

² I.R.C. § 2036(a) provides, in pertinent part, that the value of the gross estate includes "the value of all property . . . of which the decedent has at any time made a transfer. . . under which he has retained for his life . . . (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."

³ These measures culminated in the adoption of I.R.C. § 2036(b), which provides, in subsection (1), "for purposes of subsection (a)(1), retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered a retention of the enjoyment of transferred property."

⁴ See, e.g., I.R.S. Tech. Adv. Mem. 91-31-006 (Aug. 2, 1991) (citing *Byrum* and concluding that partnership interests contributed to trust were not includable in settlor-decedent's estate because of fiduciary duty owed by settlor-general partner to other partners).

⁵ See, e.g., Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005) (stating that *Byrum* could not be used to support a ruling that fiduciary constraints preclude inclusion of family limited partnership

Milliken C. Byrum settled an irrevocable trust and contributed stock in three unlisted corporations of which he held majority interests. He retained the right to vote the stock, veto transfers of the stock, and remove and replace the trustee with another corporate trustee.⁶ After the funding, Mr. Byrum owned 59% of one corporation, and less than 50% of the others. The trust maintained a minority interest in each entity. Including his retained right to vote the transferred stock, Mr. Byrum could vote over 71% of the stock in each corporation.⁷ Accordingly, the Commissioner included the transferred stock in Mr. Byrum's gross estate under section 2036(a). Mr. Byrum's executor paid the tax deficiency and sought a refund.⁸

The issues before the Court were whether Mr. Byrum retained (1) the ability to impact the beneficiaries' enjoyment of income through broad managerial control and/or (2) "enjoyment" from the transferred stock such that the value of the transferred stock was includable in his estate under section 2036(a)(2) or section 2036(a)(1), respectively.

The government argued that Mr. Byrum's retained managerial powers were equivalent to a settlor's ability to either accumulate or distribute income under *United States v. O'Malley*,⁹ and thus constituted retention of the "right to designate the persons who shall enjoy the income from the transferred property" under section 2036(a)(2).¹⁰ Because Mr. Byrum could vote the majority of the stock and elect corporate directors, he could control corporate dividend policies, thereby regulating the income stream to the trust (potentially mooted the corporate trustee's discretion to distribute or accumulate income) and affecting beneficial enjoyment of trust income.¹¹ Additionally, if the trustee wanted to generate income by selling trust-owned stock, Mr. Byrum could veto the sale.

The Court observed that, under *Reinecke v. Northern Trust*, a settlor's retention of broad managerial powers does not mandate inclusion in his taxable estate under section 2036(a)(2).¹² As *Northern Trust* was not decided under section 2036(a)(2) or its predecessor, the Court likened Mr. Byrum's retained power to the settlor-retained powers in *Estate of King v. Commissioner*,¹³ where the Tax Court held the settlor's

assets under § 2036(a)(2) and that *Byrum* has no precedential force under § 6110(k)(3), hence "claimed reliance on [it or other determinations] is unavailing."

⁶ *United States v. Byrum*, 408 U.S. 125 (1972).

⁷ *Id.* at 128-29.

⁸ *Id.* at 130-31.

⁹ *Id.* at 132. (referencing *United States v. O'Malley*, 383 U.S. 627, 631 (1966)).

¹⁰ *Id.* at 131.

¹¹ *Id.* at 131-32.

¹² *Id.* at 132-33 (referencing *Reinecke v. N. Tr. Co.*, 278 U.S. 339 (1929)).

¹³ *Id.* at 134; *Estate of King v. Comm'r*, 37 T.C. 973, 980 (1962).

ability to direct trustee management and investment of trust assets did not constitute the power to designate the enjoyment of income under section 2036(a)(2).¹⁴ Without further explanation, the Court deemed Mr. Byrum's retained powers merely managerial in nature, equivalent to the settlor-retained powers in *Northern Trust* and *King*.¹⁵

Rejecting the government's argument that Mr. Byrum's control over corporate dividend policies constituted the right to designate enjoyment of income, the Court distinguished *O'Malley*, stating that "(1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, 'in conjunction' with others, to accumulate income and thereby 'to designate' the persons who enjoyed it."¹⁶ As used in section 2036(a)(2), "right" "connotes an ascertainable and legally enforceable power."¹⁷ Because the trust instrument did not authorize Mr. Byrum to designate who should receive trust income, the Court reasoned that his ability to influence the dividend stream to the trust was not an ascertainable or legally enforceable right.¹⁸

This logic illustrates the Court's narrow construction of section 2036(a)(2), focusing on finding a legally enforceable "right" under the trust instrument rather than adopting the broader interpretation of "power" mentioned throughout the regulations.¹⁹ Treasury Regulations make clear it is immaterial whether the power is exercisable by the decedent alone or in conjunction with others, and in what capacity the power was exercisable.²⁰ This broader interpretation would likely construe Mr. Byrum's control over the directors, and their combined control over corporate dividend policies, as a power warranting inclusion.

The Court also considered whether Mr. Byrum's status as majority shareholder created a de facto right to designate beneficial enjoyment of income. Rejecting this, the Court cited practical reasons why "typical small businesses" retain earnings rather than pay dividends.²¹ However, as Justice White's scathing dissent indicated, the corporations dramatically increased dividend payments after Mr. Byrum died, illustrating his control over excess capital.²²

Placing tremendous emphasis on the fiduciary duties owed to shareholders, and corporations themselves, the Court posited that if, in obey-

¹⁴ United States v. Byrum, 408 U.S. 125, 133-34 (1972).

¹⁵ *Id.* at 134.

¹⁶ *Id.* at 136.

¹⁷ *Id.*

¹⁸ *Id.* at 136-137.

¹⁹ Treas. Reg. § 20-2036-1(b)(3).

²⁰ *Id.*

²¹ United States v. Byrum, 408 U.S. 125, 138-40 (1972).

²² *Id.* at 152 (White, J., dissenting).

ing the will of a majority stockholder, corporate directors disregarded shareholders' interests by unreasonably accumulating earnings or unlawfully paying dividends, they could be vulnerable to derivative suit.²³ Yet, shareholders rarely win suits seeking to compel dividend distributions.²⁴ The Court concluded that, under section 2036(a)(2), Mr. Byrum lacked de facto power to regulate dividend payments to the trust, much less had a "right" to designate who enjoyed the income.²⁵

The government alternatively argued Mr. Byrum guaranteed himself continued gainful employment by retaining control over each entity and its directors, and retained possession and "enjoyment" of the transferred stock under section 2036(a)(1) by reserving the right to determine the continued status of the corporations.²⁶ Rejecting this, the Court stated that "'enjoy' and 'enjoyment,' as used in various tax statutes, 'are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates.'"²⁷ Mr. Byrum's power to liquidate or merge the corporations was deemed "speculative and contingent" rather than a present benefit.²⁸ The Court also made clear the statute "plainly contemplates retention of an attribute of the property transferred – such as a right to income [or] use of the property itself."²⁹ Here, Mr. Byrum transferred the stock, but did not retain any pecuniary benefit from it.

Citing the "free enterprise system," the Court found the probability of continued employment and compensation outside the scope of substantial enjoyment, noting that dominant stockholders of closely-held corporations often hold senior positions with input regarding their compensation.³⁰ Had Mr. Byrum paid himself an unreasonably large salary, minority stockholders could hold him accountable for breaching his fiduciary duty to act in the best interest of the corporation and its shareholders. Moreover, the Court noted that the I.R.S. indirectly polices this duty by disallowing the deduction of unreasonable compensation paid to executives as business expenses.³¹ Thus, the Court held Mr. Byrum's voting control did not constitute retention of enjoyment of transferred stock under section 2036(a)(1), since he irrevocably transferred title to the stock and the right to income therefrom.³²

²³ *Id.* at 141.

²⁴ *Id.* at 158 (White, J., dissenting).

²⁵ *Id.* at 143.

²⁶ *Id.* at 145.

²⁷ *Id.*

²⁸ *Id.* at 149-50.

²⁹ *Id.* at 149.

³⁰ *Id.* at 150.

³¹ *Id.*; see I.R.C. § 162(a)(1).

³² *United States v. Byrum*, 408 U.S. 125, 126 (1972).

The Court's analysis of section 2036(a)(1), however, overlooks *Commissioner v. Estate of Church*, where the Court illustrated that estate tax can only be avoided when a settlor fully transfers possession, title, and enjoyment of his property to trust, severing all possible control or attachment.³³ Justice White's dissent is persuasive that, despite Mr. Byrum's retained right to vote the stock, veto transfers, and control dividend policies, Mr. Byrum's asserted alienation does not meet this standard.³⁴

Policy reasons also shaped the Court's decision. Believing that *Northern Trust* was likely the basis for hundreds of inter-vivos trusts, and modifying this principle could adversely impact these settlors and their estates, the Court reasoned that Congress was better equipped to reexamine and define conduct that resulted in tax consequences.³⁵ Many thought the Court's interpretation of section 2036(a) in *Byrum* created a tax loophole for settlors to fund trusts with interests in closely-held corporations and retain managerial rights without having the value of the transferred interests included in their estates.³⁶ To combat this, Congress passed various "anti-*Byrum*" measures, culminating in the adoption of section 2036(b).³⁷ However, notwithstanding Congress' clear attempt to prevent further abuse of section 2036(a)(1), *section 2036(b)* could be easily avoided by transferring nonvoting shares into trust while retaining voting shares.

Unexpectedly, while Congress meant to overturn the effect of *Byrum* by limiting section 2036(a)(1), invoking *Byrum* to prevent inclusion under *section 2036(a)(2)* became increasingly popular. Indeed, one commentator noted that *Byrum* evolved to shield powers held by fiduciaries of business entities from section 2036(a) by claiming the fiduciary duty owed by majority stockholders to promote the best interest of the entity prevented the discretionary power over distribution policies from being a "right" to designate income.³⁸ Adopting language from *Byrum*, draftspersons began crafting documents specifically emphasizing the fiduciary duties incumbent on managers to avoid the application of section 2036(a)(2), which has been particularly useful for family limited partnerships. Because the transferor, as general partner, owes a fiduciary duty to the partnership and its partners, under *Byrum* his discretionary authority over distributions of partnership income is exempt from

³³ 335 U.S. 632, 645 (1949).

³⁴ *Byrum*, 408 U.S. at 151-52 (White, J., dissenting).

³⁵ *Id.* at 135.

³⁶ See Loran L. Laughlin, *United States v. Byrum: Logic or Loophole*, 12 J. FAM. L. 2, 293 (1972-1973).

³⁷ I.R.C. § 2036(b).

³⁸ Brant J. Hellwig, *Revisiting Byrum*, 23 VA. TAX REV. 275, 329, 354 (2003).

section 2036(a)(2).³⁹ However, with recent cases attacking family limited partnerships,⁴⁰ utilizing *Byrum* to prevent inclusion under section 2036(a) may be short-lived.

³⁹ *Id.* at 331.

⁴⁰ *See supra* note 5 and accompanying text.