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Inconsistent Taxation of Grantor Powers

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Inconsistent Taxation of Grantor Powers

"Certainty," Lord Hardwicke declared in 1753, "is the mother of repose and therefore the law aims at certainty."[1] This note will explore the extent to which the law has missed the mark of certainty[2] in the taxation of trust grantors.

The heavy burden of federal income and estate taxation has prompted many persons to divest themselves of property during their lives. The property is usually given to a relative in order to shift the income[3] from the property into a donee's lower tax bracket and to avoid the payment of an estate tax on the property by incurring an inter vivos gift tax[4] which is normally less than the estate tax would have been.[5] Many of these donative transfers of wealth are accomplished by the use of inter vivos trusts.[6] The irrevocable inter vivos trust[7] is the most common vehicle employed by trust grantors seeking the above objectives.

1. Gelhorn, *The Law's Response to the Demand for Both Stability and Change: The Legislative and Administrative Response,* 17 VAND. L. REV. 91 n.1 (1963).

2. See FEDERAL ESTATE AND GIFT TAXES—A PROPOSAL FOR INTEGRATION AND CORRELATION WITH THE INCOME TAX 2 (1947) [hereinafter cited as TREASURY STUDY]. This is a joint study prepared by an advisory committee to the Treasury Department and by the Office of the Tax Legislative Counsel, with the cooperation of the Director of the Division of Tax Research and the Bureau of Internal Revenue.

3. Unless the income is used to satisfy a legal obligation of support owed by the grantor. See INT. REV. CODE of 1954, § 677 [hereinafter cited as CODE] and text accompanying notes 20-26 *infra.* For an interesting discussion of the possible inclusion of a college education in the support obligation of a parent, see Note, 18 VAND. L. REV. 1400 (1965).

4. If the grantor can be kept alive for the three years necessary to prevent the Commissioner from contending that the transfer in trust was in contemplation of death. See CODE § 2035. This statement presumes that a completed gift will not be included in the estate of the grantor; however, the remainder of this note will deal with many situations where a transfer complete for income and gift tax purposes is, or may be, incomplete for estate tax purposes.

5. This tax saving is caused by the large differential between the gift tax and the estate tax rates. See Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance,* 60 COLUM. L. REV. 326 (1960). The unfairness of this situation to persons who cannot afford to give away their property during life is manifest. Even for the well-to-do salaried person there are problems in securing income producing property to place into a trust.

6. Modern wealth consists primarily of personal property; the donative distribution of this wealth is handled to a great extent by the age-old equity device—the trust. SCOTTS, TRUSTS § 1.7 (1960). Most trusts consist of income producing securities. *Id.* § 1.7, at 18.

7. An irrevocable inter vivos trust, as the term is used in this article, is a trust established during the life of the grantor which is not expressly subject to revocation by either the grantor alone or in conjunction with anyone else or by anyone else. Revocable trusts are not created for tax purposes since they neither relieve the grantor of income taxes nor remove the property from his estate. Also, the grantor will not retain any reversionary interests. Although a trust that could only be revoked by the grantor in conjunction with an adverse party within the meaning of § 672(a) of the Code would relieve the grantor of income taxes, such trusts are not effective for the

Normally the grantor of a trust will want to retain some control over the disposition and management of the trust property. It has become increasingly apparent that the grantor's retention of certain powers, although insufficient to cause the income to be taxed to the grantor, may prevent the transfer from being complete for other tax purposes or vice-versa. This article will attempt to point out and analyze some of the more common tax inconsistencies facing the grantor who retains various dispositive, administrative, or contingent powers.

I. General Background

It has been urged that such trusts are merely the product of a "nationwide adventure in tax avoidance."[8] This note, however, will proceed on the assumption that some types of trusts subject to retained powers in the grantor are proper elements in sensible family property planning.[9]

One can readily understand the reasons for the grantor's retention of any powers when he places the property in trust for the benefit of others. First, the uncertainty of future economic conditions and future needs of the trust beneficiaries makes it impossible and impractical to include in the trust instrument explicit directions for the resolution of every future contingency. Second, if discretionary powers concerning the use of the property in trust are necessary, then it is only normal for the grantor to want to control the exercise of such powers.[10]

Yet by incorporating this natural desire into the trust, the grantor runs two substantial risks: The unexpected inclusion of property in the grantor's estate may seriously upset the estate plan of a decedent since such property is usually unavailable to bear the additional tax burden. Also, if the grantor is unexpectedly liable for the income taxes due on the trust income, then he must meet this income tax

saving of estate taxes. See Code § 2038. Normally a grantor who plans with an eye toward the estate tax as well as the income tax will eschew any reversionary interests or revocatory powers whether vested or contingent. Hereinafter, whenever a trust is mentioned it is intended to refer only to an irrevocable inter vivos trust unless otherwise indicated.

8. Westfall, *supra* note 5.

9. Holland, Kennedy, Surrey, & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft*, 53 Colum. L. Rev. 316, 359 (1953). A leading authority on trusts recognizes that tax planning in the use of trusts is not unwarranted. Scott, *op. cit. supra* note 6, § 168.

10. The old adage "you can't take it with you" is indicative of this desire to hold on to property as long as you can. If, as often is the case, the property placed in trust consists of stocks in a family business, then the grantor obviously feels that he is the best one to determine how the stocks will be used. Also, the grantor usually feels best qualified to determine the financial needs of the beneficiaries. Some grantors are afraid that if they do not retain some control over the property then the beneficiaries will abandon them.

liability with other after tax dollars. The risk of these burdens might be sufficient to deter many grantors from establishing any trusts with retained powers. Unless Congress intended to discourage all such trusts, which seems unlikely since they are explicitly recognized by the Code in Subchapter J, the inconsistencies in present tax law should be uncovered, analyzed, and avoided if possible.

Although this article will discuss the possible tax consequences of various retained powers it must be remembered that a power need not be held by a grantor in order to cause adverse tax consequences to him. For example, a power to control beneficial enjoyment held by a non-adverse party will cause the grantor to be taxed on the trust income.[11] Equally important, however, is the fact that many powers sufficient to provoke adverse tax treatment of a grantor if held by the grantor are not attributed to him if held according to the rules of the various taxes by others.[12]

This discussion will center on the tax consequences of certain powers which are attributable to the grantor leaving the question to be answered elsewhere of when a power, held by another, is attributed to the grantor.

Before discussing the tax treatment of particular retained powers, a familiarity with the basic rules for taxing trust grantors under the federal income, gift, and estate taxes is necessary. Section 674(a) of the Code provides that for income tax purposes:

> The grantor shall be treated as the owner of any portion of a trust [created as a gift] in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor. . . .[13]

The remainder of section 674 sets out detailed provisions for certain powers which, although logically contained within section 674(a), do not cause the grantor to be taxed on the trust income.[14] The gift tax rules applicable to trust grantors are almost as explicit as the income tax rules; however, the gift tax provisions are contained primarily in the Treasury Regulations interpreting section 2511 of

11. CODE § 674(a).

12. For example, a power to control beneficial enjoyment when held by a trust beneficiary will not cause adverse tax treatment to the grantor. See CODE §§ 674(a), 2436(a), 2038(a).

13. CODE § 674(a).

14. The current statutory scheme for the income taxation of trust grantors seems to indicate that property owners should be allowed a large degree of flexibility in choosing the kinds of interests they may create by transfers in trust, without loss of the income tax benefits otherwise obtainable by immediate, absolute gifts. Westfall, *supra* note 5, at 332. See also Nance, *Taxation of Trust Income to Grantors and Others as Substantial Owners of the Property*, 33 TAXES 899, 904 (1955).

the Code. These rules appear to correlate with the income tax provisions of section 674.[15]

The major estate tax rules applicable to retained powers are contained in sections 2036 and 2038 of the Code. Under section 2036 if the grantor retains either "the possession or enjoyment of, or the right to the income from, the property. . . ."[16] transferred by gift into the trust or "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,"[17] then the entire property subject to such power will be included in the gross estate of the grantor. Section 2038, applicable to powers affecting the corpus of the trust rather than the income produced therefrom, provides in part that

> The value of all property . . . [transferred by the decedent for less than adequate consideration], where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, revoke, or terminate. . . .[18]

shall be included in the estate of the grantor. The majority of the inconsistencies are between the treatment of retained powers under the income and gift tax laws and their treatment under the estate tax.[19]

Trust powers are generally classified as either dispositive or administrative. Dispositive powers are expressly intended to affect the beneficial enjoyment of trust property; whereas, administrative powers are intended to facilitate the management of the trust in furtherance of the trust objectives. Accordingly, the discussion will first consider dispositive powers and then turn to administrative powers, concluding with a comment on contingent powers which may be either one of the other types of powers that are only exerciseable upon the happening of a particular event. It will further attempt to determine whether observable or potential inconsistencies are the product of the differing functions of the various taxes. If no policy or functional reasons can be found for these inconsistencies, then the law's quest for certainty and simplicity should be given effect by eliminating them.[20]

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15. The correlation of the gift tax with the income tax rather than with the estate tax would appear to be incongruous since the Supreme Court has stated that "the purpose of the gift tax is to complement the estate tax. . . ." Harris v. Commissioner, 340 U.S. 106, 107 (1950).
16. CODE § 2036(a)(1).
17. CODE § 2036(a)(2).
18. CODE § 2038(a)(1).
19. "Many of the powers that, by virtue of § 674(b), may be held by the grantor without income tax liability are sufficient to generate liability for estate tax." BITTKER, FEDERAL ESTATE AND GIFT TAXATION 974 n.2 (1958).
20. "While the differing functions of the income and estate tax levies, to tax the substance of present enjoyment of income on the one hand and to tax testamentary

II. Dispositive Powers

A. *A Power To Use Trust Income for the Support of a Legal Dependent of the Grantor*

A grantor can retain a power to apply trust income for the support of a legal dependent who is a beneficiary of the trust without being taxed on the trust income except to the extent that such income is actually applied to the support of the dependent beneficiary.[21] The grantor can achieve this favorable income tax treatment only if he holds the power as a trustee.[22] Property transferred to a trust subject to this power qualifies as a completed gift for gift tax purposes;[23] however, there seems little doubt that the trust property would also be included in the estate of the grantor under section 2036 of the Code.[24] Sections 2038 and 2041 would also cause estate tax inclusion; however, section 2036 would include a larger portion of the property.

Obviously this is an inconsistency. The mere existence of this discretionary power to use trust income to discharge a legal obligation of the grantor has no adverse income tax consequences and is considered insufficient to prevent the transfer of corpus from being a completed gift for gift tax purposes. The estate tax law views this situation differently since a right to have income applied to discharge a legal obligation is equivalent to a reservation of the right to the income.

Apparently, Congress wanted to allow trust grantors to make sure that their transfers in trust would not render them incapable of meet-

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and other death related transfers on the other, will preclude complete correlation, the general objective of using, so far as possible, the same set of rules on retained powers is certainly desirable." Pedrick, *Grantor Powers and Estate Taxation: The Ties that Bind,* 54 Nw. U.L. Rev. 527, 562 (1959).

21. Code §§ 674(b)(1), 677.

22. Code § 677(b); see Pedrick, *Familial Obligations and Federal Taxation: A Modest Suggestion,* 51 Nw. U.L. Rev. 53, 59 n.17 (1956).

23. See Treas. Regs. § 25.2511-2(b) (1958) [hereafter the citations to the estate and gift tax regulations will be for the year of 1958 unless otherwise indicated].

24. Since income of the trust used to satisfy the grantor's support obligation would be the equivalent of having the grantor receive the money the trust property might be taxed under § 2036(a)(1). Regardless of the applicability of § 2036(a)(1) to a grantor's discretionary power to apply trust income to a dependent beneficiary, § 2036(a)(2) would include any property subject to such a power since the power can affect the beneficiaries who will receive the income. According to the literal language of § 2036 it would make no difference under the estate tax rules if the grantor had released this power prior to his death and not in contemplation of death. To include property in the estate of a grantor when the grantor has relinquished his connections and control over the property prior to his death would appear to be an inappropriate use of § 2036. See Lowndes, *Some Doubts About the Use of Trusts To Avoid Estate Tax,* 47 Minn. L. Rev. 31, 34-35 (1962). In this article the author contends that contingent powers should not cause estate tax inclusion. Surely if a power contingent at death is not includable for estate tax purposes, then a power not existent at death should not cause inclusion.

ing their support obligations.[25] If such a power were not allowable under the income tax laws, then grantors who suffered financial reverses might find themselves faced with trusts which did not allow a diversion of the trust income to meet their support obligations. Since a transfer of trust income in satisfaction of a support obligation will not affect the corpus of the trust, there is no reason not to treat the transfer of corpus as a completed gift for gift tax purposes. In considering the estate tax consequences of this power it appears relatively clear that the inclusion of the trust corpus in the estate of the grantor is necessary to prevent evasion of the estate tax. If a person retains a right to use property or its income for his own benefit until he dies, then for all practical purposes he has made only a testamentary gift of the property regardless of when the technical legal interest in the property became vested. The American Law Institute proposal for the income, estate, and gift taxation of trust grantors recognizes the necessity for this inconsistent treatment in order to prevent evasion of the higher rates of the estate tax when this is clearly the type of transaction intended to be covered by the estate tax. Thus, this aspect of the current statutory treatment of trust grantor retaining this power was incorporated into the proposed revision.[26] Although inclusion of the entire property subject to this power may be administratively convenient, it is suggested that an evaluation procedure would be fairer and more appropriate if it is desirable to encourage grantors to retain such a power. Under the income tax only trust income actually applied to the support obligation is taxed to the grantor. There does not seem to be any reason why the estate tax could not be geared so as to include only part of the trust property.

Arguably if, as a trustee, a grantor's power so to apply trust income were subject to an ascertainable standard, then section 2036 would

25. The reader must remember that if the existence of a discretionary power causes a grantor to be taxed on the trust income subject to such a power, then this may be quite a hardship on the grantor since he is not receiving any of the trust income. Thus, he must take other funds, after tax dollars, to meet this additional tax. Obviously, most grantors cannot afford to retain a power which will cause them to incur adverse income tax consequences. See Holland, Kennedy, Surrey & Warren, *supra* note 9, at 359.

26. See American Law Institute, Federal Income, Estate, and Gift Tax Statute, § X2012, commentary at 198-99 (Tent. Draft 10, 1955) [hereinafter cited ALI, Tent. Draft No. 10].

Under the Treasury Study a transfer in trust subject to a power in the grantor to apply the trust income to the support of a legal dependent would not render the transfer incomplete for purposes of the integrated transfer tax; however, there would not be less tax due since under the integrated scheme all transfers are taxed on a cumulative basis with testamentary transfers being merely the last to be made under the same overall ascending rate. See Treasury Study 25. The income tax treatment of such a trust under the Treasury proposal would be the same as under the Code. See Treasury Study 33.

not cause the trust property to be included in the grantor's estate.[27] This argument is based on the assumption, called the *Jennings* doctrine, that so long as the standard is observed, the grantor lacks any discretionary power to shift enjoyment from one beneficiary to another, and that a fear of suit for breach of trust prevents the grantor-trustee from deviating from this standard. Both of these assumptions are probably unrealistic. Numerous cases, however, have held that a power exercisable by a grantor as trustee subject to a definite standard does not cause the trust property to be included in the grantor's estate.[28] There seems to be a strong possibility that a power to apply trust income for the benefit of a legal dependent of the grantor, which power is only exercisable in accordance with a definite standard, will not cause the corpus of the trust to be included in the grantor's estate.[29] It is submitted, however, that this power should no more be allowed under an estate tax which is intended to include property subject to a grantor's control than it would be allowed under the income tax rules in the absence of specific congressional authorization. Yet, as suggested earlier, it may be possible to bring the estate tax treatment of a trust subject to this power in line with the income tax treatment. If the estate tax inclusion were geared to the extent of the power to apply income in satisfaction of the grantor's legal obligation of support so that only a realistic portion of the property would be included in the estate, then there would exist some degree of symmetry between the taxes.

B. *A Power To Accumulate Income*

Often a grantor wishes to provide that trust income may be accumulated rather than distributed to the income beneficiaries. If this power to accumulate is attributable to the grantor, then the income tax provisions require, in order for the grantor to avoid being taxed on the income, that any income so accumulated be distributed ultimately to the current income beneficiary, or his estate, since he would have received the income but for the exercise of the power

27. See, *e.g.*, Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Estate of Wier, 17 T.C. 409 (1951); Estate of Wilson, 13 T.C. 869 (1949). See generally Pedrick, *The Artful Tax Dodger Faces Life and Looks at Death*, 28 TAXES 1151 (1950).

28. See note 27 *supra*. It could be contended that CODE § 2041(b)(1)(A) indicates a congressional recognition of the validity of the *Jennings* doctrine. The existence of CODE § 2041(b)(1)(A) may, however, indicate an intent to reject the applicability of the *Jennings* doctrine to retained powers which are taxed under §§ 2036 & 2038 since Congress could have explicitly incorporated the doctrine as it did for mere donated powers in § 2041(b)(1)(A).

29. ALI, Tent. Draft No. 10, commentary at 196. A grantor should not be greedy in listing the various contingencies since a court might view the situation as a retention of substantial control by the grantor if every possible contingency imaginable will allow the grantor to affect the beneficial enjoyment of the trust.

to accumulate.[30] Basically then, this power allows the enjoyment of the trust income to be postponed but not shifted except to the extent that the accumulated income will go to the estate of a current beneficiary who dies during a period of accumulation. The existence of this power will not prevent the transfer of the corpus in trust from being considered a completed gift.[31]

The Supreme Court in *Lober v. United States*[32] indicated that for estate tax purposes a power to determine when the trust income will be enjoyed gives the grantor a right to designate the persons who shall enjoy the income. The adverse treatment of this power appears to be the result of an overly technical application of section 2036(a)(2), although it has been contended that the existence of such a power in the grantor allows the actual enjoyment of the rights of the income beneficiaries to be postponed for the life of the grantor,[33] thereby making the trust arrangement testamentary in nature. "Such a power of accumulation, however, is very limited in scope since its operation as a method of adjusting beneficial enjoyment depends upon the untimely death of the current income beneficiary."[34] The preceding opinion of an advisory committee to the Treasury has been adopted by the American Law Institute;[35] consequently, both proposals allow a grantor to retain an accumulation power as described by the present income law without causing estate tax inclusion. Moreover, since the right of accumulation affects only the income produced by the trust and Congress has indicated its approval of the power for income tax purposes it is submitted that the *Lober* decision should not be applied so as to include in the estate of the grantor the corpus of a trust subject to this power.

30. CODE § 674(b)(6)(A) & (B). These subsections contain some special variations, but their main thrust is to assure that the grantor's power of accumulation will be used only to postpone, rather than shift, the receipt of trust benefits.

31. Treas. Reg. § 25.2511-2(d).

32. 346 U.S. 355 (1953). In this case, the grantor created trusts of which he was trustee. The beneficiaries were his children who, upon reaching 21, would receive any of the trust income accumulated by the grantor. The trust principal was to be distributed to the children or their heirs when the children reached or would have reached 25; however, the grantor retained a power to advance the principal to the children before they reached 25. Consequently, the Supreme Court held that the grantor's power as trustee, to either advance the principal to the children prior to their 25th birthday or require them to wait was sufficient cause for the principal to be included in his gross estate under the rationale of § 2038.

33. See Pedrick, *supra* note 20, at 547.

34. TREASURY STUDY 21.

35. ALI, Tent. Draft No. 10, 191. This proposal purports to adopt the rule that any transfer wherein the actual enjoyment of the corpus or income therefrom is or may be geared to the life of the grantor will be included in the grantor's estate; however, an exception is made for the situation when the only possible shifting of interests will be between the existing beneficiaries and their estates due to the grantor postponing the enjoyment of the trust property involved. See Pedrick, *supra* note 20, at 547 and accompanying footnotes for a criticism of this exception.

In order to be safe a grantor may desire to make the exercise of this power of accumulation subject to a standard containing sufficient contingencies designed to effectuate the grantor's intent. Accordingly, the *Jennings* doctrine would prevent such a power from causing estate tax inclusion; however, this highlights a further inconsistency in the taxes since a standard is not necessary for favorable treatment under the income or gift tax law.

This situation provoked a leading commentator to observe that:

> The estate tax is more stringent under the impact of the *Lober* decision with respect to powers to accelerate and postpone distributions of corpus and income, but more liberal than the income tax on the matter of actually switching beneficial interests in income and corpus under the *Jennings* doctrine.[36]

It is this writer's opinion that the *Lober* rationale constitutes a serious estate tax trap which should not exist when the income accumulation powers retained by the grantor are authorized by the income tax rules.

C. *Powers To Invade Corpus*

1. *Power To Distribute Corpus to Current Income Beneficiary—Chargeable Against Beneficiary's Share of Corpus.*—A discretionary power in a grantor-trustee to distribute the principal to a current income beneficiary is a neutral power for income tax purposes if the principal advanced must be charged against the proportionate share of the corpus held for that beneficiary, even though this power is subject to no standard.[37] Under the rationale of the *Lober* case the grantor would incur an estate tax on the corpus subject to such a power,[38] although for gift tax purposes the transfer of corpus would be complete.[39] It is difficult to see how a transfer to trust with the corpus subject to an unlimited invasionary power can be considered a completed gift unless the income beneficiaries are also the remaindermen.[40] Of course, if the invasionary power cannot benefit the grantor, then from his point of view he has made a completed gift.

36. *Id.* at 552.

37. CODE § 674(b)(5)(B).

38. Arguably, since a power to invade corpus cannot adversely affect the income interests, it is logical to assume that the estate tax would not include the full value of the property transferred, but would rather be limited to the value of the remainder interest. See Estate of Du Charme v. Commissioner, 164 F.2d 959 (6th Cir. 1947). However, since an invasionary power over corpus can increase the amount presently received by the income beneficiaries, it has been contended that the language of the Supreme Court in Estate of Holmes v. Commissioner, 326 U.S. 480 (1946), and in Lober v. United States, 346 U.S. 335 (1953), indicates that the full value of the property is includable in the grantor's gross estate. ALI, Tent. Draft No. 10, 191-92.

39. *Id.* at 192.

40. *Id.* at 182, 192.

Since the donees and/or their respective amounts are not presently ascertainable, however, it can be argued that no gift has been completed.

Regardless of the actual gift tax result there remain several estate tax problems. If the income beneficiaries also have the remainder interests, then an invasionary power is merely a way to accelerate enjoyment of the trust property. Clearly, if the remainder interests are not vested in the income beneficiaries, an invasionary power should cause at least the value of the remainder interest to be included in the grantor's estate.[41] The estate tax answers are not nearly so clear when the income beneficiaries are also the remaindermen. A transfer which made it absolutely certain that the remainder interests could not be obtained until the death of the grantor would not cause the trust property to be included in the grantor's estate. It would appear anamolous to hold that a power in the grantor to cause the property to pass prior to his death is sufficient to include the property subject to the power in his estate. The present law, however, does just this by virtue of section 2037 which allows the grantor to make his death the significant point in the passage of the trust property provided that he does not retain a five per cent reversionary interest.[42] The American Law Institute proposal would apparently allow a grantor to retain an unlimited invasionary power when the income beneficiaries or their estates are also the remaindermen, provided that invasions must be charged against appropriate corpus shares.[43] This is a more liberal approach than that taken by the Treasury study which would allow only a limited power of invasion, although even this obviously permits some continuation of control over the corpus.[44] Since a limited power probably means a power subject to a standard the Treasury proposal would appear to be the same as existing law.[45] Thus, unless saved by the *Jennings* standard, any retained discretion to accelerate the distribution of corpus to a current

41. *Id.* at 213 *ex.* (k).

42. It has been urged that any trust interests the enjoyment of which is only ascertainable with reference to the death of the grantor should be included in the estate of the grantor. See Pedrick, *supra* note 20, at 535 n.31. However, this is not the case under the present estate tax law. See Treas. Reg. § 20.2037-1(e).

43. See ALI, Tent. Draft No. 10 § X2012(a)(3)(B), commentary at 182. See also Pedrick, *supra* note 20, at 547, for a discussion of the allowance of a corpus invasionary power when the income and corpus beneficiaries are the same and the invasionary power is only exercisable in favor of the income beneficiaries.

44. TREASURY STUDY 21.

45. See Jennings v. Smith, *supra* note 27. *But see* TREASURY STUDY 177, App. B *ex.* 20, where it is indicated that an invasionary power subject to a standard might be incomplete. Although this observation may have preceded the *Jennings* case since they were both handed down in 1947, it is indicative of another possible inconsistency between the income and estate taxes.

income beneficiary who would ultimately take the corpus will cause inclusion of the corpus in the grantor's estate.[46] The dangers of estate tax avoidance created by this power, which is explicitly allowed under the present income tax laws,[47] do not appear substantial enough to warrant this inconsistency in tax consequences.

The income tax only requires that corpus advancements to income beneficiaries be chargeable against their proportionate shares of the corpus.[48] This will prevent a grantor from eliminating the income interest of one income beneficiary by advancing all of the corpus to another income beneficiary. This is a fine safeguard to prevent the grantor from shifting income interests. In cases where the remaindermen are not the income beneficiaries, however, a power to advance corpus to the income beneficiaries without any limiting standard allows the grantor during his life to retain a power to determine who will get the corpus. Accordingly, such a power should cause estate tax inclusion under existing rules. Possibly, the grantor should be deemed the substantial owner for income tax purposes;[49] however, Congress has specifically authorized this power. Until the income tax rule is changed inconsistent treatment of this invasionary power is inevitable.

2. *Power To Distribute Corpus Limited by a Reasonably Definite Standard.*—Section 674(b)(5)(A) presents another problem. This section allows a grantor to retain a power to distribute corpus to any income or corpus beneficiary without incurring any income tax liability on the trust income, provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument. Supposedly this power is not inconsistent with the policies of the income tax since it applies only to corpus, *i.e.*, the income interests are fixed and unalterable by the grantor.[50] However, there is a fallacy in this supposition since if all or, in fact, any of the corpus is distributed, this will affect the amount of income produced by the trust. To this extent a grantor does retain a power to shift the income interest within the confines of the reasonably definite standard.[51] This may be an indirect adoption of the *Jennings* doctrine under the income tax rules. Of course, it can be said that the presence of the standard

46. Pedrick, *supra* note 20, at 536.
47. CODE § 674(b)(5)(B).
48. *Ibid.*
49. This would appear unlikely if the power were geared exactly to the provisions of CODE § 674(b)(5)(B).
50. See Alexandre, *A Summary of the Treasury's Study on Integration and Correlation*, 25 TAXES 955, 957 (1947).
51. For examples of various standards see Pedrick, *supra* note 20, at 536 n.33. See also Fleming, *Best Interests as a Standard for Trustee Action*, 46 ILL. B.J. 764 (1958).

prevents the grantor from exercising any real personal control. Rather, the grantor is the mere ministerial agent of the trust instrument. This makes better reading than sense. As a practical matter the grantor has considerable discretion in applying a supposedly definite standard.[52] Also, who will challenge his action? Not the trust beneficiaries; they usually have fond inheritance hopes. Possibly a trustee, particularly a commercial trustee, might challenge a grantor's decision since a distribution of all of the corpus will stop his trust fees. Most commercial trustees, however, have visions of executorship and desire to retain a community reputation for harmonious relationships with trust grantors. Apparently, the retention of this power is not as compatible as previously supposed with the income tax policy of taxing grantors on the trust income which they substantially control.

Under the gift tax law the existence of this power would not render the transfer of corpus to the trust an incomplete gift.[53] Apparently, the estate tax rules would recognize the supposed innocuousness of a reasonably definite power to invade corpus.[54] It can be argued, however, that, in addition to the Alice in Wonderland attributes of a standard, the income tax rules themselves indicate that grantor powers over corpus should cause estate tax inclusion. The income tax rules do not allow a grantor to retain a power to distribute income among various beneficiaries, even if the power is limited by a standard. Accordingly, why should it be presumed that Congress intended to allow such a power over corpus under the provisions making powers over corpus a basis for estate tax inclusion? If Congress had intended to allow retained powers over corpus subject to a standard under section 2038 of the Code, then it could have easily incorporated the rationale of section 2041(b). Although, at present an invasionary power limited by a reasonably definite standard is allowable under the estate tax, the future is uncertain. The American Law Institute proposal recognizes that, although such a power can be allowed under the income tax rules, the reservation of such a power "effectively postpones the transferee's possession or enjoyment of the transferred property until the death of the transferor. . . ."[55] It is submitted

52. For an indication that the power to invade corpus for certain contingencies is largely within the trustee's discretion, see Westfall, *supra* note 5, at 341.

53. The Treasury Regulations under the gift tax require that the grantor hold the power as a trustee whereas the grantor may hold the power in any capacity under the income tax laws. See Treas. Reg. § 25.2511-2(c).

54. See Pedrick, *supra* note 20, at 536.

55. ALI, Tent. Draft No. 10, 182. *But see* TREASURY STUDY, where such a power is allowable without adverse tax consequences on the basis "that transferors should not be entirely precluded from attempting to meet the needs of changing circumstances. . . ." *Id.* at 21. Although the Treasury's proposal is usually stricter on the powers which a grantor can retain, this exception is understandable due to the integrated transfer tax. It makes no difference whether the transfer is taxed during life

that the retention of a power to invade corpus subject to a standard should cause inclusion of the corpus by the estate tax rules as long as there is a difference between the tax rate applied to inter vivos and testamentary transfers.

III. ADMINISTRATIVE POWERS

A. *Power To Allocate Receipts and Disbursements*

Although the power to determine whether receipts and disbursements should be allocated to the income or corpus interests of a trust is normally considered administrative,[56] the income tax provision allowing a grantor to retain this power[57] is not included in the section expressly applicable to administrative powers.[58] Undoubtedly, this power will enable the grantor to exercise some control over the income and corpus interests. In addition to the general trust law applicable to this power,[59] most states have statutes which provide for this allocation process; however, these rules are often very unsatisfactory due to vagueness or other uncertainties.[60] Even a severe critic of the current statutory scheme approves the inclusion of this power in the trust instrument as necessary to allow the trust to operate smoothly and with certainty.[61]

The gift tax laws appear to recognize the necessity for this power, but the gift tax regulations do not mention it expressly.[62] There appears to be some basis for an inference that the transfer will not be deemed a completed gift if the power to allocate receipts and disbursements is exercisable by the grantor in a non-fiduciary capacity without regard to a fixed standard.[63] It is reasonable to require that a grantor hold this power as a trustee because the allocation is normally considered to be part of trust administration. Also, the primary justification for the power is the assistance which it gives trustees. Nevertheless, by requiring that the power to allocate be subject to a fixed standard, the Treasury Regulations create some uncertainties. Do the normal trust laws provide a sufficient standard?

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or at death as far as the rates are concerned. So actually the rationale of the Treasury's position is a substantiation of the present income tax treatment, but is not really applicable to the gift and estate tax rules as long as there is a rate differential.

56. See SCOTT, *op. cit. supra* note 6, § 233.

57. CODE § 674(b)(8).

58. CODE § 675.

59. RESTATEMENT (SECOND), TRUSTS § 174 (1959).

60. Dunham, *A Trustee's Dilemma as to Principal and Income,* 26 U. CHI. L. REV. 405 (1959).

61. Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance,* 60 COLUM. L. REV. 326, 336 (1960).

62. Treas. Reg. § 25.2511-2.

63. Treas. Reg. § 25.2511-2(g).

Probably not; but it would seem a little impractical to spell out in the trust instrument how the trustee will make the necessary allocations. Furthermore, if a trust instrument standard is required for gift tax purposes, then trusts created within the framework of the income tax laws will not be considered completed gifts. Since the Treasury has succeeded in having many completed gifts included in the estate of the grantor it is not unlikely that the Treasury would successfully argue that transfers in trust which are not completed gifts should be included in the estate of the grantor.

The *Lober* decision makes it possible that a power of allocation will cause estate tax inclusion regardless of its gift tax consequences. Since a power to allocate will necessarily affect the corpus interest, section 2038 might require inclusion. Although the Commissioner might argue that section 2036 is applicable, it does not seem likely that a power to allocate, by itself, could be construed as a right to designate the persons who shall enjoy the income merely because the income interests would normally be affected slightly.

This entire discussion of the possible estate tax consequences of a power to allocate would be very tenuous except for the case of *State Street Trust Co. v. United States.*[64] This case involved several administrative powers held by the grantor as trustee, including the power to allocate receipts and disbursements.[65] Although the court in *State Street* emphasized that the cumulative effect of the various administrative powers retained by the grantor as trustee was to allow the grantor to determine what persons would possess or enjoy the property or the income therefrom, it is important to note that a literal application of *State Street* along the line of the *Clifford* rationale would require estate tax inclusion of untold numbers of trusts wherein the trustee had a power to allocate and this power was attributable to the grantor.[66] Accordingly, it is submitted that in most situations the possible inconsistent estate and income tax consequences of a power to allocate has no justifiable basis in logic or function.

B. *Power To Invest*

Most of the property transferred in trust consists of stocks or other securities. In such instance, a power in the trustee to change the trust property by buying and selling is generally considered indispensable in providing for efficient and economical administration of the trust and furtherance of the trust objeetives.[67]

64. 263 F.2d 635 (1st Cir. 1959).

65. See Kamanski & Spears, *Recent Development in the Taxation of Trusts*, U. So. Calif. 12th Inst. on Fed. Tax 567, 582 n.34 (1960).

66. ALI, Tent. Draft No. 10, at 177-79; Treasury Study 38.

67. Ritchie, Alford & Effland, Decedents' Estates and Trusts 319 (2d ed. 1961). In order to effectuate the trust objectives, the trust property must be of a nature

The income tax rules allow a grantor to retain a power over the investment of trust property if exercisable only as a fiduciary or with the consent of a fiduciary.[68] Apparently, a power over investment would not affect the gift taxation of a transfer in trust subject to such a power.[69]

It has been generally assumed that the estate tax treatment of an investment power was coordinated with the income tax; particularly since there are no estate tax provisions explicitly applicable to either an investment power or the broader category of administrative powers. Consequently, an investment power in the grantor could cause estate tax inclusion only under the sections dealing with powers either to alter or amend the beneficial enjoyment of corpus or to designate the persons to enjoy the income.[70] For a very long time it was thought that these sections did not reach powers of administration, such as a power to invest.[71]

Obviously, an investment in growth securities rather than high yield securities or vice-versa could affect the beneficial enjoyment of either the income beneficiaries or the remaindermen.[72] Realizing this, the court in *State Street*, when faced with an investment power not limited by the standards normally applied under state law,[73] refused to consider it as an innocuous power. Although, as mentioned earlier in the discussion of a power to allocate, it is difficult to determine exactly what weight the court gave to each of the administrative powers involved in the *State Street* case, it would appear probable that an investment power as broadly framed as that in *State Street* would be sufficient to incur estate tax inclusion under section 2038.

Estate tax inclusion would seem to be inconsistent with the express authorization of an investment power exercisable by a fiduciary under the income tax rules.[74] It has been suggested that this inconsistency is illusory since the rationale of the *State Street* case would apparently have allowed the grantor to be taxed on the income of the trust during his lifetime.[75] This suggestion, however, has not been judicially substantiated.

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which is equal to and harmonious with these objectives.

68. CODE § 675(4)(B).

69. See Tomlinson, *Advantages and Dangers of Trustee Powers*, N.Y.U. 20TH INST. ON FED. TAX 195, 204 n.34 (1962) and accompanying text.

70. CODE §§ 2036, 2038.

71. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). See generally MERTENS, FEDERAL ESTATE AND GIFT TAXATION §§ 25.08, .39 (1959); NOSSAMAN, TRUST ADMINISTRATION AND TAXATION § 38.11 (1958). *But see* Commissioner v. Hager's Estate, 173 F.2d 613 (3d Cir. 1949), a case foreshadowing *State Street Trust*.

72. The remainder interests could be wiped out by investing the trust assets in a rapidly wasting asset.

73. See Tomlinson, *supra* note 69, at 199.

74. CODE § 675(4)(B).

75. Kamanski & Spears, *supra* note 65, at 587.

Apparently, then a grantor-trustee who retains an investment power runs a risk of estate tax inclusion. Although the risk would appear to be slight in most cases, it does exist to plague the careful planner. Accordingly, it is suggested that the risk can be obviated by making the power of investment subject to an ascertainable standard. This standard could be inclusive enough to give the grantor the desired flexibility without creating any real risk of estate tax inclusion since the inclusion of an investment power not subject to any standard is a tenuous matter.[76] The necessity of an ascertainable standard to prevent estate tax inclusion would introduce a further inconsistency between the requirements of the income and gift tax rules and the estate tax rules since no standard is required under the applicable income and gift tax provision.[77]

It should also be noted that the income tax restrictions on the investment powers of a grantor are applicable only when the trust securities are of corporations in which "the holdings of the grantor and the trust are significant from the viewpoint of voting control."[78] The rationale of *State Street* would seem to apply to any investment powers. Although neither the American Law Institute's proposal nor the Treasury Study explicitly list an investment power as one of the indicia for estate tax inclusion, both would include in a decedent's estate any property upon which he was liable for income taxes at the time of his death.[79]

It is submitted that the income tax approach to the situation where a settler retains an investment power achieves a correct balance between economic realities and the desires of the grantor. When a grantor retains an investment control over what is, in effect, his closely held corporation, it is appropriate to require that this power be exercised as a fiduciary; otherwise, there has not been a significant relinquishment of the grantor's control. When, however, the trust property does not consist of stocks in his closely held corporation, there is less incentive or desire for an investment power to be used to perpetuate the grantor's control for his own benefit. Often the grantor will have great acumen in making investments which he will want to use for the benefit of the trust. The estate tax should not be applied so as to prevent the grantor from making his investment expertise available to the trust; otherwise, either the creation of trusts will be discouraged or the trust property will not be able to

76. Bittker, Federal Income, Estate and Gift Taxation 974 n.1 (2d ed. 1958).

77. Code § 675(4)(B); Treas. Reg. § 25.2511-2.

78. Code § 675(4)(B). The regulations do not indicate exactly what is meant by the term "significant from the viewpoint of voting control."

79. ALI, Tent. Draft. No. 10, § 2012, commentary at 177-79; Treasury Study 17.

flow freely in response to the economic demands of our free enterprise system.

There appears to be no real reason why a grantor should object to having the exercise of any investment power subject to a fiduciary standard or to the consent of a fiduciary. Accordingly, it is suggested that all investment powers retained by a grantor be exercisable only as a fiduciary or with the consent of a fiduciary. Investment powers not meeting this standard should cause income and estate tax inclusion. This approach would insure consistency between the taxes and prevent the troublesome question under the income tax rules of when an investment power may be exercisable by a grantor without being subject to a fiduciary standard or the consent of a fiduciary. Also, the business acumen of the grantor will be available to insure the proper mobility of the trust property.

C. *Power To Vote Trust Securities*

Obviously, if the securities transferred in trust are in a family corporation which the grantor has built up during his life, then the grantor will have a strong desire to retain control over the management of this corporation. Probably the grantor will consider himself the only person qualified to determine how the business is run. In this situation the income tax rules require that the grantor exercise any retained voting power as a fiduciary or with the consent of a fiduciary,[80] if the securities are in a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control. The rationale of *State Street* would apparently cause stocks subject to the grantor's voting control to be included in his estate since the grantor would be able to affect the declaration of dividends of the corporation and other aspects of its activities which, in turn, could affect the interests of the trust beneficiaries. The extent to which the grantor could actually affect the interests of the beneficiaries would appear to be very limited except in those cases explicitly dealt with under the income tax rules, *i.e.*, where the holdings of the trust and the grantor were significant. Thus, where the securities comprising the corpus of the trust do not either by themselves or in conjunction with other securities subject to the grantor's control constitute a significant voting interest in the corporation, there does not appear to be a basis for estate tax inclusion.

The recognition by the income tax rules that a retained power to vote securities which constitute a significant interest in a corporation will allow the grantor to exercise significant control over the trust property appears applicable under the estate tax rules of section

80. CODE § 675(4)(A).

2038. Although many commentators deprecate the effectiveness of a fiduciary standard in limiting the actions of a grantor, it is suggested that any voting powers which pass muster under the income tax rules should not cause inclusion under the estate tax. Moreover it is suggested that, as with investment powers, it would be better if the exercise of all voting powers were subject to a fiduciary standard.

IV. CONTINGENT POWERS

Contingent powers are not really a separate category of powers which a grantor may retain over a transfer in trust since either a dispositive or an administrative power may be contingent. Also, contingent powers closely resemble powers subject to an ascertainable standard since a contingent power arises only upon the happening of a particular event.

Normally, contingent powers, unless they fall prey to section 673[81] dealing with reversionary interests, will not cause the grantor to be taxed on the trust income.[82] Nor will they cause estate tax inclusion under section 2038 if not vested at the time of the grantor's death.[83] The Treasury has contended, however, that contingent powers can cause estate tax inclusion under section 2036(a)(2).[84] For example, if the grantor has a contingent power to appoint himself trustee, then the Treasury would consider this sufficient reason to attribute all of the trustee's powers to the grantor.[85] By attributing the trustee powers to the grantor the Treasury would render the trust property includible in his estate in many situations. Presently there has been no judicial recognition of the Treasury's position on contingent powers.[86]

It has been suggested that a recent revenue ruling bodes trouble for contingent grantor powers.[87] Under this ruling, a transfer in trust will not be considered a completed gift as long as the actual beneficial receipt by the donee remains subject to a power in an independent trustee to alter or amend the trust. The rationale of the ruling appears to be that the actual receipt by the donee is contingent upon the non-exercise of the trustee's power. Obviously this will create estate problems for the grantor of such a trust since if the transfer is not a gift, then the Treasury will surely contend that the property should

81. CODE § 673.
82. Section 674(A) refers only to powers held by the grantor.
83. Treas. Reg. § 20.2038-1(a)(3), (b).
84. Treas. Reg. § 20.2036-1(b)(3); see Lowndes, *Some Doubts About the Use of Trusts To Avoid Estate Tax,* 47 MINN. L. REV. 31 (1962).
85. See Treas. Reg. § 20.2036-1(b)(3).
86. See Lowndes, *supra* note 84, at 34-35.
87. Rev. Rul. 13, 1962-1 CUM. BULL. 181.

be included in the grantor's estate.[88]

Apart, however, from the implications of trustee powers, the contingency rationale of the revenue ruling may be applicable to contingent grantor powers. If the happening of the contingency would vest the grantor with a power to alter the beneficial enjoyment of the trust, then the transfer in trust may not be treated as a completed gift since the receipt by the donee will be subject to the grantor's control upon the happening of the particular contingency.

Since the existence of a vested power in a trustee which renders contingent the receipt of the remainder interests has not resulted in estate tax inclusion for the grantor, it may be unnecessary to worry about estate tax inclusion due to a contingent grantor power which, if vested, would make the actual receipt by the beneficiaries contingent upon the non-exercise of the power. The Treasury Study would apparently require income tax inclusion of property transferred subject to a contingent grantor power to revest the property in himself;[89] however, it is not clear whether a contingent power not exercisable in favor of the grantor would cause the same treatment.[90] Presumably there would be no difference. The estate tax problems of contingent powers and reversionary interests are not particularly acute under an integrated transfer tax since inter vivos gifts are not treated more favorably than testamentary gifts. The American Law Institute proposal,[91] which is much nearer to the present system of taxation, would not impose an income tax on a grantor who holds a contingent power. Nor would the existence of such a power cause estate tax inclusion unless the contingency were such that it made the grantor's death a significant event in the devolution of the property.[92]

It is suggested that no adverse tax consequences should flow from the existence of a power as long as it remains contingent except for estate tax purposes when the contingency is geared to the life of the grantor. Accordingly, unless the law changes rapidly in this area there does not appear to be any danger in the retention of contingent powers which are not geared to the life of the grantor so as to make the disposition appear to be testamentary. Even if the grantor's death were significant in the passage of the trust property there would not be, as pointed out earlier, any estate tax inclusion unless the grantor retained at least a five per cent reversionary interest.

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88. Otherwise, a grantor making such a transfer could escape any income, gift, or estate taxation. See Lowndes, *supra* note 84, at 49.

89. Treasury Study 32-33.

90. *Ibid.*

91. ALI, Tent. Draft No. 10, at 178.

92. *Id.* at 177-78.

V. Conclusion

The grantor must be careful in choosing the powers which he retains over property placed in a non-reversionary trust. The income tax rules are too liberal in their allowance of substantial dispositive powers. This liberality is probably due to their origin. The present income tax rules concerning the taxation of trust grantors were based on the Treasury Regulations promulgated in response to the *Clifford* case. Since the *Clifford* case involved a reversionary trust the regulations were geared to recognize the interest of the grantor in the trust corpus which was intended to return to him. Problems occur when the concepts embodied in these regulations are applied to trusts in which the grantor has no reversionary interest. The courts have often held, as noted earlier, that many of the grantor powers authorized by the income tax rules are inappropriate under the estate tax rules governing non-reversionary trusts. It is not unreasonable to assume that many grantors of non-reversionary trusts have been induced to retain substantial dispositive powers due to their explicit authorization in the income tax provisions. It is suggested that the income tax provisions should be amended to deal separately with reversionary and non-reversionary trusts. The income tax rules concerning non-reversionary trusts would then establish a narrower scope for retained grantor powers. A narrowing of the income tax rules would do much to promote consistency in the tax treatment accorded the grantors of non-reversionary trusts.

The estate tax treatment of administrative powers is probably out of line with the realities of life. Many grantors feel a strong desire and responsibility to continue the management of their wealth for the greater benefit of their loved ones. The few instances where a grantor misuses administrative powers should not cause all grantors to forego the administrative powers due to a fear of estate tax inclusion. If all administrative powers are held as a fiduciary, then the fiduciary obligations enforceable by equity should be sufficient to handle the exceptional case.

Contingent powers are a curious breed. Obviously, if the contingency is geared to the survivorship of a beneficiary or otherwise to the life of the grantor, then estate tax inclusion appears to be appropriate. A contingency unrelated to normal testamentary considerations should not cause adverse tax consequences unless the power vests prior to the death of the grantor.

Unless Congress accepts the very logical approach of the Treasury Study which eliminates the distinction between inter vivos and testamentary gifts and coordinates the substituted transfer tax with the income tax, trust grantors will continue to run the gauntlet of inconsistencies either through inadvertance or in quest of tax savings. A possible reason why Congress has been reluctant to adopt the Treasury Study is that the Study does remove a large part of the tax advantage attendant to inter vivos giving. Without this tax advantage people might hold on to their property until death, thereby removing enormous amounts of wealth from the flow of commerce and promoting the accumulation of wealth in a few hands. Obviously, society has a strong interest in avoiding these results. Unfortunately Congress has not been very interested in dealing positively with the problems presented in this note. Hopefully some of the more dangerous spots in the gauntlet of inconsistencies have been illuminated pending congressional reform.

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