6-1-1960

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presumption would support a conviction if the defendant failed to rebut it. In this manner the defendant would be convicted without actual proof of scienter. Further this provision is in conflict with the Supreme Court's holding in Speiser v. Randall which prohibits a state from shifting the burden of proof to the defendant when the crime charged involves a limitation placed upon freedom of speech. The analogy would seem clearly to be that the burden could not be shifted to the defendant when the statute involved a limitation placed upon freedom of the press. It is submitted that the legislature should reconsider this apparently unconstitutional provision.

CHARLES E. DAMERON III

Estate and Gift Taxation—Discretionary Trust—Grantor As Life Beneficiary

A useful and not uncommon trust arrangement is one that gives the trustee absolute discretion to pay income to the grantor or to accumulate it for the remaindermen. For additional flexibility a controllable power to invade principal is often lodged in the trustee to insure that the grantor will not be financially embarrassed should an unforeseen emergency arise. This Comment is concerned primarily with the federal estate tax consequences of such a trust although the basic gift tax consequences are developed as a corollary. Although it appears that the tax law affecting such trusts has not been definitively developed, trends in some areas seem clearly discernible. On the other hand, to the writer's surprise, many pertinent areas seem never to have been considered by the authorities.

For purposes of this Comment an inter vivos trust of the following basic outline will be assumed: the independent trustee has absolute discretion to pay income to the grantor for life or to accumulate; the trustee, pursuant to ascertainable external standards, is empowered to invade principal for the grantor's benefit; the grantor has no other interests in or power over the trust; the remaindermen must survive the grantor; the trust is governed by North Carolina law.

The problem is whether the interests reserved by the grantor will cause inclusion of the corpus in his gross estate by virtue of the incomplete inter vivos transfer sections of the Internal Revenue Code of 1954, chiefly sections 2036(a)(1) and 2037. Also to be considered are the steps that the grantor of such a trust might take to rid himself of the tax-risky interests.


E.g., "support, maintenance, and educational needs." It has been held that a state court determination of what is or is not an ascertainable standard is not binding in federal tax cases. Michigan Trust Co. v. Kavanagh, 137 F. Supp. 52 (E.D. Mich. 1955). Contra, Lowndes & Kramer, Federal Estate & Gift Taxes 198 (1956), declaring that it is a matter of local law.
I. Inclusion Under Section 2036(a)(1)—The Income Element

Tax Law

Does the discretion conferred upon the trustee by the grantor to pay the income to the grantor for life fall within the purview of section 2036(a)(1)? There seems to be only one appellate court case on this point, In re Estate of Uhl. There the decedent grantor had created a trust reserving the right to one hundred dollars a month of the income of the trust and it was conceded that the amount of the corpus necessary to produce this amount was includible in his gross estate. In addition, however, the trust provided: "[T]hat the trustee may in his discretion . . . pay a greater sum than One hundred dollars ($100.00) per month if it shall seem advisable . . . ." Such excess could be paid only out of income. The Commissioner contended that this amounted to a right to all the income from the entire corpus and accordingly sought to include the entire corpus in the gross estate. The propriety of this determination was the sole issue in the case. The Tax Court had held that the entire corpus was includible on the grounds that the decedent's creditors could have reached the full amount of the trust income and that the decedent could have obtained the enjoyment and economic benefit of the full income by the simple expedient of borrowing money and relegating the creditor to reimbursement from the trust. The Tax Court, however, so held without the benefit of any local (Indiana) law to the effect that creditors could reach the entire income where there was a vested remainder in third persons. The Court of Appeals reversed. It admitted that there were no cases in point under the federal estate tax law, but it considered the gift and estate tax laws in pari materia, at least on this matter, and looked to three gift tax cases for precedent: Herzog v. Commissioner, Rheinstrom v. Commissioner, and Ben F. Hazelton, Jr. In those cases the courts held that where income could be paid the grantor in the absolute discretion of the trustee, the donor retained no right to it and thus a completed gift was made. Accepting the conclusion that the grantor had no direct right to this discretionary income, the court in the Uhl case concluded that the corpus would not be includible.

“[T]he value of the gross estate shall include the value of all property . . . to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property . . . .” Int. Rev. Code of 1954, § 2036(a)(1). All references hereinafter to code sections are to the 1954 Internal Revenue Code.

Footnotes:
2 “The value of the gross estate shall include the value of all property . . . to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property . . . .” Int. Rev. Code of 1954, § 2036(a)(1). All references hereinafter to code sections are to the 1954 Internal Revenue Code.
3 241 F.2d 867 (7th Cir. 1957).
5 116 F.2d 591 (2d Cir. 1941).
6 105 F.2d 642 (8th Cir. 1939).
7 40 B.T.A. Memo 660 (1940).
in the gross estate. The Tax Court had not relied on the grantor's right to the income, however, but had based its decision on the right of decedent's creditors to obtain the full income. The Court of Appeals held that the Tax Court erred in construing Indiana law and reversed, concluding that the remainder of the corpus in excess of the amount necessary to produce one hundred dollars a month, being beyond decedent's control and subject to the trustee's uncontrolled discretion to divert income from it, passed to the remaindermen and accordingly was not includible in the grantor's estate.

The Tax Court in the *Uhl* case relied primarily on the case of *Alice Spaulding Paolozzi*. There the grantor created a trust whereby the trustees in their absolute discretion were to pay her the net income of the trust. The Massachusetts law which governed enabled creditors of a settlor-beneficiary of a discretionary trust to reach the maximum amount which the trustee could pay the beneficiary. The court reasoned that the grantor could obtain the enjoyment and economic benefit of the full income by incurring debts and relegating the creditors to reimbursement from the trust. Therefore the court held that the grantor had made a taxable gift of only the remainder of the corpus and that the full value of the life estate of a person of grantor's age should be deducted from the value of the trust.

A related case not mentioned by the Court of Appeals in *Uhl* is *Carolyn Peck Boardman*. There decedent created a trust whereby the trustees for the life of the grantor could distribute income and principal to her "as the Trustees deem necessary for her comfort, support and/or happiness." Practically all of the income was distributed to the grantor, and there were several distributions of principal. The Tax Court held the whole corpus includible in the decedent-grantor's gross estate. It said that the grantor intended that no one other than herself have the income so long as she lived. Moreover, the court concluded that the word "happiness" was so broad that the trustees could not have resisted her demand for the income. The inclusion was based on the predecessor of section 2036. It will be noted that the trust instrument provided a standard on which the trustee was to exercise his discre-

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8 The Court of Appeals did not repudiate the theory of the Tax Court, but, there being no Indiana case in point, it refused to find Indiana law against the taxpayer. The court in referring to the Tax Court's theory regarding creditor's rights did make one remark, which, with due respect to the court, seems questionable. It said, "Of course, such a right, if it existed, was the right of the creditors, not that of the grantor." 241 F.2d at 870. Obviously, this is true, but this right in the creditor directly gives the grantor full power and economic control over the income of the trust. As was said in *Corliss v. Bowers*, 281 U.S. 376, 378 (1930), "[T]axation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid."


10 20 T.C. 871 (1953).
tion—namely, the comfort, support and/or happiness of the grantor—which the grantor could enforce in equity.

Since the estate tax law on this point is evidently in pari materia with the gift tax law, review of the gift tax cases in this area is necessary. The Paolossi case has already been discussed.

In Rheinstrom v. Commissioner the question material was whether there was a gift of income which independent trustees could in their absolute discretion accumulate or pay over to the grantor for life. It was held that the grantor had retained no interest or control over the fund and thus a taxable gift was made. Creditors' rights were not mentioned.

Hersog v. Commissioner considered the question more thoroughly. There the independent trustee could pay income in his absolute discretion to either the grantor or his wife. The question was whether a gift tax was due and owing on the entire corpus or only on the value of the remainder. It was held that the grantor had retained no right to income, but had only a possibility that the trustee would allocate to him. The court doubted that the grantor or his creditors could, under New York law, reach any interest in the trust other than what the trustees in their absolute discretion elected to pay to the grantor, and the case was decided accordingly. Moreover, the court expressed doubt that an estate tax would be imposed on the grantor of this trust, saying that the grantor retained no right to income. Of course, the court admitted that the mere fact of gift tax liability does not preclude estate tax liability also.

Ben F. Hazelton, Jr. involved a trust whereby an advisory committee might in its absolute discretion direct the trustee to pay to the grantor income for his “suitable comfort and support and . . . general welfare . . . .” A gift tax deficiency was determined on the ground that the grantor had no right to the income. No mention was made of the possibility of the grantor’s creditors reaching the entire income.

The most recent gift tax case on this matter is Commissioner v. Vander Weele. Under the terms of a trust created by a young wife the independent trustees were to pay to the grantor income for her life “such reasonable and substantial portion of the entire net annual income of the entire trust estate as to the Trustees in their sole judgment and discretion shall deem desirable and ample for the comfortable well-being and enjoyment of the Donor . . . .” Moreover, the trustees in their sole judgment and discretion could invade principal and accumulate income to provide for the “comfortable well-being” of the grantor to the extent that they deemed “advisable.” The Tax Court held that no taxable

1105 F.2d 642 (8th Cir. 1939).
1116 F.2d 591 (2d Cir. 1941).
1240 B.T.A. Memo 660 (1940).
13254 F.2d 895 (6th Cir. 1958).
15
gift was made, relying exclusively on the Paolozzi case as to the income part of the trust. The Court of Appeals affirmed. It was settled under Michigan law, the controlling local law, that creditors of the beneficiary could reach all the income that the trustees could distribute to her, as well as principal if, as in this case, the trustee had power to distribute it. This, under the Paolozzi doctrine, would give the grantor the full economic benefit of the trust. Moreover, stress was laid on the understanding of the grantor and the trustees that the trust would be liberally construed to keep the grantor in funds for her accustomed standard of living. The court said that the Herzog and Uhl cases were “clearly distinguishable.” It would seem that the only satisfactory distinction between Vander Weele and the Herzog and Uhl cases is the established right of creditors to reach the entire income under local law. The right clearly existed in Vander Weele’s jurisdiction and was relied upon, whereas the courts in Herzog and Uhl doubted the existence of that right and decided accordingly. In Vander Weele the court stated in dictum that this trust “would have the tendency to preserve the property transferred in trust for estate-tax taxation.”

To summarize, it appears that while thoroughly definitive cases directly concerning estate tax consequences are lacking, it would seem safe to assume that the gift tax law is in harmony with the estate tax law in this area, so that with the gift tax cases, a few principles may be established. First, a pure discretionary trust, nothing else appearing, is a complete gift, Herzog, Rheinstrom, and Hazelton, and will not cause inclusion in gross estate, Uhl. Second, if the grantor can demand all of the income, the corpus will be cast into gross estate, Boardman. Third, if under local law the creditors of the grantor can reach all the income, no taxable gift is made except of the remainder, Paolozzi and Herzog, Rheinstrom, and Hazelton, respectively.

18 On the authority of Christiana K. Gramm, 17 T.C. 1063 (1951), the Tax Court held that such a broad invasion possibility resulted in no gift of the remainder.
17 254 F.2d at 898.
18 A helpful article is Covey, Power to Distribute to Grantor, 98 TRUSTS & ESTATES 322 (1959). There the author discusses the cases herein discussed. He concludes that the key to tax consequences of absolute discretionary trusts for the grantor is the right of creditors under local law to reach the entire income. It is on this ground alone that he explains the different results in the recent cases of Uhl and Vander Weele. Concern is expressed over the evident tendency of the courts, as, for instance, in Vander Weele, to look at the extrinsic facts in determining the tax consequences in this area. Obviously this presents difficulties to the estate planner in that how facts might be subsequently construed by a court is impossible to predict. However, the author concludes that the cases furnish a consistent test—namely, whether or not creditors can reach the funds.
19 On this point it seems that the same transfer concept is being developed by the courts so that properly laid gift or estate taxes will be mutually exclusive of one another. Covey, supra note 18, at 326. However, this principle seems inapplicable in regard to §§ 2037 and 2038. See discussion in notes 47 and 71 infra.
20 See also Treas. Reg. § 25.2511-2(b) (1958) which seems to be in accord. All references hereafter to regulation sections are to the current regulations under the 1954 Internal Revenue Code.
Vander Weele, and by implication corpus will be includible in gross estate, Vander Weel and Uhl (Tax Court version). Fourth, it seems that, if in fact the grantor intended to get all the income, inclusion in gross estate may occur. Boardman and Vander Weele. Thus tax consequences turn on factors depending in large degree upon the governing trust law in the local jurisdiction.

**Trust Law**

There seems to be no North Carolina case involving a discretionary trust where the grantor is the sole life beneficiary. In the case of Carter v. Young testator's testamentary trust directed semi-annual payments to "my . . . wife for the use (in such proportions and in such manner as she herself may decide) of herself and of my grandson . . . ." After making a few small allotments to the grandchild the wife ceased and declared that she did not intend to make further apportionments. Suit was brought on behalf of the minor grandchild alleging his need and the wife’s abuse of discretion. The court held that the wife's refusal to exercise the discretionary power was a breach of trust, defeating the intent of the settlor and damaging the grandson. If thereafter she failed to exercise her discretion fairly and equitably the court indicated that it would do so. Just how broadly the court will hereafter apply the Carter case remains to be seen. But the import of it seems to be that unless the settlor has expressly authorized his trustee to pay nothing, the beneficiary has a cause of action in equity based on abuse of discretion if the trustee wholly withholds distribution of income. There seems to be no reason why this right would not be extended to the settlor-beneficiary. Note that the settlor in Carter had not used terms such as "uncontrolled" or "absolute" in describing the trustee's discretion. Consequently the court construed the trust as one discretionary only as to when and in what "reasonable" amounts distribution should be made. The trust herein considered, being absolutely discretionary, of a different sort.

There seems to be no North Carolina case dealing with the rights of a settlor's creditors against a discretionary trust for his benefit. In

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21 Reversed on other grounds by the Court of Appeals.
22 193 N.C. 678, 137 S.E. 875 (1927). Compare Woodard v. Mordecai, 234 N.C. 463, 67 S.E.2d 639 (1951), where the refusal of a trustee in good faith to invade principal as he had discretion to do was held not to be an abuse of discretion.
23 After exhaustion of such interests of the judgment debtor as are subject to execution, a remedy against his equitable interests is provided by N.C. GEN. STAT. §§1-352 to -368 (1953). No provision, however, expressly relates to the rights of a creditor against a discretionary trust created by the debtor for his own benefit. As to whether the creditor's bill has been supplanted by the statutory remedy, see Note, 35 N.C.L. REV. 414 (1957).
24 Cf. Bank of Union v. Heath, 187 N.C. 54, 121 S.E. 24 (1924), holding that creditors could reach the whole interest of beneficiaries of a testamentary trust where the trustees had discretion to postpone payment of principal, at least where
Pilkington v. West, involving a non-discretionary trust, the settlor-life beneficiary had provided that the trustee should hold for her sole use and benefit "wholly free from interference, debts and liabilities ... ." The Supreme Court said: "[O]ne cannot remove his property from liability for his debts or restrict his right of alienation by a conveyance to a trustee for the sole use and benefit of the owner, grantor."26 The reference to creditors must be regarded as dictum since no creditor was claiming rights in the property. One may question whether these terms purport to restrain alienation, but if the court so construed them the statement is a holding since the right to alienate was the issue in the case. Among others, the court cited as authority for the above quotation Scott on Trusts,27 which points out that even where spendthrift trusts are valid one in favor of the grantor is ineffectual, and the grantor can assign his interest in the income and principal and his creditors can reach it. It is against public policy to permit the owner of property to create for his own benefit an interest in that property which cannot be reached by his creditors.

Scott also deals with discretionary trusts for the settlor,28 stating the rule to be that where the settlor creates a discretionary trust of which he is himself a beneficiary, his creditors can reach his interest, even though the trustee in the exercise of his discretion chooses to pay nothing. Scott is supported by the weight of authority.29 The Restatement of Trusts (Second), section 156(2) provides: "Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."

However, in Herzog v. Commissioner30 the court refused to follow the Restatement, there being no controlling New York case, because the grantor was not the sole beneficiary, a factor which in Greenwich Trust Co. v. Tyson31 was held not to alter the result. Also, it will be noted that the Court of Appeals in Uhl did not hold that the creditors could not reach the income, but relied on the absence of Indiana authority to the effect that they could.

there is no gift over. This is in accord with the general rule. II Scott, Trusts § 155 (2d ed. 1956).

27 Id. at 580, 99 S.E.2d at 802.
28 II Scott, Trusts § 156 (2d ed. 1956).
29 II id. § 156.2.
30 E.g., Greenwich Trust Co. v. Tyson, 129 Conn. 211, 27 A.2d 166 (1942); Ware v. Gulda, 331 Mass. 68, 117 N.E.2d 137 (1954); Petty v. Moores Brook Sanitarium, 110 Va. 815, 67 S.E. 355 (1910); see P-H Wills, Trusts & Estates §§ 3735; Griswold, Spendthrift Trust: § 461 (1947). But see Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941), which involved alternative beneficiaries, and In re Uhl's Estate, 241 F.2d 867 (7th Cir. 1957), wherein the court refused to find local law in accord with the general rule.
31 116 F.2d 591 (2d Cir. 1941).
32 129 Conn. 211, 27 A.2d 166 (1942).
In the instant problem it is most difficult to determine what the tax consequences are as long as the state rule is not settled. As was noted earlier, the federal courts in *Uhl* and *Herzog* refused to hold against the taxpayer when the tax consequences depended on local law and the particular jurisdiction had not ruled on the crucial point. It would be a gamble in the instant problem to assume that such favorable treatment would ensue in tax litigation over such a trust in North Carolina. Federal courts are often put in the position of deciding a state law question that has not been ruled upon by the state courts. In such event the federal court adopts the rule which it believes, using all available indicia, the state court would adopt. Considering the policy behind the general rule, together with the dictum in *Pilkington*, it is hard to imagine that a federal court would not conclude that the North Carolina law is in accord with the general rule.

II. Inclusion Under Section 2037—The Invasion Possibility

Recall that in the inter vivos trust under consideration the trustee pursuant to ascertainable standards is empowered to invade principal for the grantor. Will this cause inclusion in the grantor’s estate under section 2037? Of course, if inclusion of the corpus is caused by one code section the applicability of another is, as a practical matter, immaterial. However, section 2037 should be considered here for at least two reasons: first, a court considering the matters might not hold in accord with the conclusion reached above in regard to the income element; and second, should the grantor successfully dispose of the income element, the invasion element would then be the Commissioner’s only ground for levying an estate tax.

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33 "The obligation of a federal court to accept local law extends not merely to definitive decisions, but to considered dicta as well, and if explicit pronouncements are wanting, the federal court should endeavor to discover the law of the state on the point at issue by considering related decisions, analogies, and any reliable data tending convincingly to show what the state rules is." Id. at p. 3312.
34 "Where the applicable state law will directly determine tax liability there is a distinct burden on the proponent to satisfy the court that the state law, as construed in connection with the terms of any instrument of transfer involved, does in fact support his thesis." 1 *Mertens, Federal Gift & Estate Taxation* § 10.04 at 610 (1959) [hereinafter cited as *Mertens*].
35 Section 2037(a) provides: "The value of gross estate shall include the value of all property . . . to the extent of any interest therein of which the decedent has . . . made a transfer . . . by trust or otherwise, if —
   (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and
   (2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 per cent of the value of such property.”
36 Consideration herein of § 2038 is not deemed necessary. Even if a right to compel invasion constitutes a power to terminate, revoke or alter within the meaning of § 2038, it appears that the same right is a § 2037 reversionary interest. 3
The trust being considered herein requires that the remaindermen survive the grantor. The first question is, therefore, whether the power of invasion subject to "fixed," "external" standards lodged in the trustee amounts to a reversionary interest within the meaning of section 2037. The cases hold that it does.

The leading case on the point seems to be *Blunt v. Kelly*. The trust instrument provided: "Should in their opinion the necessity arise, the Trustees are hereby empowered to use such portion of the principal of the trust fund as may seem proper for the support, care or benefit of . . . [the grantor]." The question was whether the corpus was includible in the grantor's gross estate under the forerunner of the present section 2037. The court held that the trustees were not free to make an uncontrolled decision regarding invasion, but were bound to exercise their discretion in good faith pursuant to the standards specified and were subject to control of a court of equity if they failed to do so. Accordingly the court concluded that since the necessity of invasion might arise so long as the grantor lived the transfer was intended to take effect in enjoyment after death and was thus includible.

In *Commissioner v. Irving Trust Co.* the trustee was empowered "in its absolute discretion" and "as it deems advisable" to invade for the grantor the corpus in excess of an amount necessary to produce a specified income for life tenants. The court held that under the trust

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MERTENS §§ 25.33, 25.28 to .30. Thus as the five per cent limitation is met, the whole corpus is cast into gross estate, and if the reversionary interest is valued at less than five per cent § 2033 will require inclusion of that amount anyway. LOWNDES & KRAMER, FEDERAL ESTATE & GIFT TAXES 118 (1956). Section 2038, on the other hand, does not require inclusion of a power subject to a contingency beyond the decedent's control and which has not occurred before his death. 3 MERTENS § 25.11. Thus it would seem that if the grantor at his death were not in position to enforce invasion because of circumstances beyond his control, there would be no right to revoke. See Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Cyrus C. Yawkey, 12 T.C. 1164 (1949); Daisy Christine Patterson, 36 B.T.A. 407 (1936), petition to review dismissed sub nom. Helvering v. Patterson, 99 F.2d 1007 (10th Cir. 1939). Though perhaps rare, the situation could arise where under the circumstances there existed at decedent's death a present right in equity to compel invasion for a nominal amount, less than five per cent of the value of the transferred property. Would § 2038 cause inclusion only of the amount subject to recall, or would it cause inclusion of the whole remainder out of which this amount would be taken? There seems to be no case on this situation but 3 MERTENS §§ 25.44, .46, seems to indicate that the whole interest which is affected by the power to compel invasion is includible in gross estate.

Presently, the rule seems to be that if there are no such standards, an independent trustee having, rather, absolute discretion to invade principal, there is nothing retained by the grantor and thus there will be no inclusion under either § 2037 or § 2038. See 3 MERTENS §§ 25.33, 25.29, .30. It does not appear, however, that the courts have considered the right of the grantor's creditors to each principal in connection with these two code provisions. See Ware v. Gulda, 331 Mass. 68 (1954) N.E.2d 137 (1954). The rationale of the Tax Court in *Paolozzi* and *Uhl* would seem equally applicable in arriving at the conclusion that the grantor had retained, in effect, a power to revoke or terminate the entire trust. See Covey, *Power to Distribute to Grantor*, 98 TRUSSES & ESTATES 322, 326 (1959).

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131 F.2d 632 (3d Cir. 1942).
147 F.2d 946 (2d Cir. 1945).
involved the trustee was vested with a pure discretion which the grantor could not cause to be exercised in his favor. The court said:

In a case where the return of any part of the corpus will depend solely upon the discretion of the trustee the true test as to its inclusion in the taxable estate of the settlor is whether the trustee is free to exercise his untrammeled discretion, or whether the exercise of his discretion is governed by some external standard which a court may apply in compelling compliance with the conditions of the trust instrument. If the former, the corpus is not subject to taxation as a part of the settlor's estate.\(^4^0\)

Also in point is Toeller's Estate v. Commissioner.\(^4^1\) The clause which caused the litigation provided: "Should misfortune or sickness cause the expenses of Trustor to increase, so that in the judgment of the Trustee the net income so payable to Trustor is not sufficient to meet the living expenses of Trustor, then . . . said Trustee is authorized to pay . . . such portions of the principal of said Trust Estate as may be necessary under the circumstances." It was held that the words provided a fixed standard for ascertaining when invasion would be necessary. This created an enforceable fiduciary obligation which the trustee had no arbitrary right to ignore. Therefore since the settlor retained the conditional right to repayment of part or all of the corpus independent of the will of the trustees, the court sustained the Tax Court's inclusion of the corpus under the forerunner of section 2037. Also in this case the taxpayer argued that even if an interest in the corpus was retained, only the reasonable value of this interest should be included. To this the court replied: "The important point is that the possibility was present, by reason of the language employed by the trustor, and no limit was imposed on the extent to which the corpus could be applied, beyond the setting up of the standards which should invoke the application."\(^4^2\)

The Five Per Cent Limitation

Since the five per cent limitation has been introduced into section 2037 by the Technical Changes Act of 1949,\(^4^3\) the crucial question is whether the right to invade through the enforcement of the fiduciary's discretion gives decedent an interest equal to five per cent of the value of the transferred property as of the date of death.\(^4^4\)

\(^4^0\) Id. at 949. \textit{But see} discussion of creditors' rights against principal in note 37 supra.

\(^4^1\) 165 F.2d 665 (7th Cir. 1948).

\(^4^2\) Id. at 667.

\(^4^3\) 63 Stat. 891 (1949).

\(^4^4\) In \textit{Lowndes & Kramer, Federal Estate & Gift Taxes} (1956) the authors remark at page 116, n.28: "It would seem that under Section 2037 the value of the settlor's reversionary interest [referring to a right of grantor to compel invasion of principal subject to an external standard] would seldom exceed 5 per cent of the value of the transferred property (if it is capable of valuation at all) so that nothing would now be taxable to the settlor's estate under Section 2037."
The regulations\(^{46}\) declare that actuarial principles may be used if applicable, but where the interest is not susceptible to actuarial valuation, then fair market value is used. It seems safe to conclude that the right of invasion in the instant trust is not capable of being calculated actuarially. There seems to be no case under section 2037 since 1949 which has considered valuation of a right to enforce invasion pursuant to a fixed standard. Therefore analogous situations will have to be considered.

It would appear that because of the five per cent rule the probability of invasion would have to be estimated. There have been cases where for purposes of computing gift taxes and charitable deductions the courts have been required to determine valuation as affected by a power of invasion. *McHugh v. United States*\(^{46}\) contains a good statement of the law. There the rule for charitable deductions where the remainderman is a charity and the trustee has a power of invasion for the life tenant, as established by a line of cases, including several from the Supreme Court, was stated. The rule is that a charitable deduction is allowed if (1) the trustee's power of invasion is limited to an ascertainable standard capable of being stated in terms of money, and (2) the facts at the time of the transfer show the likelihood of invasion and the value of the power of invasion under the circumstances. The court in *McHugh* held these principles applicable where the question involved the gift tax on a trust between private parties. Note, however, that section 2037 is concerned with the value immediately before the decedent's death, rather than at the time of the transfer.\(^{47}\)

Congress seems originally to have intended certain gift tax rules regarding valuing invasion rights to apply in valuing reversionary interests. In 1949 the Conference Committee in regard to section 2037 wrote:

The decedent's reversionary interest is to be valued by recognized valuation principles . . . and, of course, without regard to the fact of the decedent's death. The value shall be ascertained as though the decedent were, immediately before his death, making a gift of the property and retaining the reversionary interest. The rule of *Robinette v. Helvering* (318 U.S. 184), under which a reversionary interest not having an ascertainable value under recognized valuation principles is considered to have a value of zero, is to apply. Thus, if a reversionary interest consisting of a right enforceable in equity to compel a trustee to apply trust corpus for the support and maintenance of the grantor would be considered to have a value of zero for gift tax purposes were it

\(^{45}\) § 20.2037-1(c)(3).

\(^{46}\) 142 F. Supp. 927 (Ct. Cl. 1956).

\(^{47}\) This is the reason that the gift tax and estate tax under § 2037 are not mutually exclusive. In principle, on this point § 2038 is similar.
being retained under a transfer by gift, it is to be similarly valued for the purpose of the conference amendments.\(^48\)

However, as noted earlier the regulations do not expressly incorporate any gift tax rules but rather adopt a fair market value rule regardless of the non-applicability of actuarial rules. Moreover, Congress seems to have receded from its original position. The House and Senate Reports on the 1954 Code in connection with section 2037 state:

The decedent's reversionary interest is to be valued by recognized valuation principles and without regard to the fact of decedent's death. Where it is apparent from the facts that property could have reverted to the decedent under contingencies that were not too remote, the reversionary interest is not to be necessarily regarded as having no value merely because the value thereof cannot be measured precisely.\(^49\)

Although the case did not involve valuing a power of invasion, in *Estate of Cardesa*,\(^60\) decided in 1958, the court relied, among other things, on the 1949 conference report above quoted and held that where an actuarial conclusion would be but a guess the reversionary interest must be considered to have a valuation of zero. It does not appear that the fair market value of the interest was considered. The issue in *Cardesa* was the valuation of a reversionary interest for the five per cent limitation in section 2037.

Turning now to the gift tax law to which reference has been made above, Revenue Ruling 54-538\(^51\) seems to indicate the Commissioner's view. Prior to this ruling *Christianna K. Gramm*\(^62\) had held that where the grantor put all her income-producing property, valued at eighty-three thousand dollars, in trust, reserving a life estate and giving the trustee power to invade corpus for the "comfort, education, maintenance or support" of the grantor, there had been no taxable gift to the remainderman. The Tax Court considered, in view of the moderate amount of the corpus, that the right of invasion for grantor's comfort, though the amount was incapable of determination, would very probably be exercised to a substantial extent. This holding on the surface seemed contrary to *Smith v. Shaughnessy*\(^53\) and *Robinette v. Helvering*\(^54\) which the Commissioner in the Revenue Ruling summarized:

The law in those cases is that where a donor transfers property retaining a reversionary interest which is capable of valuation by

\(^50\) 261 F.2d 423 (3d Cir. 1958).
\(^51\) 1954-2 C.B. 316.
\(^52\) 17 T.C. 1063 (1951).
\(^53\) 318 U.S. 176 (1943).
\(^54\) 318 U.S. 184 (1943).
recognized actuarial methods, the value of the retained interest should be excluded from the gift, but where the value of the reversionary interest is not susceptible of valuation by recognized actuarial methods, the entire gift is complete.\textsuperscript{65}

The Commissioner said that the \textit{Gramm} case should be viewed in light of the unusual and particular circumstances of the case. The Revenue Ruling then held that even in such a case as \textit{Gramm} the amount required for the grantor's support in his accustomed mode of living may be ascertained and valued as an annuity and the excess of the corpus over the retained rights would be a gift. The Commissioner, on the point of ascertaining the extent of invasion, cited two cases: \textit{Ithaca Trust Co. v. United States},\textsuperscript{56} and \textit{Blodget v. Delaney}.\textsuperscript{67} These cases deal with ascertaining invasion rights for determining a charitable deduction. In both cases the courts, as was done in \textit{Gramm}, recognized the propriety of looking to the extrinsic facts to determine likelihood of invasion.

It is submitted that there is no reason why the principles used in valuing a reversionary interest in the gift tax and charitable deduction cases, especially the reference to extrinsic facts, should not be applicable to valuing the reversionary interest for the five per cent limitation in section 2037. It is noted that the regulations under section 2037 do not adopt the gift tax rule of \textit{Robinette} as stated by the Conference Committee of 1949, but reflect the approach indicated in the 1954 Congressional Report. However, as noted above, \textit{Estate of Cardeza} proceeded on the rule reflected in the 1949 Conference Committee Report notwithstanding the 1954 Congressional Report.

\textbf{Conclusion}

It seems that where the trustee has been given a discretionary right to invade corpus conditioned on a fixed standard the grantor is deemed to have a reversionary interest within the purview of section 2037 by reason of the right in equity to enforce the standard of invasion. In determining the crucial question of whether the value of the reversionary interest exceeds five per cent of the transferred property, although there are no cases squarely in point, it seems that the likelihood and extent of invasion are to be determined in view of the standard of the trust instrument together with the extrinsic circumstances. It is arguable that if the interest cannot be actuarially valued it will be deemed to have a zero value; however, the Commissioner could invoke the fair market value rule provided in the Regulations.

\textsuperscript{65}1954-2 C.B. at 317.
\textsuperscript{56}279 U.S. 151 (1929).
\textsuperscript{67}201 F.2d 589 (1st Cir. 1953). See especially Mr. Chief Judge Magruder's interesting concurring opinion at 594.
III. Remedies for Existing Trusts

The following section is designed to point out at least some of the problems that will be encountered and the avenues that will be available should a grantor of an existing trust of the type herein considered desire to avoid inclusion of the corpus in his gross estate.

**Tax Considerations**

Any action will, of course, be subject to the catch-all estate tax regulation providing: "If a decedent transfers an interest in property or relinquishes a power in contemplation of death, the decedent's gross estate includes the property subject to the interest or power to the extent that it would be included under section 2036, 2037 or 2038 if the decedent had retained the interest or power until his death."

It now appears as to the type trust herein considered that a gift tax on the whole corpus may not be proper. Under the *Paolozzi* and *Vander Weele* concept, the full value of a life estate, i.e., the income interest, should not be taxable nor should the amount of principal determined to be under the grantor's control because of the trustee's duty to invade pursuant to a fixed standard.

If a gift tax has been paid on the above stated basis it follows that another gift tax is due upon the relinquishment, termination, or assignment of the interests originally reserved which have never been subjected to a gift tax. If there has been an appreciation in the value of the corpus, the value of the subsequent gift, i.e., the relinquishment or assignment, will be calculated on the increased value, it seems.

If a gift tax has been levied on the theory that the full value of the property constituted a taxable gift—either because the parties were not cognizant of the authorities and arguments indicating the contrary, or if so aware, because they doubted the validity thereof—then determining subsequent gift tax consequences will be more difficult. The Commis-
sioner will not, of course, be estopped to claim another gift or an estate tax, merely because he would have to adopt a position inconsistent with the proper retention of the original gift tax. If a gift tax was paid on the whole property transferred on the theory that there was a completed gift, the grantor has the regulation and Uhl together with Herzog, Rheinstrom and Hazelton to support the propriety of this position as to the income element. As to the right to compel invasion all that need be shown to demonstrate a completed gift is that at the time of the transfer the likelihood of invasion was negligible. If it be determined that a gift tax on the whole transfer was proper, then the extinguishment or transfer of either of the retained interests should not be subject to another gift tax. Moreover, no estate tax should be levied by reason of the retention of the income expectancy. On the other hand even though the gift may have been complete notwithstanding the right to compel invasion, nevertheless an estate tax might be incurred by its retention.

As to the grantor’s equitable power to cause invasion of principal, if it be determined that the original gift tax erroneously included an ascertainable amount subject to the grantor’s control, then the relinquishment, termination, or other disposal of it by the grantor completes the gift as

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64 See Blumberg v. Smith, 138 F.2d 956 (7th Cir. 1943), discussed in note 62 supra. This Comment will not consider under what circumstances a refund can be obtained. See also §2504 and regulations thereunder.

65 §25.2511-2(b) : "For example, if a donor transfers property to another in trust to pay the income to the donor or to accumulate it in the discretion of the trustee, . . . [and provides] that the remainder should go to X or his heirs, the entire transfer would be a completed gift."

66 The Court of Appeals version from which it can be argued that unless it is clearly shown that the state rule allows creditors to reach the discretionary income, the Commissioner has failed to make out his case.

67 Recall, however, that in Rheinstrom and Hazelton no consideration was given to the right of creditors to reach income.

68 See §23.2511-2(b) ; Robinette v. Helvering, 318 U.S. 184 (1943) ; McHugh v. United States, 142 F. Supp. 927 (Ct. Cl. 1950). As a practical matter if there has been an appreciation in the value of the corpus the grantor will want to urge a completed gift.

69 See Burnet v. Guggenheim, 288 U.S. 280, 285 (1933) ; "Congress did not mean that the tax should be paid twice, or partly at one time and partly at another. If a revocable deed of trust is a present transfer by gift, there is not another transfer when the power is extinguished. If there is not a present transfer upon the delivery of the revocable deed, then there is such a transfer upon the extinguishment of the power." See also Louis J. Kolb, 5 T.C. 588 (1945) ; Orrin G. Wood, 40 B.T.A. 905 (1939).

70 See Covey, Power to Distribute to Grantor, 98 TRUSTS & ESTATES 322, 326 (1959). The cases support this conclusion. See Vander Weele and Herzog.

71 In connection with §2037 there may be an instance in which a gift tax or an estate tax does not exclude the other, unless, as for instance in Vander Weele, the invasion possibility is valued so high at the original gift as to wholly prevent any gift tax. This would occur when at the time of the gift the circumstances would not justify a deduction from the value of the remainder for the invasion possibility, but because of developments subsequent to the gift, the circumstances immediately before decedent’s death cause an increase in the value of the invasion right. No case involving this situation has been found.
to the principal and a gift tax is due on the amount by which the gift of the remainder was incomplete.\textsuperscript{72}

If it be determined that the original gift tax was erroneously paid without excluding the grantor's interest in the income, it is the value of a full life estate that has been improperly included,\textsuperscript{73} because, since the trustee could pay all the net income to the grantor, under the general rule his creditors could reach that amount. Although no case in point has been found, reason dictates that should the grantor relinquish or assign this interest a gift tax will be levied on the value of a life estate in the corpus at the time of the transfer.\textsuperscript{74} The fact that a transferee of this interest might not be entitled to the full income\textsuperscript{75} would be immaterial; it is the value that the grantor parts with, not what the donee receives that determines the gift tax.\textsuperscript{76} However, if the donor retains an enforceable right to have the taxes paid from the transferred property, the amount of the gift is reduced by the amount of the taxes.\textsuperscript{77}

\textit{Conveyancing Methods Available}

Putting aside tax considerations for a moment, the question arises: how can the grantor dispose of his interests?

No reason appears why the grantor cannot release, or to use the tax term, relinquish, his interests and powers.\textsuperscript{78} Even if the right to compel invasion is regarded as "personal"\textsuperscript{79} and therefore inalienable\textsuperscript{80} it seems that it can be released.\textsuperscript{81}

\textsuperscript{72} Mertens \S\S 35.01, .02. See also \S 2504.

\textsuperscript{73} Paolozzi and Vander Weele.

\textsuperscript{74} See \S 2504 and regulations thereunder, especially \S 25.2504-2. It would appear that issues other than valuation are involved. \textit{Quaere}, in regard to \S 25.2504-1(d), whether the "erroneous inclusion" referred to means erroneous under the law at the time, or erroneous in light of the present law. The House and Senate Reports which are identical are not very enlightening. The material part provides: "It is believed that once the value of a gift has been accepted for purposes of the tax by both the Government and the taxpayer, this value should be acceptable to both in measuring the tax to be applied to subsequent gifts. For that reason the bill provides that the value of a gift as reported on a taxable gift tax return for a prior year is to be conclusive as to the value of the gift (after the statute of limitations has run) in determining the tax rate to be applied to subsequent gifts." H.R. REP. No. 1337, 83rd Cong., 2d Sess. (1945); 3 U.S. CODE CONG. & ADM. NEWS, 83rd Cong., 2d Sess., 1945 at 4120. If neither the power to compel invasion nor the circuitous right to income were segregated for valuation at the time of the original gift there is doubt whether this provision would be applicable.

\textsuperscript{75} Restatement, Trusts (Second) \S 156(2) (1959) declares that the transferee can demand the full income. \textit{Contra}, Dravo Trust, 79 Pa. D. & C. 79 (1951).

\textsuperscript{76} Mertens \S 35.25(1)-2(a).

\textsuperscript{77} Sarah Helen Harrison, 17 T.C. 1350 (1952); 5 Mertens \S 36.04.

\textsuperscript{78} See Wilmington Trust Co. v. Carpenter, 75 A.2d 815 (Del. Chan. 1950); Restatement, Trusts (Second) \S 343 (1959). This Comment will not consider the various future interests problems that might be encountered. However, it would not seem that acceleration would occur if the remaindermen were required to survive the grantor, although acceleration is chiefly a question of the grantor's intent. See Simes & Smith, Future Interests \S 796 (1956).


\textsuperscript{80} Restatement, Trusts (Second) \S 343(i) (1959).
It may be that the trust could be revoked or terminated, depending on the circumstances. According to the general rule the settlor and beneficiaries, if none are under an incapacity, can cause the termination of an inter vivos trust.

Whether the settlor can assign the interests presents a somewhat more difficult problem. The beneficiary, other than the settlor, of a discretionary trust cannot make a valid assignment since he has nothing to assign. But the question here is whether the settlor who creates a discretionary trust in his own favor can assign his income interest thereunder, as well as the right to compel invasion of corpus for his benefit. There seems to be no case presenting this precise question. It is clearly established that: (1) a spendthrift trust in favor of the settlor is ineffectual and he may assign his interest and his creditors may reach it; and (2) that creditors of a discretionary settlor-beneficiary can reach his interest. Therefore, it would seem that a settlor-beneficiary of a discretionary trust could make a voluntary assignment. It has been reasoned that if under local law creditors of the settlor-life beneficiary of a spendthrift trust could reach the whole income, then the settlor-life beneficiary could make a voluntary assignment. Moreover, the Restatement of Trusts (Second) section 156(2) clearly makes no distinction between voluntary assignees and creditors, providing: "Where a person creates for his own benefit . . . a discretionary trust, his transferee or creditors can reach the maximum amount which the trustees under the terms of the trust could pay to him or apply for his benefit." (Emphasis added.)

In Dravo Trust a woman created a trust whereby she was to receive so much net income as the trustees in their discretion determined. Also there was a spendthrift clause. To avoid estate taxes she assigned her interest. The assignment was held valid, although the court held, contrary to the Restatement, that the assignee was entitled only to what the trustees decided to pay, rather than the whole income.

Since creditors can reach principal as well as income, it would seem that the same considerations would apply to an assignment of the

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83 III Scott, Trusts § 338 (1956). Caveat: There may be circumstances where the beneficiaries would be making a gift-back. Cf. Cerf v. Commissioner, 141 F.2d 564 (3d Cir. 1944).
84 Id. § 155.
85 Id. § 156.
86 Id. § 156(2).
87 The court in Vander Weele assumed that the settlor-beneficiary could assign or transfer her interest in the trust. 254 F.2d at 898.
right to compel invasion, unless the right is personal. Assuming that
the right to compel invasion may be assigned, the problem arises whether
the yardstick—for example, of proper support, maintenance, and educa-
tion—is to be applied to the assignee's or the grantor's situation. It
might be that the grantor's situation would continue to govern the
propriety of invasion but that the money would be paid to the assignee.
On the other hand, it might be that the trustee would be required to
invade when the assignee's situation qualified under the standard.

While the North Carolina court has not had occasion to deal with
this problem in connection with a trust of the type herein considered,
the statement in Pilkinson v. West that one cannot retain an interest
in a trust and restrict the right of alienation thereof strongly suggests
that the court would sustain an assignment of the reserved interests, both
of the income and the right to compel invasion.

IV. Recommendations

While the law governing and affecting the problems discussed in this
Comment is not definitively developed, at least trends and danger areas
are noticeable. It seems particularly clear that a North Carolina grantor-
beneficiary of a trust which is absolutely discretionary as to income
distribution is sitting on an estate tax powder keg. Also, it seems that
a right to the return of principal by invasion by the trustee, whether
pursuant to a fixed standard, or in his absolute discretion is a potential
estate tax trap.

Consequently, it would seem that it would hardly be advisable to
create a trust of the type herein considered without serious deliberation
as to the tax dangers. Of course, other factors might outweigh the tax
disadvantages.

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(1953). II Scott, Trusts § 160. Most of the personal trust cases involve a right
of occupancy of a house.


93 An interesting income tax question would arise if the assignment were for
value. Where the full net income life beneficiary of a trust sells his interest for a
consideration the amount received is taxable as capital gain. Bell's Estate v. Com-
missioner, 157 F.2d 454 (8th Cir. 1945). The case is premised on Blair v. Commiss-
ioner, 300 U.S. 5 (1937). In Blair it was held that an assignment of a full
income interest in a trust carried with it an interest in the trust corpus and the
corresponding rights and remedies for the enforcement of the trust. In accord with
Bell's Estate are: Allen v. First Nat. Bank & Trust Co., 157 F.2d 592 (5th Cir.
1946), cert. denied, 330 U.S. 828 (1946); McAllister v. Commissioner, 157 F.2d
235 (2d Cir. 1946) (surrender rather than sale of the life interest). The purchaser
of a life estate, even if he is the remainderman, may amortize the cost of the wasting
capital asset thus acquired over the life expectancy of the measuring life. Bell v.
Harrison, 212 F.2d 253 (7th Cir. 1954). The question would be, therefore, whether
an assignment of the interests retained by the grantor of the type trust herein con-
sidered would be within the scope of Blair.

94 See note 37 supra.
As for existing trusts, unless other advantages are deemed more important, considering, among other matters, the gamble that an untimely death will claim the grantor before any long range economic benefits can be derived from the trust, it would seem prudent for the grantor of such a trust to rid himself of the retained interests. If the assignment is made to a dependent of the grantor great care should be taken that the transfer is not made with the intent of discharging the legal duty of support. The use, possession, right to income, or other enjoyment of the transferred property is considered retained under section 2036(a)(1) to the extent that it is to be applied toward the discharge of a legal obligation of the decedent. Where, however, such is not the intent and the dependent can use the property without restriction, there is no inclusion in the grantor's gross estate. Moreover, where an independent trustee has absolute discretion whether or not to distribute to the dependent it has been held that no inclusion results. The cases found involved a trust originally created for the dependent, but no distinction in principle readily appears where the grantor transfers his retained interests to a dependent.

If the grantor of an existing trust chooses to make an intra-family assignment, either for value or gratuitously, it would seem prudent to provide sufficient limitations over to prevent the re-acquisition by inheritance of the assigned interests should a premature death befall the principal assignee. It would seem prudent in the assignment to recite that the grantor recognizes the two interests he retains and that he expressly assigns both. Then, to assure that the grantor has divested himself of all the interests, it would seem prudent to execute a release or relinquishment to the trustee the day following the assignment. Such release would recite that the grantor has previously made an assignment and that should it be judicially determined invalid in whole or in part, the interest the assignment purported to transfer is hereby released.

In addition to the relative saving as between the estate tax liability and the tax on a present gift of the retained interests, the possibility that property which has appreciated in value since acquired must be sold to pay the gift taxes, with the resultant additional income tax liability, must be considered. See Lowndes & Kramer, Federal Estate & Gift Taxes 846 (1956). § 20.2036-1(b) (2); Commissioner v. Dwight's Estate, 205 F.2d 298 (2d Cir. 1953), cert. denied, Estate of Dwight v. Commissioner, 346 U.S. 871 (1953). Colonial-American Nat. Bank v. United States, 243 F.2d 312 (4th Cir. 1957); Wishard v. United States, 143 F.2d 704 (7th Cir. 1944). Commissioner v. Douglass' Estate, 143 F.2d 961 (3rd Cir. 1944); McCullough v. Granger, 128 F. Supp. 611 (W.D. Pa. 1955). In the latter case it was considered insignificant that the trustees were the wife and a son of the grantor, the beneficiary being another son. See Merchant's Nat. Bank v. Morrissey, 329 Mass. 601, 109 N.E.2d 821 (1953), where the court seemed reluctant to believe that the grantor intended to assign a right to demand principal where the assignment was of all "right, title, and interest."
Because of the dearth of authorities good practice would seem to require that the assignment or release or other disposal be tested in the state courts\textsuperscript{100} or that a revenue ruling or closing agreement be sought.

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\textsuperscript{100} See Brandis v. Trustees of Davidson College, 227 N.C. 329, 41 S.E.2d 833 (1947), 26 N.C.L. Rev. 69 (1947), where trustees sought a declaration regarding power to sell. It was held that declaratory judgment was inappropriate. Rather, the court said, a bill for instructions should have been brought.