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be divulged will curtail freedom of consultation with legal advisers.⁴⁶ The *Garner* decision should have limited impact, since the privilege would be denied only when a corporation is involved in a suit with its shareholders and the shareholders can show "good cause" why it should not be extended. Since the need for counsel is still eminent, full disclosure by honest management should not be affected.

MICHAEL D. MEEKER

Federal Estate Taxation—The State Street Trust Doctrine, 1959-1970: R.I.P.

In March, 1970, the Court of Appeals for the First Circuit buried one of the most vexatious concepts in the field of estate taxation. The court, in *Old Colony Trust Co. v. United States*,¹ specifically overruled *State Street Trust Co. v. United States*² by holding that "no aggregation of purely administrative powers"³ would cause the corpus of a trust to be included in the settlor's estate under sections 2036(a)(2) and 2038 of the Internal Revenue Code of 1954.⁴ In *State Street* the court held that when a decedent-settlor had retained as trustee broad powers of administration which permitted him to exchange trust property without reference to value, to invest in securities yielding either high income or no income at all (specifically including wasting investments) and to allocate assets to income or principal in all cases (whether state law as to proper alloca-

⁴⁶ See Comment, *The Lawyer-Client Privilege: Its Application to Corporations, The Role of Ethics, and Its Possible Curtailment*, 56 NW. U.L. REV. 235, 256-59 (1961).

¹ 423 F.2d 601 (1st Cir. 1970).

² 263 F.2d 635 (1st Cir. 1959).

³ 423 F.2d at 603.

⁴ INT. REV. CODE of 1954, §§ 2036(a)(2), 2038. Section 2036 of the Code includes in a decedent's estate property transferred to another in which the decedent retained a life estate. Specifically included is property with respect to which the decedent retained "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." This section is only applicable to transfers made after March 3, 1931. Section 2036 includes the total amount of the property transferred. Section 2038 includes within a decedent's estate transferred property subject to the power of the decedent to "alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death." It makes no difference under section 2038 whether the decedent ever owned the property subject to the power; it is only necessary that the decedent had the power on the date of his death or had transferred it in contemplation of his death. Both sections 2036(a)(2) and 2038 include property even if the power is exercisable only in a fiduciary capacity. Treas. Reg. §§ 20.2036-1(b)(3), 20.2038(a) (1958).

tion was in doubt or not), then the settlor-trustee had retained the right to "designate the persons who shall possess or enjoy the property or the income therefrom" under section 2036(a)(2) and the power "to alter, amend, revoke, or terminate" under section 2038.⁵

The *State Street* trust was administered under the laws of Massachusetts subject to the supervision of the state courts of equity. The first circuit felt that although these state courts would intervene should the trustee act in utter disregard of a beneficiary by putting "all, or nearly all, of the trust assets in wasting investments [or] in a property yielding little or even no income,"⁶ nonetheless, a trustee who possessed broad management powers could substantially shift the benefits of such a trust between the life tenants and remaindermen.⁷ The decision was grounded in the idea that the state courts had no ascertainable standard by which to enforce the rights of beneficiaries with adverse interests.⁸ The effect of this holding was to throw considerable doubt on the tax consequences of irrevocable inter vivos trusts incorporating wide administrative powers.⁹

Sound drafting practices until *State Street* had called for broad discretionary powers in the trustees to prevent the trust from being crippled by delay and expense of frequent court approval.¹⁰ It was not surprising therefore that, at the next opportunity, the Massachusetts Supreme Judicial Court launched an attack on the decision and began to demonstrate the degree of supervision that the state courts would impose over fiduciaries. The newly militant posture was evident in *Boston Safe Deposit & Trust Co. v. Stone*,¹¹ which involved the power of the trustees to determine reasonably the value of assets for distribution.¹² The supreme court, in finding that the trustees had valued the assets reasonably, pointed out that "a court of equity may control a trustee in the exercise of a fiduciary discretion if it acts beyond the bounds of a reasonable judgment or unreasonably disregards usual fiduciary principles, or the purposes of the trust, or

⁵ 263 F.2d at 637-39. Both sections 2036 and 2038 are applicable regardless of whether the settlor-trustee holds the power alone or with another as long as the cotrustees do not have substantial adverse interests. It is necessary that the settlor hold the power in a fiducial capacity either as trustee or by implication from the trust instrument.

⁶ *Id.* at 638-39.

⁷ *Id.*

⁸ *Id.* at 639.

⁹ See Barrett, *The Marital Deduction*, 50 MASS. L.Q. 18 (1965).

¹⁰ See generally Note, 45 IOWA L. REV. 426 (1960).

¹¹ 348 Mass. 345, 203 N.E.2d 547 (1965).

¹² The facts found by the lower court indicate that this was a clear case of reasonable and impartial determination of value.

if it fails to observe standards of judgment apparent from the applicable instrument.'"¹³ The court pointedly asserted that it disagreed with the suggestion to the contrary by the majority in *State Street*.¹⁴

The Massachusetts court made an even more telling attack in *Old Colony Trust Co. v. Silliman*.¹⁵ The trust in this case was set up to benefit an intervening life estate with a charitable remainderman and included the power of the trustee to decide whether to treat accretions and expenses as income or principal. The court held that the power to allocate accretions as disbursements between income and principal would defeat the intent of the trust if the trustee could substitute his uncontrolled discretion for the established rules and, as in *Boston Safe*, Massachusetts courts would hold a fiduciary to "reasonable regard of usual fiduciary principles" when applying discretionary powers.¹⁶ "Reasonable regard" was interpreted to mean that established rules would be applied.¹⁷ *Boston Safe* and *Silliman* both cited with specific approval Judge McGruder's dissent in *State Street* and substantially clarified the degree of supervision that Massachusetts courts would exercise over fiduciaries.¹⁸

The United States Tax Court, which at the time of *State Street* was not obligated to consider the holdings of other federal courts,¹⁹ supported the position of the Massachusetts court in two significant decisions.

¹³ 348 Mass. at 351, 203 N.E.2d at 552.

¹⁴ As Chief Judge Magruder indicated . . . in his dissent [in *State Street*] . . . a Massachusetts Court of Equity will 'supervise the administration of . . . trusts so as to control any attempt to shift the incidence of their enjoyment.' Even broadly expressed administrative and management powers . . . 'are limited by standards which the Massachusetts court of equity could and would apply to supervise effectively . . . [proper trust] administration.' We disagree with any suggestion to the contrary . . . in the majority opinion in that case

Id. at 351 n.8, 203 N.E.2d at 552 n.8.

¹⁵ 352 Mass. 6, 223 N.E.2d 504 (1967).

¹⁶ *Id.* at 10, 223 N.E.2d at 507.

¹⁷ *Id.*

¹⁸ See also *Briggs v. Crowley*, 352 Mass. 194, 224 N.E.2d 417 (1967) (trust provisions purporting to relieve trustees from duty of accounting except to donor ineffective as against public policy to deprive beneficiary standing to compel accounting); *Holyoke Nat'l Bank v. Wilson*, 350 Mass. 223, 214 N.E.2d 42 (1966) (trustees are required to exercise power to invade corpus for beneficiary's comfort, maintenance, and support with proper regard to accepted fiduciary principles); *Copp v. Worcester Co. Nat'l Bank*, 347 Mass. 548, 199 N.E.2d 200 (1964) (discretionary power of the trustee to invade corpus of trust to the extent of five hundred dollars for the proper maintenance of the settlor's wife had to be exercised in accordance with fiduciary standards).

¹⁹ The Tax Reform Act of 1969 changed the United States Tax Court from an administrative agency to a court deriving its powers from article I of the Constitution. Tax Reform Act of 1969, 26 U.S.C. § 7441 (Supp. V, 1965-69).

*Estate of Edward E. Ford*²⁰ involved in inter vivos trust administered under the laws of New York. The settlor had named himself sole trustee and had retained the power to invade the corpus "for the purpose of defraying expenses occasioned by illness, infirmity or disability, either mental or physical, or for his support, maintenance, education, welfare and happiness."²¹ He also had retained the administrative powers to allocate receipts, losses, and expenses to either income or principal and to invest in such classes of property as the trustee might in his discretion select. The classes of property specifically included investments not normally considered appropriate for trusts.²² The court held as to the invasion power, that although "happiness" does not normally provide an ascertainable standard, in this case the power was circumscribed by the requirement that the beneficiary be in "need" of funds. This requirement so limited the definition of "happiness" that a New York court of equity would be able to find the requisite external standard to enforce the beneficiaries' rights.²³ The court rationalized the administrative powers as being "commonly included in trust instruments," noting that abuse of discretion "would be subject to equity court of review."²⁴ Further, the majority specifically found that since each of these powers was subject to supervision by the equity court, the *State Street* rule that the powers, when viewed in the aggregate, would require inclusion under sections 2036 and 2038, did not apply.²⁵

Ford was decided by a split court with five judges dissenting, but in the following year a united court decided the case of *Estate of Phyllis W. McGillicuddy*²⁶ on similar grounds. This case involved the validity of a charitable deduction from the taxable estate. The Commissioner's position was that the trustee's powers were so broad that he could shift the beneficial interests between the income beneficiary and the charitable remainderman, thus rendering the value of the remainder interest unascertainable.²⁷ The powers involved were the trustee's right to invest in regulated securities companies and to determine all questions of income or principal. The latter power was not restricted to those areas of the law

²⁰ 53 T.C. 114 (1969).

²¹ *Id.* at 121.

²² *Id.* at 128.

²³ *Id.* at 126-27.

²⁴ *Id.* at 127-28.

²⁵ *Id.* at 127-29.

²⁶ 54 T.C. 315 (1970). This trust was also administered under the laws of Massachusetts.

²⁷ *Id.* at 320-21.

in doubt.²⁸ The court simply relied on the statement of Massachusetts law contained in *Silliman*²⁹ that the power to allocate accretions and expenses between income and principal was primarily a management power allowing the trustee to use good faith in instances of doubt and that the granting of such power would not authorize the favoring of either the life beneficiary or the remainderman.³⁰

The principal case, *Old Colony Trust Co. v. United States*,³¹ involved an inter vivos trust administered under the laws of Massachusetts for the benefit of the son of the settlor-trustee. The settlor had retained the power to decrease payments of income to the beneficiary when "the stoppage of such payments is for his [the beneficiary's] best interests."³² The trustee also had broad administrative powers including the power to make investments not normally considered safe for trustees, and to "determine, what was to be charged or credited to income or principal."³³ Here again the government sought to include the entire corpus of the trust in the decedent's taxable estate on the basis that both the power of distribution and of management gave the settlor-trustee the right to designate who should enjoy the property under section 2036(a)(2).³⁴ Turning first to the management powers, the first circuit made short work of the government's argument. Citing the chain of cases discussed above, the court came to the conclusion that *State Street* was wrong in concluding that even though each individual power would be subject to control by a Massachusetts probate court, the aggregate of the powers gave the trustees such control over the corpus as to be equated with substantial ownership.³⁵ The mere existence of purely administrative powers was deemed insufficient in itself to work an inclusion under either section 2036(a)(2) or 2038(a)(1) for trusts administered in Massachusetts.

The inquiry into the power over distribution centered on a search for an ascertainable standard in the body of the trust instrument.³⁶ Words authorizing distribution as needed to maintain the beneficiary's way of life would have provided such a standard.³⁷ However, the authorization

²⁸ *Id.* at 318-19.

²⁹ See p. 813 *supra*.

³⁰ 54 T.C. at 323.

³¹ 423 F.2d 601 (1970).

³² *Id.* at 602.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 603.

³⁶ *Id.* at 603-04.

³⁷ *Id.* at 604.

to withhold payments when in the "best interests" of the settlor's son was clearly an unascertainable standard; this result was reinforced by the parent-child relationship between the trustee and beneficiary.³⁸ Although the absence of "best interests" criteria resulted in the taxpayer losing his case, he did nonetheless establish an important change in existing tax law.

The undeniable effect of *Old Colony* is to prevent the corpus of a trust from being included in a decedent-trustee's estate under sections 2036(a) (2) and 2038(1)(b) solely because of broad discretionary administrative powers. But since the decision was based on the degree of supervision over fiduciaries by Massachusetts courts, the government's position is not entirely vitiated as to other jurisdictions. It is appropriate therefore to consider the probable result of such an argument in light of the supervision provided by North Carolina courts.

Unfortunately, it is not clear that North Carolina courts of equity will exercise their jurisdiction to control the discretionary powers of trustees under circumstances that would prevent a *State Street* inclusion. When the powers are restricted by a court, the two most commonly employed means are by finding an abuse of discretion³⁹ and by finding protection for remaindermen and/or beneficiaries in interpretation of the settlor's intent.⁴⁰ The scope of control exercised by courts with respect to abuse of discretion depends upon judicial definition of terms such as "improper motive" and "reasonable judgment." Interpretation of intent often does not give such leeway, however, since in many cases the plain wording of the instrument makes clear the settlor's intent to provide unbridled discretion in the trustee in administration of the trust.⁴¹ In any event, the

³⁸ *Id.* The parent-child relationship between the trustee-settlor and the beneficiary makes the "best interests" requirement even more vague since each parent has his own opinion as to what is in the best interest of a child.

³⁹ The courts find abuse of discretion of the trustee "if he acts dishonestly, or if he acts with improper even though not dishonest motive, or if he fails to use his judgment, or if he acts beyond the bounds of reasonable judgment." *Woodward v. Mordecai*, 234 N.C. 463, 471, 67 S.E.2d 639, 644 (1951); RESTATEMENT OF TRUSTS § 187 (1935); 65 C.J. *Trusts* § 539 (1933).

⁴⁰ *Little v. Wachovia Bank & Trust Co.*, 252 N.C. 229, 113 S.E.2d 689 (1960); *Carter v. Kempton*, 233 N.C. 1, 62 S.E.2d 713 (1950); *Hester v. Hester*, 16 N.C. 328 (1829).

⁴¹ *See, e.g., State Street Trust Co. v. United States*, 263 F.2d 635 (1st Cir. 1959). In order to find an intent that is contrary to the plain words of the instrument, the court would have to find ambiguity in the mere existence of classes of beneficiaries with adverse interests. It is entirely possible for the court to conclude that the scope actually intended by the settlor was uncontrolled discretion and then the question is clearly put as to where the external standard of control is that will provide guidance to both trustee and the courts.

key is an external standard of control that will prevent the corpus from being included in the decedent-settlor's taxable estate.

The North Carolina Supreme Court in *Lichtenfels v. North Carolina National Bank*⁴² determined that where the trustee had broad investment powers, including specifically the power not to diversify, the court would not surcharge the trustee for failure to diversify. The court stated that "the directives of a Will are honored and given effect unless some overriding and compelling reason requires deviation."⁴³ The court on several occasions has expressed a willingness to intervene in the management of a trust but these have been, by and large, cases of gross abuse of discretion amounting to bad faith or fraud.⁴⁴ There are no cases dealing squarely with court supervision of powers as broad as those granted in *State Street* or as would be available if the trust incorporated the statutory powers of the North Carolina Powers of Fiduciaries Act.⁴⁵ In short there does not appear to be a judicially enforced external standard other than one for gross abuse of discretion.

Nonetheless, the supreme court on occasion has expressed an attitude towards discretionary powers that is strongly reminiscent of the language used by the Massachusetts Court in *Silliman*.⁴⁶ An excellent example, *Campbell v. Jordan*,⁴⁷ dealt with the discretionary power to distribute trust principal. This case held that where the trustee has the power to distribute to lifetime beneficiaries limited by the requirement that the distribution be "necessary and best" for the beneficiary and consistent with the welfare of the trust estate and the testator's family, the trustee could not distribute un-

⁴² 268 N.C. 467, 151 S.E.2d 78 (1966).

⁴³ *Id.* at 479, 151 S.E.2d at 85.

⁴⁴ *Kuykendall v. Proctor*, 270 N.C. 510, 155 S.E.2d 293 (1967) (trustee was the guardian of the incompetent life beneficiary and was also the remainderman under the terms of the trust); *Erickson v. Starling*, 233 N.C. 539, 64 S.E.2d 832 (1951) (self-dealing for profit on part of trustee); *Lightner v. Boone*, 222 N.C. 205, 22 S.E.2d 426 (1942) (trustee accused of using trust funds to speculate in his own name).

⁴⁵ N.C. GEN. STAT. §§ 32-25 to -27 (1966 & Supp. 1969). This statute includes a variety of specific powers but the following are those commonly considered to have adverse estate tax consequences: the power to sell and exchange property [§ 32-27(2)], to invest [§ 32-27(3)], and to allocate receipts and expenses between income and principal [§ 32-27(29)]. For these adverse consequences to occur the trust must, of course, be inter vivos with the settlor retaining the condemned powers to himself personally or as a fiduciary. If there is a possibility that the settlor may become a trustee, the powers may also result in adverse consequences. Treas. Reg. § 20.2036-1(b)(3).

⁴⁶ See p. 813 *supra*.

⁴⁷ 274 N.C. 233, 162 S.E.2d 545 (1968).

less the beneficiary could show that these conditions were met.⁴⁸ After holding the trustee's powers so limited on these facts, the opinion cited a Maine case⁴⁹ defining discretion "as deliberate judgment,—the discernment of what is right and proper. It implies soundness of judgment—judgment directed by circumspection." The court in *Campbell* then quoted the Restatement of the Law of Trusts for the proposition that where a trust is created for successive beneficiaries, the trustees must act with due regard for their interests.⁵⁰ *Kemp v. Paterson*,⁵¹ a New York case which restricted the power of the trustee to invade the corpus for the best interests of the beneficiary, also found favor with the North Carolina court. The *Kemp* decision held that best interest of the beneficiary meant "'best interests' . . . within the framework of the status bestowed upon her by the settlor, the status of a life beneficiary, not of a recipient of the entire trust res."⁵² Such language, if applied to broad administrative powers, would probably be sufficient to remove them from tax liability even under *State Street*. This position is anything but certain, however, since the language in *Campbell* is only dicta.

The first circuit in *State Street*, whether by design or not, was recognizing that a trustee with broad management powers is in fact able to shift the benefits of a trust between life beneficiaries and remaindermen. These shifts can be significant to parties with adverse interests even if not for tax purposes. Yet the trend today continues toward broad trustee discretion in the interest of sound estate management⁵³ despite the possibility, or even probability, of a corresponding loss of fiduciary responsibility and loyalty.⁵⁴ The holding in *Old Colony* presents an opportunity to the North

⁴⁸ *Id.* at 241; 162 S.E.2d at 551.

⁴⁹ *In re Murray*, 142 Me. 24, 30, 45 A.2d 636, 638 (1946). The power involved in this case was the power to invade for the comfortable support and maintenance of the life beneficiary. The court held that the trustee's discretion was not absolute and that he must act with due regard to the interests of successive beneficiaries.

⁵⁰ 274 N.C. at 242, 162 S.E.2d at 551.

⁵¹ 4 App. Div. 2d 153, 163 N.Y.S.2d 245, *aff'd*, 6 N.Y.2d 40, 159 N.E.2d 661, 188 N.Y.S.2d 161 (1959).

⁵² *Id.* at —, 163 N.Y.S.2d at 248. "Best interests" in this case amounted to terminating the trust to avoid a fifty-six per cent British estate tax. It was clear that the trustees were acting honestly and in good faith. The remaindermen were the children of the life beneficiary. This case represents protection with a vengeance of remainder interests from trustee discretion. As a practical matter, the infant remaindermen would have benefited by the termination of the trust.

⁵³ Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U.L. REV. 627 (1962); Horowitz, *Uniform Trustees' Powers Act*, 41 WASH. L. REV. 1 (1966).

⁵⁴ Note, *Trusts—The North Carolina Fiduciary Powers Act and the Duty of Loyalty*, 45 N.C.L. REV. 1141 (1967).

Carolina General Assembly to achieve the dual objective of insuring that trustees maintain a high standard of responsibility and at the same time assist North Carolina taxpayers in contests with the government.

The General Assembly has demonstrated its awareness of the possible tax consequences to the settlor who incorporates all of the powers in North Carolina General Statutes section 32-27. But the admonition that "[n]o power . . . shall be exercised by such fiduciary in such a manner as, in the aggregate, to deprive the trust or the estate . . . of [a] tax exemption, deduction or credit . . .,"⁵⁵ is probably totally ineffective as a tax avoidance device because it not only provides no standard by which the trustee may govern his conduct but also provides no standard by which the courts may supervise a fiduciary's management of a trust.

Any statute that would limit the discretionary powers of a trustee to compliance with usual or common law fiduciary principles or which would impose active supervision of trusts by the courts is bound to negate part of the freedom that many estate planners seek in setting up trusts with broad management powers. Yet when one considers the need for continued fiduciary responsibility and the added incentive of protection from tax liability, the price may not be high at all.

MIKE CRUMP

Federal Jurisdiction—The Property Rights Exception to Civil Rights Jurisdiction Under Section 1343(3)

Section 1343 of Title 28 of the United States Code vests the federal district courts with

original jurisdiction of any civil action authorized by law to be commenced by any person:

•••••

- (3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens or of all persons within the jurisdiction of the United States¹

Section 1343(3), available regardless of the amount in controversy, is important to potential litigants who desire a federal forum for the

⁵⁵N.C. GEN. STAT. § 32-26(b) (1966).

¹28 U.S.C. § 1343 (1964).