INTER VIVOS TRANSFERS: TRUSTS AND POWERS OF APPOINTMENTS

*BY HUBERT L. WILL**

A GENERATION AGO the usual estate plan consisted primarily if not entirely of a carefully drawn will. In recent years, however, the increasing importance of income and estate taxes among other factors has made more diversified planning desirable with the result that the creation of inter vivos or living trusts has become a favorite estate planning technique. While Supreme Court decisions and amendments to the federal tax laws in the past twenty years have diminished the tax advantages which at one time attached to the use of living trusts, such trusts, nevertheless, remain a useful means for achieving certain economic and legal objectives, including some tax benefits. In fact, such trusts have become increasingly popular in recent years not only in connection with estate plans for persons of great wealth, but also for men of moderate means, and one authority has expressed the opinion that when the virtues of living trusts "come to be generally realized in the business community, and in the law offices, the arrangement will be recognized as perhaps the most useful tool in all of estate planning." [1]

One of the most important factors in determining whether to include a trust in an estate plan and, if so, tne type of trust to use is the relative importance of tax savings. In the '30s it was undoubtedly the most important single consideration. Today, on the other hand, a member of the faculty of a leading law school, who is also an authority on the law of trusts, recently told the writer that he was currently advising his students to ignore the possible tax aspects of any trust they might create since "the tax laws are either so unfavorable or so uncertain in their application to trusts that little can be gained by any extended consideration of them in connection with the creation of a trust." There is, of course, a great deal of truth in the statement that the federal gift, estate, and income taxes in their application to trusts, and particularly to settlors of trusts, have in recent years become increasingly unfavorable or uncer-

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[1] SHATTUCK, AN ESTATE PLANNER'S HANDBOOK 77 (1948).

tain or both. And it is also true that the purposes of the settlor must always be the primary consideration in all estate planning. But any estate planner who ignores the tax implications of the trusts he is creating may soon see his sins of omission come back to confront him in the form of unnecessary tax payments.

As has been previously pointed out in this symposium, the relative importance of tax savings varies with every estate plan.[2] In very large estates with a wide variety of assets, it may be the paramount consideration. On the other hand, in smaller estates where the principal asset is frequently the controlling interest in a particular business, other factors will probably outweigh taxes in determining the final plan.

It is not the purpose of this article either to examine the almost infinite details of the law of trusts or the mechanics of drawing a trust nor even to speculate at any length on the probable future pattern of federal taxation of trusts. This symposium is intended as a working guide for the general practitioner's use in preparing the occasional estate plan which he is called upon to evolve. Accordingly, a discussion of the most important economic and legal considerations which make the creation of an inter vivos trust desirable or undesirable as part of an estate plan would appear to be the most helpful, and the writer has set his sights with this as the target. In addition, because of the important advantages or disadvantages which may result from the proper or improper handling of powers of appointment in trusts, a discussion of this subject is also included.

What then are the possible advantages of an inter vivos trust? In the first place, it must be pointed out that there are two basic types of such trusts: the so-called ordinary or irrevocable trust and the controlled or revocable trust. While any attempt at general definition of two legal categories which include as many variations as do irrevocable and revocable trusts will inevitably not be entirely accurate, for purposes of our discussion here we may consider an irrevocable trust as one in which the settlor has no right of revocation and in which he has retained no economic interest either in the res of the trust or the trust income. In a revocable trust, on the other hand, the settlor has reserved a right of revocation and may have retained an economic interest in either the res or the trust income.

In connection with these two forms of living trusts, it is interesting to note that each of them bears a similarity to other arrangements discussed in this symposium as possible estate planning techniques. For example, while there are differences which in particular cases make an outright gift more or less desirable than an irrevocable trust, many of the advantages of giving while living discussed in the previous article also apply to such a trust.[3] In fact, as a general rule an irrevocable trust

[2] Spencer, *The Function of the Lawyer in Estate Planning*, see p. 1 at 4 *supra*.

[3] Epstein, *Inter Vivos Transfers: Gifts, Joint Ownerships, and Contemplation of Death*, see p. 18 *supra*.

should be used only as a more advantageous substitute for an outright gift. In both, the donor or settlor gives up all interest in the property which is the subject of the gift or the corpus of the irrevocable trust, and the federal gift, estate, and income tax consequences to the donor or settlor are usually similar.

On the other hand, while again there are differences which may make one or the other more desirable in a particular case, the revocable trust and the testamentary trust are in many respects similar. In both, the settlor, so long as he lives, retains an interest in and effective control over the property comprising the corpus of the trust. Similarly, the federal tax implications are likely to be the same, although as will be discussed later, some tax advantages may accrue through the use of the inter vivos trust.

We come back then to the question of when inter vivos trusts are desirable and useful in an estate plan and when they should be avoided.

IRREVOCABLE TRUSTS

Let us consider first the ordinary or irrevocable trust. From an economic point of view, as has already been pointed out, the creation of an irrevocable trust means that the settlor has in effect made a gift of the property which goes into the trust. Unless the settlor is certain beyond doubt that he will never require the assets in question for his own business or personal purposes, the irrevocable trust should be avoided.[4] The same basic consideration, of course, determines the wisdom of an inter vivos gift.[5]

If, however, the individual whose estate is being planned possesses substantial assets, some of which he is willing to dispose of permanently, or if he has reached that stage of life where he is no longer active in the business world and is satisfied that he will never need the property in question or the income therefrom, there are a number of situations in which the irrevocable trust may be more advantageous than an outright gift.

In the first place, the use of an irrevocable trust permits the settlor to specify the persons who will receive the future benefits of the gift and thus avoid one of the worst hazards of a gift, the transfer of the property through death of the donee, or otherwise, into the hands of persons to whom the donor has no desire to make a gift or who may even be antagonistic to him.

Second, the use of an irrevocable trust rather than an outright gift enables the settlor to protect as well as limit the beneficiary in his enjoy-

[4] WORMSER, THEORY AND PRACTICE OF ESTATE PLANNING 86-88 (2d ed. 1948); SHATTUCK, *op. cit. supra* note 1 at 77 ff.

[5] Epstein, *op. cit. supra* note 3 at 19.

ment of the gift and thus prolong its beneficial enjoyment by preventing its waste or dissipation.

Finally, an irrevocable trust, if properly drawn, possesses all the income and estate tax advantages of a gift, most of which do not attach to a revocable trust.[6]

To illustrate the possible advantages of an irrevocable trust, let us look at a number of situations in which such a trust is the ideal device to use.

Frequently a person of means desires to make provision for the continuing comfort and support of nondependent members of his family, other relatives, or unrelated persons. If he makes annual payments from his income, they will be taxed at his high surtax rate and may, in addition, be subject to gift tax. Particularly if he intends ultimately to make a substantial gift to the beneficiaries and is in a position to relinquish control of the property currently, an irrevocable trust will accomplish his purposes and, at the same time, if properly drawn bring him income, gift, and estate tax savings. Such a trust is frequently used, therefore, to provide regular allowances to augment the income of grown children who are not yet adequately established in earning power or to provide current assistance to incompetent or indigent brothers, sisters, nephews, and nieces. A fairly common practice in such trusts, if the settlor desires that the nondependent relative or his heirs should not ultimately receive the corpus, is to make an educational, religious, or other charitable organization the eventual remainderman. In this way assistance is provided for a period of years or for life, and the principal is ultimately devoted to a charitable purpose.

The irrevocable trust may also be profitably utilized for charitable purposes in connection with the establishment of a charitable foundation. As is well known, the federal tax laws are designed to encourage taxpayers to contribute generously to public and private charities.[7] The proper use of a charitable foundation, which is customarily either in the form of an irrevocable trust or a nonprofit corporation, permits the settlor to obtain the full benefit of the favorable exemptions for charitable contributions in the federal income, estate, and gift taxes. At the same time, by reducing the size of the estate on which an estate tax will have to be paid, it reduces the need for cash at the settlor's death, thus decreasing the possibility of a forced sale of a portion of the assets at subnormal prices.

In addition, a charitable trust provides a means for preserving control of a business, often a serious estate planning problem where large, valuable business units are owned and controlled by a single individual.

[6] In addition, of course, the irrevocable inter vivos trust possesses all the advantages over a testamentary trust outlined later herein in the discussion of revocable inter vivos trusts. See p. 62 *infra*.

[7] *See* INT. REV. CODE §§ 23(o), 101(6), 812(d), and 1004(a)(2).

Frequently such an individual is faced with the fact that if he attempts to transfer his interest in the business to his family by inter vivos gifts, the gift tax will be so large as to force a sale of a portion of the business to pay the tax while if he permits the business to pass at his death, the even larger estate taxes will make necessary the sale of an even greater portion of his interest. Either way, his control or that of his family over the business may be jeopardized. Often ownership of a majority interest in a business is significant to a person of wealth primarily because of the control it permits over the policies of the business and the assurance that he will receive regular compensation for personal services and is relatively insignificant in terms of dividends or other return on capital, most of which would be consumed by income surtaxes if paid to the individual.

The charitable foundation utilizing an irrevocable trust is a possible solution to such a dilemma, for the settlor can serve as one of the trustees and provide for a board of trustees composed of members of his family and other persons he desires to assist him in managing the business who, given the power to fill vacancies among the trustees, can perpetuate the control indefinitely. At the same time, some deserving charity obtains the income from the capital, most of which would otherwise be paid in income taxes.[8]

Still another use of the irrevocable trust is to hold life insurance policies. Inasmuch as the subject of life insurance trusts is more fully discussed later in this symposium,[9] the writer will merely observe in passing that no tax advantages will accrue from the creation of an irrevocable insurance trust, except where (1) a spouse or some other person having an insurable interest in the insured's life takes out the policies and pays all the premiums out of his or her independent funds, (2) the insured has none of the incidents of ownership, and (3) the proceeds are not payable to the insured's estate.

A fairly common use of an irrevocable inter vivos trust, which may or may not be part of an estate plan, is in divorce settlements in connection with alimony and support payments. If the establishment of the trust is pursuant to the terms of a valid and binding decree of divorce or separate maintenance and the instrument itself is properly drawn, the settlor will obtain substantial tax benefits from this form of final settlement with an ex-spouse.[10] As already noted, such an alimony or support trust is not necessarily part of an estate plan, but the initial impetus for many such plans has come from an over-all appraisal of an individual's assets first made in connection with a divorce settlement.

[8] For an excellent discussion of the use of charitable foundations, see 2 POLISHER, ESTATE PLANNING AND ESTATE TAX SAVING 572 ff. (2d ed. 1948).

[9] Waldo, *Life Insurance and Estate Planning*, see p. 95 at 112 *infra*.

[10] For a discussion of the present status of alimony trust income, see 1 RABKIN & JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION E4 § 4, 912b ff. (1942).

While other circumstances or situations in which an irrevocable trust may be the best device to use as part of an estate plan will undoubtedly occur to the reader from the foregoing examples and the discussion of the tax implications of irrevocable trusts which follows, the most important consideration in setting up such a trust is always whether or not the settlor can safely give up all interest in the property which is to go into the trust. An irrevocable trust is frequently preferable to an outright gift. It is rarely, if ever, a sound alternative for a revocable or testamentary trust.

TAX ASPECTS OF IRREVOCABLE TRUSTS

The first tax which comes into play upon the creation of an irrevocable trust is the federal gift tax. The general formula for computation of the gift tax and the effect of gifts in prior years upon the current year tax are discussed earlier in the symposium.[11] Certain special considerations applicable to gifts in trust, however, must be at least briefly referred to here.

At one time the courts held that the trust was the donee of a gift in trust and the settlor was entitled to one annual exclusion per trust, regardless of how many beneficiaries the trust had or, conversely, how many trusts were set up in the particular year for the same beneficiary.[12] This, of course, resulted in tax-conscious settlors establishing large numbers of identical small trusts for the same beneficiary. The present rule, however, permits the settlor only one annual exclusion for each beneficiary without reference to the number of trusts or other gifts.[13] While the tax advantages of individual trusts no longer exist, it is still desirable for a number of other reasons, however, to set up separate trusts for each beneficiary if the corpus lends itself to division among several trusts.

The principal practical problem in the application of the gift tax to irrevocable inter vivos trusts is that of valuation. Any interest irrevocably and absolutely disposed of, whether a life estate, term interest, or a remainder, is subject to gift tax on its commuted value, which is the present worth of the interest determined by reference to actuarial tables on the life expectancy of the various beneficiaries.[14]

An additional important consideration in the application of the gift tax to irrevocable trusts is the provision that the $3,000 annual exclusion per individual donee or beneficiary is not applicable to gifts of "future interests." These include reversions, contingent or vested re-

[11] Epstein, *op. cit. supra* note 3 at 22.

[12] Commissioner v. Krebs, 90 F.2d 880 (C.C.A. 3rd 1937); Commissioner v. Wells, 88 F.2d 339 (C.C.A. 7th 1937).

[13] Helvering v. Hutchings, 312 U.S. 393, 61 Sup. Ct. 653 (1941); U. S. Treas. Reg. 108, § 86.10 (1943).

[14] *Id.* § 86.19.

mainders, and other estates, whether or not supported by a particular intermediate interest or estate, "which are limited to commence in use, possession, or enjoyment at some future date or time." [15] This means that in a trust giving a life or term interest to *A* with the remainder to *B*, only one exclusion for the gift to *A* will be allowed, the remainder to *B* being considered a "future interest." Further, if the income is to be paid to *A* only in the discretion of the trustee or upon the happening of certain contingencies, even *A's* interest will be deemed "future" and no exclusion allowed.[16]

Finally, not only is the annual exclusion not applicable to "future interests," but it is also disallowed where the value of the interest cannot be determined, *e. g.*, if the trustee has discretion to terminate the interest or where the interest is to terminate on the happening of some indeterminate future contingency such as marriage or where it is shown to be of no value.[17]

While the tax advantages of an irrevocable trust lie in the fact that if the trust is properly drawn, the corpus is not includible in the settlor's estate for estate tax purposes and the income of the trust is not taxed to him, the category of trusts which may enjoy these tax benefits has been so narrowed by the courts and Congress in the past twenty years that at least a general knowledge of the present limitations on such trusts is essential to an understanding of their possible use.

Let us examine first the problems with respect to the federal estate tax. It is apparent, of course, that the question of whether an irrevocable trust was created "in contemplation of death," [18] presents substantially the same problems as in the case of an outright gift, and the reader is referred to the discussion earlier in the symposium on that subject.[19]

While the question of whether an irrevocable trust was created in contemplation of death is frequently a troublesome one, the really difficult estate tax problems have arisen in connection with the provisions of Section 811(c) of the Internal Revenue Code relating to the inclusion in a decedent's estate of any interest:

> ". . . of which he has at any time made a transfer, by trust or otherwise, . . . intended to take effect in possession or enjoyment at or

[15] *Id.* § 86.11. The broad scope of the regulations in this connection has been sustained in Commissioner v. Disston, 325 U.S. 442, 65 Sup. Ct. 1328 (1945); Fondren v. Commissioner, 324 U.S. 18, 65 Sup. Ct. 499 (1945); Ryerson v. United States, 312 U.S. 405, 61 Sup. Ct. 656 (1941); United States v. Pelzer, 312 U.S. 399, 61 Sup. Ct. 659 (1941).

[16] Fondren v. Commissioner, *supra* note 15; Ryerson v. United States, *supra* note 15; French v. Commissioner, 138 F.2d 254 (C.C.A. 8th 1943); Commissioner v. Brandegee, 123 F.2d 58 (C.C.A. 1st 1941).

[17] Margaret A. C. Riter, 3 TC 301 (1944); Elizabeth H. Polk, 5 TCM 357 (1946).

[18] INT. REV. CODE § 811 (c).

[19] Epstein, *op. cit. supra* note 3 at 34.

after his death, or of which he has at any time made a transfer, 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, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; . . ." [20]

The history of the change in the concept of what retained interests in trusts are includible in a decedent's estate is a fascinating one and should be read in detail by every lawyer not only in connection with estate planning but as general background in the potential vagaries of American jurisprudence. While we are here concerned not so much with the interesting past as with the more important present and future, a quick look at the evolution of the present rule is, nevertheless, essential to its understanding as well as to an estimate of the future and is particularly appropriate in the light of two recent Supreme Court decisions.[21]

The history of the tax status of reservations of life income by a trust settlor graphically illustrates the checkered course of federal estate tax application to trusts. From the passage of the first estate tax law in 1916 until the 1930 decision of the Supreme Court in *May v. Heiner*,[22] which held to the contrary, it was assumed that trusts in which the settlor reserved a life income fell within the category of transfers intended to take effect in possession or enjoyment at death and that the corpus was, therefore, includible in the settlor's estate. After the decision in *May v. Heiner*, the Treasury Department almost immediately brought other cases before the Supreme Court attempting to obtain its reversal, but *May v. Heiner* was followed by the Court on March 2, 1931, in three *per curiam* opinions.[23] This so disturbed the Acting Secretary of the Treasury, Ogden Mills, that he urged Congress immediately to enact corrective legislation, and on March 3, 1931, the following day, a joint resolution was adopted amending what is now Section 811 (c)[24] so as to make the corpus of any trust with reserved life income subject to federal estate tax. The joint resolution itself left open the question of whether trusts created prior to the date of its enactment were to be treated on the basis of *May v. Heiner* or were subject to estate tax, but there is considerable legislative

[20] INT. REV. CODE § 811 (c).

[21] Commissioner v. Church's Estate, 335 U.S. 632, 69 Sup. Ct. 322 (1949); Spiegel's Estate v. Commissioner, 335 U.S. 701, 69 Sup. Ct. 301 (1949).

[22] 281 U.S. 238, 50 Sup. Ct. 286 (1930).

[23] Burnet v. Northern Trust Co., 283 U.S. 782, 51 Sup. Ct. 342 (1931); Morsman v. Burnet, 283 U.S. 783, 51 Sup. Ct. 343 (1931); McCormick v. Burnet, 283 U.S. 784, 51 Sup. Ct. 343 (1931).

[24] Joint Resolution of March 3, 1931, 46 STAT. 1516-17 (1931).

history indicating that Congress did not consider or intend the resolution to be retroactive.[25]

In 1938 the Supreme Court in *Hassett v. Welch* and *Helvering v. Marshall*,[26] companion cases, held that neither the joint resolution nor a similar provision in the Revenue Act of 1932 [27] applied to trusts created prior to March 3, 1931, and that *May v. Heiner* consequently governed pre-1931 trusts. Accepting these decisions, the Treasury Regulations since 1938 also have followed the *May v. Heiner* doctrine with respect to trusts created prior to that date.[28]

On January 17 of this year, the Supreme Court completed the cycle by reversing *May v. Heiner* specifically and, in effect, also *Hassett v. Welch* and *Helvering v. Marshall*, as well as the Treasury Regulations, so that the rule now is that the corpus of every trust, regardless of when created, in which the settlor reserves a life income is part of his estate for federal estate tax purposes.

Perhaps even more erratic has been the pattern with respect to the application of the provisions of Section 811 (c) to trusts containing what have come to be known as "possibilities of reverter." One year after *May v. Heiner*, the Supreme Court held in *Klein v. United States* [29] that under a trust in which the grantor conveyed property to her husband for his life provided that if he survived her the corpus was to go to him in fee, but that the fee was to remain in the wife if the husband predeceased her, and where the applicable state law (Illinois) made the death of the wife before the husband a condition precedent to his taking, the value of the corpus was includible in her estate as an interest to take effect in possession or enjoyment at death, even though she predeceased the husband.

Four years later (1935) in two cases [30] involving interests generally similar to those in the *Klein* case, except that under the applicable state law (Missouri) the grantor was deemed to have transferred legal title to the corpus subject to a condition subsequent which might effect a reverter, the Court held that the corpus of the trust was not part of the settlor's estate.

Then in 1940 followed the famous, or infamous, as you will, *Hallock* decision.[31] Expressly disregarding and discarding traditional principles and technicalities of legal title and conveyancing, the Court there held that under a trust in which the settlor's wife was given a life interest with

[25] *See* the analysis of the legislative history in Justice Frankfurter's dissenting opinion in Commissioner v. Church's Estate, 335 U.S. 632, 667, 69 Sup. Ct. 337, 345 (1949).

[26] 303 U.S. 303, 58 Sup. Ct. 559 (1938).

[27] Revenue Act of 1932, § 803 (a), 47 STAT. 279 (1932).

[28] U. S. Treas. Reg. 105, § 81.18 (1942).

[29] 283 U.S. 231, 51 Sup. Ct. 398 (1931).

[30] Helvering v. St. Louis Trust Co., 296 U.S. 39, 56 Sup. Ct. 74 (1935); Becker v. St. Louis Trust Co., 296 U.S. 48, 56 Sup. Ct. 78 (1935).

[31] Helvering v. Hallock, 309 U.S. 106, 60 Sup. Ct. 444 (1940).

a remainder in fee if she survived him, provided that if the settlor survived his wife the corpus would revert to him on her death, and where in fact the settlor predeceased his wife, the corpus, less the value of the wife's life estate, was includible in the husband's estate.

The *Hallock* case was followed by a large number of decisions in which the courts attempted to draw some line of demarcation or evolve some standard as to the scope of the doctrine. The Tax Court decisions attempted to establish a rule based upon the degree of remoteness of the possibility of reverter.[32] On the other hand, the Treasury Regulations rejected remoteness of the reversion as a factor of any significance.[33] This also appeared to be the attitude of the Supreme Court in several related, although not entirely analogous, cases.[34]

All doubt on the subject, however, was removed on January 17 by the decisions in the *Church* and *Spiegel* cases,[35] particularly the latter. In the *Spiegel case,* the setttlor had created a trust in 1920 which provided that during his life the trust income was to be divided among his three children, the share of any child predeceasing the settlor to be divided among his surviving children. On the settlor's death, the corpus was to be distributed in the same manner. As distinguished from all of the previous cases in which the Supreme Court had held the corpus includible in the settlor's estate, the trust here contained no express provision for the ultimate reversion of the property to the settlor if all the named beneficiaries pre-deceased him. On the contrary, the settlor evidenced every intention of disposing completely and irrevocably of his interest in the corpus. Accordingly, if a possibility of reverter under the trust existed at all, it did so only by operation of law and not as a result of an express reservation in the trust.

Whether under the provisions of Illinois law, the settlor did have a possibility of reverter by operation of law was one of the disputed points in the case. The majority of the Court accepted the conclusion of the Circuit Court of Appeals that he did; the minority concluded either that he did not or that there was such doubt on the subject that the case ought to be remanded to the Circuit Court of Appeals so that a declaratory judgment action might be brought in the state courts to obtain a definitive determination of the disputed question of law.[36]

Notwithstanding the fact that the settlor evidenced no intention to reacquire the corpus at any time in the future, that the existence of a possi-

[32] *See* Estate of Nettie Friedman, 8 TC 68 (1947); Estate of Edward P. Hughes, 7 TC 1348 (1946); Estate of George W. Hall, 6 TC 933 (1946).

[33] U. S. Treas. Reg. 105, § 81.17 (1942), particularly the examples thereunder.

[34] Commissioner v. Estate of Field, 324 U.S., 113, 65 Sup. Ct. 511 (1945); Fidelity Co. v. Rothensies, 324 U.S. 108, 65 Sup. Ct. 508 (1945).

[35] See note 21 *supra.*

[36] *See* the dissents of Justices Burton, Estate of Spiegel v. Commissioner, 335 U.S. 701, 708, 69 Sup. Ct. 301, 304, and Frankfurter, Commissioner v. Church's Estate, see note 25 *supra.*

bility of reverter by operation of law under the Illinois law was in serious dispute, that even if he did possess such a possibility of reverter the chances that he would survive all his children and grandchildren were approximately one and one-half out of one hundred at the time of the creation of the trust in 1920, and that he actually was survived by three children and three grandchildren, the Court held that the entire value of the corpus of approximately $1,000,000 was part of his estate, resulting in an estate tax of $450,000.[37]

It is to be noted that once again the cases have run the gamut. Ironically enough the *Spiegel* decision, which represents the ultimate logical extension of the *Hallock* case in which the Court rejected the niceties of conveyancing and other legal technicalities and looked to economic realities, results in a $450,000 estate tax being paid on an interest which at the time of creation of the trust had a commuted value of $4,000 at most, on which the estate tax would be approximately seventy dollars, all because in establishing the trust the legal technicality of providing a specific ultimate remainderman other than the settlor was neglected.

Apparently, technicalities can neither be relied upon nor ignored. Had the Court adhered to its philosophy of the *Hallock* case that the realities of the settlor's action would be determinative, a rational standard for application of the estate tax based on fundamental principles of economic justice might have resulted. As things now stand, however, the net result of the Court's labors on the subject over the past twenty years appears to be merely the substitution of one series of technicalities for another and the collection of some estate taxes in the process.[38]

In any event, the only safe way at present to protect against future difficulties on this score is to make certain that under no circumstances will the remainder revest in the grantor, for in the language of the Court,

> ". . . an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter." [39]

[37] It is to be particularly noted that whereas in the earlier cases and under the Regulations, U. S. Treas. Reg. 105, §§ 81.10 and 81.17 (1942), the value of outstanding life estates was excluded from the gross estate of the settlor, the Court, wittingly or unwittingly, in the *Church* and *Spiegel* cases included the entire value of the trust corpus in the settlor's estate without deduction of the value of any intermediate vested life estates.

[38] For some interesting suggestions as to possible patterns of taxation of *Hallock* trusts, see Spencer, *The Federal Estate Tax on Inter Vivos Trusts; A Common Sense Rule for Hallock Cases*, 59 HARV. L. REV. 43 (1945); Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337 (1942). Congressional action on the subject, particularly in the light of the taxation of the entire corpus in the *Church* and *Spiegel* cases, seems almost inevitable.

[39] Commissioner v. Estate of Church, *supra* note 21 at 645, 69 Sup. Ct. at 329.

If all possible alternative remaindermen have been exhausted and there still remains some possibility of reverter, no matter how slight mathematically, the final technical remainder should be granted either to the heirs of the last-named remainderman, excluding the settlor, or for charitable purposes generally.

Not only is it essential that the settlor divest himself of all interest in the corpus of the irrevocable trust, but he must also give up any "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. . . ." [40]

This means that the settlor at the time of creation of an irrevocable trust must not only be satisfied to dispose of all his interest in the corpus, but must also either be certain as to the persons or groups of persons he desires to enjoy the benefits of the trust in the future or be satisfied to trust someone else's judgment in the matter, for the retention of any right to alter or amend the terms of the trust will in almost every case result in the imposition of federal estate tax.

One more observation with respect to the estate tax aspects of irrevocable trusts. Some ingenious reader may conceive that the tax benefits denied by Section 811(c)[41] and the decisions thereunder if the settlor retains any interest in the principal or income or any power to alter or designate beneficiaries may be salvaged by the creation of reciprocal trusts in which two parties set up substantially similar interests and powers in each other. The rule of the cases, however, is that similar reciprocal trusts created at substantially the same time result in each party being taxed as though he were also the settlor of the trust of which he is the beneficiary.[42]

So much for the gift and estate tax implications of irrevocable trusts. There remain the important questions arising in connection with the federal income tax.

It is, of course, beyond the scope of this article to cover all the innumerable income tax questions and problems which may arise in connection with an irrevocable trust. Generally speaking, an irrevocable trust is a separate taxable entity and the trustee must report the gross income less allowable deductions and pay a tax for the trust just as though it were an individual taxpayer.[43] The principal difference between the taxation of an individual and that of a trust is the allowance to the latter, in addition to the deductions against gross income ordinarily allowable to an individual, of a further deduction for all trust income which is currently

[40] INT. REV. CODE § 811(c).

[41] *Ibid.*

[42] Cole's Estate v. Commissioner, 140 F.2d 636 (C.C.A. 8th 1944); Lehman v. Commissioner, 109 F.2d 99 (C.C.A. 2d 1940); Estate of John H. Eckhardt, 5 TC 673 (1945).

[43] For a comprehensive discussion of the application of the federal income tax to irrevocable trusts, see KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES 52-448 (1948).

distributed or distributable or which is properly paid or credited to the beneficiaries and such income is included in the gross income of the beneficiaries.[44]

From the point of view of estate planning, however, the important tax questions arise not so much in connection with the taxation of income to the trust or the beneficiaries, but in those circumstances in which the income is taxed to the settlor, for income tax savings ordinarily result only when the grantor is relieved of the tax and either the trust or the beneficiaries pay it.

There are three general categories of trusts the income of which is taxed to the settlor: (1) revocable trusts in which the grantor has the power by action on his part or in conjunction with another person whose interests are not substantially adverse to get the corpus back;[45] (2) trusts, the income of which the settlor has the power by action on his part or in conjunction with a non-adverse person either to distribute to himself or accumulate for future distribution to himself;[46] and (3) trusts which do not fall in categories (1) or (2) but under all the circumstances of which, the grantor is deemed to be the substantial owner of the corpus and, therefore, taxable on the income.

Trusts in categories (1) and (2) are covered specifically by the provisions of Sections 166 and 167 of the Internal Revenue Code and are discussed briefly later in connection with revocable trusts.[47] The boundaries of the third category, however, trusts in which the settlor is deemed to be the substantial owner of the corpus, or what are commonly referred to as *Clifford* trusts,[48] are still in the process of clarification. As a result, any trust, even though clearly outside the scope of Sections 166 and 167, in which the grantor merely parts with the income for a limited number of years is likely to be ignored for income tax purposes and the income taxed to the grantor under Section 22(a) of the Internal Revenue Code[49] on the theory that he is receiving benefits which are equivalent to income.

As indicated, this theory first received the Supreme Court's imprimatur in *Helvering v. Clifford*.[50] The trust there involved was for a term of five years except that it would terminate earlier upon the death of either the settlor or his wife. The settlor was also the trustee and reserved broad administrative powers to himself in that capacity. His wife was

[44] INT. REV. CODE § 162(b) and (c).

[45] *Id.* § 166.

[46] *Id.* § 167.

[47] See p. 64 *infra*.

[48] From Helvering v. Clifford, 309 U.S. 331, 60 Sup. Ct. 554 (1940).

[49] Section 22(a), readers will recall, is the basic provision of the Internal Revenue Code containing the general definition of gross income and, in contrast to §§ 166 and 167, has no special application to trust income.

[50] Helvering v. Clifford, see note 48 *supra*.

the sole income beneficiary during the five-year period and upon termination the corpus would revert to the settlor. Stressing that no one of these facts was controlling, the Court concluded that where all were combined "we have at best a temporary allocation of income within a family group," [51] and the income was held taxable to the settlor notwithstanding the existence of the trust.

The decision shattered the theretofore-accepted conclusion that settlors were taxable on the income of trusts only if Section 166 or 167 was applicable and started a guessing game which is still going on as to where the boundary line of taxability under the doctrine will ultimately be drawn. Some of the courts have concluded that it was to be limited to "rather exceptional and extreme cases" [52] as the *Clifford* case itself obviously was. Other lower court decisions,[53] however, have shown a tendency to broaden the scope of the doctrine although the Supreme Court itself has shed no further light on the subject.

The Treasury Department, on the other hand, has taken a broad view of the doctrine. Section 29.22(a)-21 of the Income Tax Regulations [54] announces that certain single factors alone, rather than the combination of factors which the Court found persuasive, are sufficient to make the income taxable to the settlor under Section 22(a).[55] If, for example, the corpus or the income of the trust will or may revert to the settlor within ten years after the date of creation of the trust or within fifteen years if the beneficiary is other than a charity and the settlor or a spouse (living with the settlor and not having a substantial adverse interest in the income or corpus) has certain enumerated administrative powers, such as the power to vote stock or direct trust investments, then under the Treasury Regulations the income is taxable to the settlor.[56]

Similarly, regardless of the length of the trust or other factors, if the settlor or some other nonadverse person has the power to alter, determine, or control the beneficial enjoyment of the corpus or income, that fact alone, the Treasury Department says, will make the income taxable to the settlor unless the power is not exercisable until after ten years or after fifteen years in the case of trusts within the fifteen-year rule previously discussed.[57]

[51] Helvering v. Clifford, see note 48 *supra* at 335, 69 Sup. Ct. at 557.

[52] United States v. Morss, 159 F.2d 142, 143 (C.C.A. 1st 1947).

[53] *See* Helvering v. Elias, 122 F.2d 171 (C.C.A. 2d 1941), holding the settlor taxable on the income of six and one-half year trusts in which he reserved no control but the beneficiaries of which were the settlor's children; Leonard Farkas, 8 TC 1351 (1947), holding that a life beneficiary of a trust who assigned his interest in trust to his brothers and sisters for a period of ten years, naming a brother as trustee, remained taxable on the income.

[54] U. S. Treas. Reg. 111, § 29.22(a)-21, as added by T. D. 5488, 1946-1 CUM. BULL. 19, amended by T. D. 5567, 1947-2 CUM. BULL. 9.

[55] INT. REV. CODE § 22(a).

[56] U. S. Treas. Reg. 111, § 29.22(a)-21(b) and (c).

[57] *Id.* § 29.22(a)-21(d).

Another factor which, according to the Treasury Regulations, is sufficient in and of itself to tax the income to the settlor is administrative control over the corpus or income which control may or will be exercised primarily for the benefit of the settlor, including a power in the grantor or some person not having a substantial adverse interest (1) to purchase, exchange, or otherwise deal with the trust corpus or income for less than full consideration in money or money's worth, (2) to permit the settlor to borrow the corpus or income without adequate interest or security, or (3) to permit the settlor to reacquire the corpus by substituting other property.[58]

The necessary limitations of this discussion together with the absence to date of any really definitive decision on the subject, notwithstanding the fact that over one hundred opinions attempting to apply the *Clifford* doctrine have been handed down by the various circuit courts of appeals,[59] preclude any exhaustive analysis here either of the cases or the Treasury Regulations. Because of the almost infinite combinations and permutations of rights, powers, interests, and benefits which may be created in trusts, it is conceivable that no simple absolutes will ever be arrived at by the courts in this connection, although it is much to be hoped that more order will evolve from the *Clifford* chaos than now exists.

The only advice which can safely be given a reader preparing a trust which may fall within the growing tentacles of the doctrine is that he make a careful study of the principal cases, the Treasury Regulations, and some of the erudite commentaries in the legal periodicals on the subject [60] before making his own best guess. Even after doing all this, the planner should warn the client that the income tax possibilities are necessarily uncertain, for even reliance on the Treasury Regulations, which now seem extreme enough when compared with the facts in the original *Clifford* case, may ultimately turn out to be hazardous.

The foregoing discussion of the gift, estate, and income tax aspects of irrevocable trusts serves to underscore the basic principle with respect to such trusts emphasized at the outset. Unless the settlor is prepared to divest himself of all interest in both corpus and income to the same extent as he would in making an outright gift, no substantial tax benefits are likely to accrue, and an irrevocable trust should be avoided.

The discussion of the present limitations on estate and income tax savings also serves as an excellent transition into the subject of revocable

[58] *Id.* § 29.22(a)-21(e).

[59] For a comprehensive list of decisions by the various circuit courts of appeal, see KENNEDY, *op. cit. supra* note 41 at 683-686.

[60] See Casner, *Taxation of Incomes Under T. D. 5488; As Modified By Proposed Amendments to Clifford Regulations*, 84 TRUSTS & ESTATES 233 (1947); Eisenstein, *The Clifford Regulations and the Heavenly City of Legislative Intention*, 2 TAX L. REV. 327 (1947); Pavenstedt, *The Treasury Legislates: The Distortion of the Clifford Rule*, 2 TAX L. REV. 7 (1946); Guterman, *The New Clifford Regulations*, 1 TAX L. REV. 379 (1946).

trusts, for it should be apparent that if reservation of life income, possibility of reverter, administrative control, comparatively short duration, or other factors are going to deprive the trust of the tax advantages of irrevocable trusts, the estate planner whose settlor desires to include any of the foregoing will be well advised immediately to direct his attention to some form of revocable trust.

REVOCABLE TRUSTS

The business advantages of a revocable inter vivos trust are many and in most instances obvious. As a matter of fact, the overwhelming majority of the numerous trusts currently being established as part of estate plans are revocable trusts. As suggested earlier, the revocable inter vivos trust is in many respects similar to, and is frequently an alternative for, a testamentary trust. Accordingly, it will be useful not only to consider the over-all advantages of a revocable living trust, but also to compare such a trust with its testamentary alternative.

With an inter vivos revocable trust, the settlor has an opportunity during his lifetime and while he can still alter, amend, or revoke the trust, to see how the trustee functions and how, in all probability, the trust will be carried out after his death. This is one important respect in which such a trust is superior to a testamentary trust.

A second advantage of a revocable trust is its continuity. Whereas a testamentary trust must be set up as part of the probate of the settlor's estate with the inevitable delays attendant on the probate process, the living trust will continue in operation with no delay and a minimum of disturbance upon the settlor's death.

A third advantage of such a trust is its comparative economy. Not only are the initial costs, including drafting the trust instrument and fees of the trustee, relatively low, but the savings at and after the settlor's death are also likely to be substantial because the trust corpus is not subject to probate.

A fourth advantage is the privacy of an inter vivos trust. This may be significant either to protect against disclosure of the identity of particular beneficiaries, *e.g.*, the incompetent relative, or to avoid revealing important business information, both of which are frequently impossible in the probate court.

A fifth advantage is the opportunity which such a trust presents for the settlor to select the law which he desires to govern the administration of his property. A number of states, for example, prohibit nonresident corporate trustees. This in effect limits the prospective corporate trustees of testamentary trusts to those in the state of the decedent's domicile. By use of an inter vivos trust, on the other hand, the settlor can select a cor-

porate trustee anywhere. Frequently, too, a resident of a community property state may desire that his property not be administered under community property rules. Or again, there may be tax advantages in the selection of a trustee in a state having no income tax.

A sixth advantage is the relative certainty of an inter vivos revocable trust. Neither the alleged nor actual incompetence of the settlor will affect the administration of his property during his life nor is it likely to serve as a basis for upsetting the trust on his death, a lurking danger in all testamentary trusts.

A seventh advantage, and probably the most important of all, is the extreme flexibility of a revocable trust. The settlor not only is in a position to take any necessary action to protect his own business or economic interests, but he can also alter or amend the trust at any time to reflect changes in the identity or circumstances of the beneficiaries.

While other incidental advantages may exist in specific instances, such as the freedom from attack by creditors [61] or the protection against loss or dissipation in the later years of life, the desirability of an inter vivos trust over a testamentary trust in most instances is apparent.

The most common type of a revocable living trust is the protective family trust. While the Revenue Act of 1948 has made certain technical variations desirable which will be discussed later,[62] the general pattern of such a trust is that the father sets it up placing the property in the hands of a competent trustee, reserving a life income and a right to veto investment and other business judgments of the trustee, and the power to amend or revoke the trust. Usually he provides for a life income to his wife after his death and during her life or after her death also to his children, with remainders either to the children or grandchildren. The trustee is given broad powers to handle the trust in the interests of the beneficiaries, including the right to invade principal if necessary.

The settlor may deposit in such a trust most of his securities and other investment assets and some of his life insurance policies, withholding sufficient policies so that some can be used to supply ready cash if needed upon his death and some policies can be placed on option settlement for his wife. If, in addition, he executes a will specifying the distribution of his personal effects and home real estate but providing that the residue of his estate shall be "poured over" to the trustees of the inter vivos trust for inclusion therein, a complete and highly satisfactory estate plan for the average individual will result.

[61] *See* Gurnett v. Mutual Life Ins. Co., 356 Ill. 612, 191 N.E. 250 (1934); *cf.* Smith v. Northern Trust Co., 322 Ill. App. 168, 54 N.E.2d 75 (1944), in which a revocable trust into which the settlor had placed substantially all of his assets was set aside after his death to permit the widow to recover her statutory one-third interest. See also, 92 A. L. R. 282 (1934); 93 A. L. R. 1211 (1934).

[62] See p. 66 *infra*.

Two basic legal questions arise in connection with revocable trusts, the answers to which must be found for the appropriate jurisdiction before such a trust may be safely used as part of an estate plan. The first is whether a revocable trust effects a valid, subsisting, and immediate transfer of the corpus so as to eliminate any possibility of the trust being held to be testamentary in nature and thus invalid unless executed in conformance with the applicable Statute of Wills.[63]

While the courts of some states have held that the reservation by the settlor of substantial control plus the power to revoke results in the trust being testamentary in character,[64] the majority of the jurisdictions, including Illinois, recognize the validity of the trust as an inter vivos transfer, even though the settlor has reserved very broad powers and interests in the trust.[65]

The other basic question concerns the validity of a testamentary provision directing that the residue of an estate be transferred to the trustees of an inter vivos trust for inclusion in the corpus of the latter, or what is sometimes known as a "pour over" from an estate into a living trust. While it has been suggested that such a transfer may be justified on the ground that the trust is an independent entity,[66] the generally-accepted basis for such a provision is the traditional doctrine of incorporation by reference. This appears to be the justification for such "pour overs" in Illinois.[67] Accordingly, it is highly desirable in the drafting of a will that reference be made only to then-existing trusts. Further, the testator should be informed that any change in the trust must be accompanied by a codicil to the will recognizing and incorporating the amendment.

TAXATION OF REVOCABLE TRUSTS

As a general observation, it can be said that as a result of amendments to the Internal Revenue Code and the decisions of the Supreme Court, the revocable living trust does not exist so far as federal taxes are concerned. In consequence, no gift tax is ordinarily payable at the time of creation of the trust, the income is taxable to the settlor whether distributed or not, and the corpus is includible in the decedent's estate. While this may appear to detract from the desirability of creating such

[63] ILL. REV. STAT., c. 3, §§ 193-205 (1947).

[64] See cases compiled in 1 SCOTT, TRUSTS § 57.2, 339-340 (1939).

[65] People v. Northern Trust Co., 289 Ill. 475, 124 N.E. 662 (1919); Gurnett v. Mutual Life Ins. Co., 356 Ill. 612, 191 N.E. 250 (1934); Bergmann v. Foreman State Tr. and Sav. Bank, 273 Ill. App. 408 (1934).

[66] See 1 SCOTT, *op. cit. supra* note 64 § 54.3, 293-300 (1930).

[67] While the Supreme Court of Illinois has apparently never considered a case involving the incorporation by reference of a trust in a will, the doctrine of incorporation by reference is well established in Illinois with respect to wills. *See* Newhall v. Newhall, 280 Ill. 199, 117 N.E. 476 (1917); Bottrell v. Spengler, 343 Ill. 476, 175 N.E. 781 (1931); Eschmann v. Cawi, 357 Ill. 379, 192 N.E. 226 (1934).

trusts, it should be remembered that these tax consequences are substantially the same as when the settlor creates a testamentary trust while the living trust has all the economic and other advantages previously pointed out.

While the foregoing general observations cover most situations, it will be apparent on even casual reflection and examination of the pertinent provisions of the Internal Revenue Code [68] that innumerable gift, estate, and income tax questions may arise in connection with trusts which are not clearly irrevocable on the one hand and not clearly revocable on the other.

The limitations of this symposium preclude any comprehensive analysis or discussion of the gift, estate, or income tax refinements with respect to those borderline trusts. A quick look at the applicable statutory provisions and a few specific cases, however, may give the reader a feel for the problems involved and serve as a background for further research in particular cases.

Section 811(d) of the Internal Revenue Code [69] specifies that to the extent that a settlor at the date of death has either alone or in conjunction with any other person, the power "to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death," the estate tax shall apply. While this language is broadly construed to include any trust in which the grantor has the power in any way to alter the enjoyment of the property,[70] it does not include the power to make mere ministerial or managerial changes or the power to make decisions which cannot materially affect the beneficial interests in the trust.[71]

So far as the income tax implications of these borderline trusts are concerned, as pointed out earlier, whether or not the income of a trust is taxable to the settlor depends on the applicability of Section 166 or 167 of the Internal Revenue Code or the expanding scope of Section 22(a) as interpreted in the *Clifford* [72] and succeeding cases.[73] The former two sections have been literally and strictly construed by the courts and re-

[68] Particularly INT. REV. CODE §§ 166, 167, 811, and 1000.

[69] Any reader desiring to investigate further into the tax possibilities and probabilities of such intermediate trusts will obtain valuable assistance by examining 1 POLISHER, *op. cit. supra* note 8 at 90-137, 360-406, 2 POLISHER, at 431-439, 447-449, 486-499; KENNEDY, *op. cit. supra* note 41 at 559-696.

[70] *See* Commissioner v. Estate of Holmes, 326 U.S. 480, 66 Sup. Ct. 257 (1946); Union Trust Co. of Pittsburgh v. Driscoll, 138 F.2d 152 (C.C.A. 3d 1943), *cert. denied*, 321 U.S. 764, 64 Sup. Ct. 521 (1944); Chickering v. Commissioner, 118 F.2d 254 (C.C.A. 1st 1941), *cert. denied*, 314 U.S. 636, 62 Sup. Ct. 70 (1941).

[71] *See* Reinecke v. Northern Trust Company, 278 U.S. 339, 49 Sup. Ct. 123 (1929); Dort v. Helvering, 69 F.2d 836 (App. D. C. 1934), *cert. denied*, 293 U.S. 569, 55 Sup. Ct. 80 (1934); George F. Fiske Estate, 5 TCM 42 (1946); Oscar H. Perrin Estate, 3 TCM 225 (1944); Estate of Henry S. Downe, 2 TC 967 (1943), *app. dism'd*, (C.C.A. 2d 1944).

[72] Helvering v. Clifford, 309 U.S. 331, 60 Sup. Ct. 554 (1940).

[73] See note 57 *supra*.

quire no extended examination here, while the *Clifford* doctrine has been previously discussed.

One technical observation concerning the application of the Revenue Act of 1948 to revocable trusts should be made. Inasmuch as the corpus will be includible in the settlor's estate, the same considerations with respect to the marital deduction apply as in the case of testamentary trusts.[74] Accordingly, it is desirable taxwise to create two separate trusts, in at least one of which all of the income is payable to the widow for life, and over the corpus of which she is given an unlimited power of appointment so that it qualifies for the marital deduction, while the ultimate distribution of the corpus of the second trust is either fixed by the settlor or the widow is given only a limited exempt power of appointment over it.[75]

In short summary, the revocable inter vivos trust is already the most widely used trust device in estate planning and, as planners and settlors reconcile themselves to the elimination of tax advantages previously assumed to exist in connection with such trusts, will undoubtedly become even more popular. It has numerous economic, social, and legal advantages over the testamentary trust, for which in most cases it is a superior alternative while taxwise it is no less advantageous.

POWERS OF APPOINTMENTS

"The power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out." [76] This unequivocal approbation by one of the country's leading authorities in the field of future interests should warrant the careful inspection of powers of appointment by every estate planner.

Not only is the power of appointment an efficient device, but it can also be a comparatively simple technique which should be better understood by general practitioners and more widely used.

The chief virtue of the power of appointment, of course, is that it enables the settlor to empower some person in whom he has confidence, such as his wife or a child, to determine the future distribution of income or corpus at a time frequently long after the settlor's death and in the light of circumstances at the later time.

While examples of the desirability and usefulness of such a power are almost endless, a brief description of its effectiveness in a few very common situations should suffice.

Among the difficult questions which the grantor of a trust always faces at the time of creation are what provision, if any, he shall make

[74] See Miller, *Transfers by Will*, p. 81 *infra*.
[75] INT. REV. CODE § 812(e).
[76] Leach, *Powers of Appointment*, 24 A. B. A. J. 807 (1938).

for possible surviving spouses of his children and whether or not he shall provide for equal remainders to his grandchildren.

When the trust is set up, some of the settlor's children may be married, others single. How the various marriages will work out is obviously uncertain. One son may die after the settlor but at a sufficiently early age so that his wife is left with minor children. A daughter may marry a husband with adequate resources so that even if she predeceases him, he will neither need nor want any part of her interest in the trust. Another son may outlive his wife but find that among his children—the settlor's grandchildren—some are economically well off while others need financial assistance. Still another child may encounter marital difficulties after the settlor's death and die either divorced or separated from his or her spouse.

Obviously no settlor can hope directly to specify a pattern of distribution which will adequately take care of even the contingencies just referred to, much less the almost infinite range of other possibilities.

The use of a power of appointment, however, can go a long way toward solving this problem. If each of the grantor's children is given a special or limited power of appointment to designate by will the distribution of his share of the trust fund income and corpus as between his spouse and children, the pattern of ultimate distribution within that group can be determined in the light of later circumstances. Since ordinarily the settlor's children will live twenty to thirty years longer than the settlor, the desirability of permitting them to specify the distribution after their death is apparent.

It is obvious, of course, that innumerable variations or limitations of the special power just discussed are possible. Frequently a settlor will prefer to give an initial special power to his wife. If the settlor lacks confidence in the judgment of a particular child or if one is an incompetent, alternative arrangements will, of course, have to be made. Under ordinary circumstances, however, the proper use of a power of appointment will add greatly to the effective and efficient utilization of a trust over a comparatively long period of time.

The reader will have noted that the foregoing example referred to a "special" or "limited" power of appointment. There are, of course, two categories of powers of appointment, general and special, and the estate planner must understand the distinctions between them, particularly since substantial tax consequences depend on which is used.

As the title indicates, a general power is unlimited and the holder may designate anyone, including himself, a beneficiary and give as broad or as narrow an interest as he may determine. A special or limited power, on the other hand, restricts the holder either in the persons he may designate, the interest he may confer, or both.

It must be pointed out that for federal tax purposes, a power to appoint to a class of which the holder of the power is a member is considered a general power although it is technically a special power of appointment.

While the general power has some use in estate plans, the special power, both because it enables the settlor to exercise a desirable minimum degree of control over the future distribution of the trust and because of the tax advantages it enjoys over the general power, has become by far the more widely used.

Before discussing the tax aspects of powers of appointment, it should be noted that an important legal question which must be borne in mind in creating such powers is the application of the Rule Against Perpetuities.[77] Apparently the fear of coming a cropper on this common law rule plus the fact that powers of appointment are slightly unorthodox in the traditional pattern of property rights has deterred many practitioners from making full use of this very effective device.

If, however, the draftsman will remember that in the case of inter vivos trusts, the date for determining lives in being is the date of creation of the trust (except in Delaware) and will limit the future interests accordingly, while at the same time impressing on the settlor that the trust must be amended if other children are born to him or if his marital status changes, occurrences which should always cause re-examination of a revocable trust in any event, the Rule Against Perpetuities need present no serious problems.[78]

TAX ASPECTS OF POWERS OF APPOINTMENT

As in the case of other estate planning techniques, powers of appointment involve the federal gift, estate, and income taxes. The first two of these were completely revised in their application to powers of appointment by the Revenue Act of 1942.[79] In addition, the Revenue Act of 1948,[80] providing for a marital deduction in connection with both the gift and estate tax, specifically limits such a deduction to powers of appointment meeting certain qualifications.

The standards for powers of appointment which will qualify for the marital deduction are the same for both gift and estate taxes.[81] All of the following conditions must exist:

[77] For an excellent discussion of the Rule, see Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638 (1938).

[78] The importance of periodic re-examination of estate plans, particularly documents such as trusts and wills, cannot be over-emphasized. Amendments to the Internal Revenue Code, significant decisions of the federal or state courts, as well as changes in the families of the settlor or the beneficiaries, frequently necessitate amendment of the basic documents.

[79] Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942); 56 STAT. 798.

[80] Pub. L. No. 471, 80th Cong., 2d Sess. (April 2, 1948).

[81] INT. REV. CODE §§ 812(e), 1004(a)(3).

1. The property subject to the power of appointment must pass from the settlor in trust, either through an inter vivos or testamentary trust.
2. Under the terms of the trust, the surviving spouse must be entitled for life to all of the trust income, which income must be payable at least annually.
3. The surviving spouse must have the power to appoint the entire corpus free of the trust to a class which includes the surviving spouse or his or her estate.
4. Such power of appointment must be exercisable by the surviving spouse alone and may not be subject to termination by any other person.
5. No other person may have any power to appoint any part of the corpus to any person other than the surviving spouse.

If the power of appointment meets the foregoing qualifications, the gift or bequest is eligible for the marital deduction.

This means that, so far as the gift tax is concerned at the time of creation of a living trust, if a qualified power of appointment to the settlor's spouse is included, one-half of the value of the property subject to the power of appointment will be deducted from the value of the gift for gift tax purposes. Other than (1) such a qualified power of appointment to a spouse, (2) a reservation by the settlor of a general power of appointment (which results in the trust being in effect a revocable trust since the settlor may appoint himself), or (3) a reservation by the settlor of a power to alter, amend, revoke, or terminate, the inclusion of a power of appointment in an inter vivos trust will not affect the gift tax on creation of the trust. Accordingly, the general principles discussed earlier in connection with the gift tax on irrevocable and revocable trusts will be applicable even if a power of appointment to a person other than the settlor or his spouse is included, for the test of gift tax application is the extent of the present gift.[82] From the settlor's point of view, a power given another person to direct the future distribution of the corpus or income of a trust does not diminish the settlor's gift at the time of creation of the trust.

A much more difficult tax question arises in connection with the release or exercise of a power of appointment.

The 1942 revision of the gift tax, as related to powers of appointment, specifically provides that "An exercise or release of a power of appointment shall be deemed a transfer of property by the individual possessing such power." [83] The only exceptions to this general provision

[82] See pp. 52 and 64 *supra*.

[83] INT. REV. CODE § 1000(c).

making the exercise or release of powers of appointment subject to gift tax are as follows:

1. A power to appoint within a limited class which does not include any persons other than the spouse of the holder of the power, the spouse of the grantor of the power, descendants (including adopted and illegitimate descendents) of either the holder or the grantor of the power or their spouses, except that the holder of the power may not be included even though a descendant of the grantor, and the charitable, educational, etc., donees described in Sections 1004(a) (2) and (b) of the Internal Revenue Code, and
2. A power to appoint within a restricted class if the holder of the power has no interest in the property and if the power is not exercisable to any extent for the benefit of the holder of the power, his estate, creditors, or the creditors of his estate.[84]

While the 1942 amendments substantially reduce the types of powers exempt from gift tax, the foregoing two categories utilized with a little ingenuity are adaptable to a surprisingly large number of situations.

A very serious problem, however, exists in the application of Section 1000(c) to family trusts. Typically such trusts empower the trustee to invade the corpus if necessary to provide adequate annual income for the widow of the settlor or to accumulate a portion of the annual income if it is greater than the widow requires. If the trustee, frequently a son or daughter, likewise has an interest in the remainder or in a subsequent life estate, the Treasury takes the position that because of the trustee's interest, his exercise of either the power of invasion or the power of accumulation is the exercise of a power of appointment not within the two exempt categories. As a result, any invasion of the corpus, for example, is considered a taxable gift to the extent of the trustee's pro rata interest in the remainder. As the statute now reads, therefore, in order to avoid gift tax, the power of invasion or accumulation may be invested only in a disinterested trustee.

One way of accomplishing this is to designate co-trustees, one of whom has no interest in the trust, with the specific provision that all powers to alter the distribution of income or corpus to the life tenant or life tenants shall be exercised solely by the disinterested trustee.

The limitations established by the 1942 amendments are applicable to the exercise of powers of appointment after January 1, 1943, even though created prior to October 21, 1942, the date of enactment of the Revenue Act of 1942. Congress, however, has specifically exempted from

[84] INT. REV. CODE § 1000(c).

gift tax the release prior to July 1, 1949,[85] of any power of appointment other than one reserved by the settlor of the trust if the power was created prior to October 21, 1942.[86]

It is apparent from the foregoing discussion that there is need for further clarification of the gift tax aspects of powers of appointment, and further legislation may be anticipated on the subject. As things now stand, however, the only safe course of action is to limit any power of appointment so as to bring it within the two exempt categories previously discussed, remembering all the while that a power to terminate, invade corpus, or accumulate income may constitute a power of appointment even though not expressly worded as such.

The estate tax, like the gift tax, has a dual aspect in its application to powers of appointment, presenting questions both as to the grantor of the power and as to the donee of the power.

With respect to the grantor, who is ordinarily the settlor of the trust, it has already been noted that a reservation by him of a general power of appointment results in the trust being in effect revocable and that the reservation by the settlor of the power to alter, amend, revoke, or terminate the trust likewise results in the corpus being taxed as part of his estate.[87] On the other hand, as in the case of the gift tax, the creation of a power in a person other than the settlor or his spouse will ordinarily not affect the application of the estate tax to the trust at the settlor's death.

As already indicated, the Internal Revenue Code was revised in 1942 so far as the application of the estate tax to the holder of a power of appointment is concerned. Section 811 (f) now provides that there shall be included in the gross estate of a decedent the value of any property with respect to which the decedent (a) had at the time of his death a power of appointment, (b) had at any time exercised or released a power of appointment in contemplation of death, or (c) had at any time exercised or released a power of appointment by a disposition intended to take effect in possession or enjoyment at or after his death, or by a disposition under which he retained for life or any period which did not in fact end before his death (1) the possession or enjoyment of, or the right to, the income from the property or (2) the right, either alone or in conjunction with any person, to designate the persons who were to possess or enjoy the property or the income therefrom, except in case of a

[85] Revenue Act of 1942, § 452(c), as amended by Pub. L. No. 635, 80th Cong., 2d Sess. (June 12, 1948).

[86] Specific legislation authorizing the release of general as well as special powers of appointment have been enacted in most states, including Illinois. *See* House Bill 403, Ill. Laws 1943, p. 6, effective May 25, 1943, ILL. REV. STAT., c. 30, §§ 177-182 (1947).

[87] See p. 65 *supra*.

bona fide sale for an adequate and full consideration in money or money's worth.[88]

The only exceptions to the foregoing general provisions are limited or special powers falling within the same categories previously outlined in connection with the gift tax.[89] While it may be anticipated that Congress will sooner or later provide somewhat broader categories of exempted powers, as things now stand, the warning previously expressed in connection with the gift tax must be here repeated. Readers are urged, so far as possible, to limit any powers strictly to the exempt categories. There are, of course, circumstances in which a general or other non-exempt power must be used to accomplish the settlor's purposes, in which event the tax consequences must be accepted.

With respect to powers created prior to October 22, 1942, if the holder of the power died before July 1, 1949, without exercising the power or if he was under a legal disability to release the power at his death or if such disability was not removed more than six months before his death, Congress has exempted the power from the application of the estate tax. Similarly, any power created before October 22, 1942, which has been released by the holder prior to July 1, 1949, or within six months after the removal of any disability which existed as of October 21, 1942, is likewise exempt.[90]

Frequently in considering the estate plan of a holder or donee of a power of appointment, the question arises as to whether it would be wise to exercise the power by creating another power. If the future family pattern is so uncertain as to make a specific exercise of the power inadvisable, it may be worth the tax price to exercise it by creating another power. To the extent that a power is so exercised, however, even though an otherwise qualified and exempt power, the property made subject to the new power is taxable in the estate of the holder of the first power.[91]

Generally, therefore, it is wise to exercise the power, either by making an outright appointment of the property or, better still, by giving a life interest and a remainder. The latter technique has considerable tax attraction. If the original settlor confers a qualified limited power upon a son, for example, specifying that subject to the limitations of the Rule Against Perpetuities, the son shall have the power to appoint a life interest and remainder, the son may appoint a life estate to his spouse and remainders to their children with only one tax, either the gift tax at the time of creation of the original trust if it is an irrevocable trust or the estate tax at the original settlor's death, being payable on the three-generation transfer effected.

[88] *See* U. S. Treas. Reg. 105, § 81.24 (1942).

[89] See p. 70 *supra*.

[90] Revenue Act of 1942, § 403(d), as amended by Pub. L. No. 635, 80th Cong., 2d Sess. (June 12, 1948).

[91] INT. REV. CODE § 811(f)(2).

It will be seen from the foregoing discussion of the gift and estate tax aspects of powers of appointment that as a result of the amendments effected by the 1942 Revenue Act, any powers created currently must be carefully drawn. In addition, in the absence of further legislation, certain desirable powers cannot be created without incurring tax penalties. On the other hand, even with the limitations imposed by the 1942 Act, the area in which powers of appointment may be profitably utilized is still large, and estate planners should give careful consideration to their use.

Finally, there remains the question of the application of the federal income tax to grantors and donees of powers of appointment.

It is immediately apparent, of course, that particularly with respect to grantors of powers of appointment, we are back to the application of Sections 166 and 167 of the Internal Revenue Code plus the *Clifford* doctrine, all of which have already been generally discussed.[92]

A brief examination of the sections and the *Clifford* doctrine in their specific application to powers of appointment will, however, be helpful. For example, while the reservation by the settlor in an inter vivos trust of the power to appoint the corpus of the trust by will clearly makes it includible in his estate for estate tax purposes,[93] it is not considered a power to revest under Section 166 so as to make the income taxable to the settlor.[94]

Conversely, a power to revest title to the corpus in the grantor held by a person not having a substantial adverse interest in the disposition of the corpus or income subjects the grantor to income tax under Section 166,[95] yet the corpus is apparently not includible in the settlor's estate if the power of revestment or revocation is in any person other than the settlor, regardless of whether such person has an adverse interest or not.[96]

There are a number of other reserved powers which will cause the income to be taxed to the settlor. If, for example, the corpus may be invaded for the benefit of the grantor, either by his action alone or in conjunction with a nonadverse trustee, the trust is considered revocable and under Section 166 the income is taxable to the settlor.[97]

[92] See p. 59 *supra*.

[93] Millard v. Maloney, 121 F.2d 257 (C.C.A. 3d 1941), *cert. denied*, 314 U.S. 636, 62 Sup. Ct. 100 (1941); Adriance v. Higgins, 113 F.2d 1013 (C.C.A. 2d 1940).

[94] Commissioner v. Bateman, 127 F.2d 266 (C.C.A. 1st 1942); Commissioner v. Brown, 122 F.2d 800 (C.C.A. 3d 1941); Knapp v. Hoey, 104 F.2d 99 (C.C.A. 2d. 1939).

[95] *See* Clair R. Savage, 4 TC 286 (1944).

[96] *See* Herzog v. Commissioner, 116 F.2d 591 (C.C.A.2d 1941); Hugh M. Beugler Trust, 2 TC 1052 (1943), *affd. sub. nom.* Commissioner v. Irving Trust Co., 147 F.2d 946 (C.C.A. 2d 1945).

[97] U. S. Treas. Reg. 111, § 29.166-2

The income is also taxable to the grantor if he reserves the right to direct the disposition of the income or to alter or amend the provisions of the trust with respect to the income beneficiaries.[98] On the other hand, where the right to change the distribution is limited to a reallocation among named beneficiaries without the right either to introduce new beneficiaries or to eliminate present beneficiaries and where the grantor is not the trustee and holds no administrative powers, the income has been held not to be taxable to the settlor.[99]

The power to direct the disposition of income is, of course, one of the significant factors which the Treasury Regulations hold to be sufficient in and of itself to cause the grantor to be taxed on the income.[100] What factor or combination of factors will result in the grantor being deemed a substantial owner of the trust corpus and, therefore, subject to tax on its income is, of course, the question raised by the *Clifford* case, the subsequent lower court decisions, and the Treasury Regulations previously discussed. As indicated earlier, the Regulations are very broad. The only reserved powers to affect the disposition of income which under the Regulations do not make the income taxable to the settlor are (1) those exercisable only by will, (2) those limited to appointment among charitable beneficiaries, (3) those exercisable by independent, though not necessarily adverse, trustees, and (4) those exercisable by the grantor or dependent or related trustees within limited groups or for limited periods of time.[101]

Again the limitations of this symposium prevent a comprehensive examination of the application of the income tax to powers which bring the trusts involved close to the borderline between revocability and irrevocability, as those terms are used herein. The few examples which have been considered, however, should make it apparent that the creation of such powers and such trusts is risky business.

It is far better to reserve broad powers to the settlor of a trust under which he may revoke, amend, alter, or otherwise deal with the corpus or income and pay the attendant income and estate taxes than it is to limit the grantor's powers in an effort to shade the tax line, only to find later that the anticipated tax savings are illusory and the settlor is both subject to tax and subsantially restricted in his powers with respect to the trust.

In summary, trusts and powers of appointment are among the most effective and important techniques available to estate planners. Unfortunately, they are insufficiently understood and as a result are not as

[98] Commissioner v. Buck, 120 F.2d 775 (C.C.A. 2d 1941).

[99] Hawkins v. Commissioner, 152 F.2d 221 (C.C.A. 5th 1945). (Note that the decision was by a divided court.)

[100] U. S. Treas. Reg. 111, § 29.22(a)-21(d).

[101] *Ibid.*

widely utilized as their merits warrant. It should be apparent even from the necessarily brief consideration of inter vivos trusts and powers of appointment presented herein that the economic and social advantages of both are substantial. In addition, while in the past two decades the tax advantages have been reduced, there are, nevertheless, a number of circumstances in which either an inter vivos trust or a power of appointment or both will permit tax savings as well as providing the most efficient and effective means for disposing of the settlor's estate.