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## Section 2038: Present Economic Benefit v. Technical Vesting of Title or Estates

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## NOTES

### Section 2038: Present Economic Benefit v. Technical Vesting of Title or Estates<sup>1</sup>

#### THE STATUTE

##### *Introduction*

Section 2038 of the 1954 Internal Revenue Code, regarding revocable transfers, has been unduly neglected by the periodicals, but not by the courts.<sup>2</sup> Tax planners are apparently keeping mum, yet the litigation and case law are profuse and economically significant. Indeed, the creation of an inter vivos trust, revocable or irrevocable, can scarcely be attempted without artfully acknowledging section 2038. This note will analyze the statute and examine in detail some problems of special concern.

Section 2038 of the Code gathers for the gross estate the value of *all* property transferred, excluding real property located outside of the United States:

To the extent of any interest therein of which *the decedent* has at any time *made a transfer* (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, *where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power* (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), *to alter, amend, revoke, or terminate*, or where any such power is relinquished in contemplation of decedent's death.<sup>3</sup> (Emphasis added.)

Assume that two inter vivos trusts were created. Trust A was created in a jurisdiction where trusts are made revocable by virtue of state law. In Trust A the decedent granted to himself and a corporation, as co-trustees, certain property the income of which was to be payable to his wife for her life and upon her death corpus was to be distributed to his

1. Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), and Lober v. United States, 346 U.S. 335 (1953), have both expressly pointed out that section 2038 of the Code is more concerned with present economic benefit than with the technical vesting of title or estates.

2. In recent years only two significant articles have appeared which probe in depth the scope of section 2038: Pedrick, *Grantor Powers and Estate Taxation: The Ties that Bind*, 54 NW. U.L. REV. 527 (1959), and Gray & Covey, *State Street — A Case Study of Section 2036(a)(2) and 2038*, 15 TAX L. REV. 75 (1959). Both, however, are principally confined to a discussion of the adequate external standard doctrine of 2038 law. The cases collected in the services, on the other hand, are beyond counting. See generally 1 CCH FED. EST. & GIFT TAX REP. ¶ 1475.

3. INT. REV. CODE OF 1954, § 2038(a) (1) [hereinafter cited as Code §].

two children. In this trust, the decedent-trustee reserved to himself the following powers which rendered the estate taxable: (1) to revest himself with beneficial ownership,<sup>4</sup> (2) to shift beneficial interests among the designated beneficiaries,<sup>5</sup> (3) to designate new beneficiaries,<sup>6</sup> (4) to shift beneficial interests among others than the designated beneficiaries,<sup>7</sup> (5) to accelerate beneficial interests among named beneficiaries,<sup>8</sup> and (6) to appoint by will or to change shares by will.<sup>9</sup>

Trust B, on the other hand, was created in a jurisdiction where inter vivos trusts are not made revocable by virtue of state law. In Trust B the decedent created an irrevocable inter vivos trust, to be administered solely by a corporate trustee, income payable to his wife for life, and upon her death corpus to be distributed to his two children. By virtue of the trust indenture the following powers were created and no tax liability was incurred.

- (1) The trustee had the sole power to revoke the trust or to return any part of it to the grantor.<sup>10</sup>
- (2) The grantor could appoint a new trustee in the event of the resignation of the original trustee.<sup>11</sup>
- (3) The grantor retained the right to be consulted in determining investment policies.<sup>12</sup>
- (4) The grantor retained the right to make additions to corpus.<sup>13</sup>

Section 2038 provides that where the enjoyment of the property transferred is subject to a power in the decedent-grantor to alter, amend, revoke, or terminate at the date of his death, the value of the property transferred is includible in the decedent-grantor's gross estate. Therefore, any of the six powers reserved by the decedent-trustee in Trust A, standing alone, would be sufficient to render the property transferred taxable under section 2038.<sup>14</sup> On the other hand, the four powers created and reserved in Trust B are not sufficient to alter, amend, revoke, or terminate

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4. *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929). For a general background for footnotes 4 through 13 see the 2038 CCH explanation in 1 CCH FED. EST. & GIFT TAX REP. ¶ 1475.

5. *Union Trust Co. v. Driscoll*, 138 F.2d 152 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944).

6. *Porter v. Commissioner*, 288 U.S. 436 (1933).

7. *Union Trust Co. v. Driscoll*, 138 F.2d 152 (3d Cir. 1943).

8. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

9. *Commissioner v. Chase Nat'l Bank*, 82 F.2d 157 (2d Cir.), *cert. denied*, 299 U.S. 552 (1936).

10. *Treas. Reg.* § 20.2038-1(a)(3) (1958) [hereinafter cited as *Reg.* §].

11. *United States v. Winchell*, 289 F.2d 212 (9th Cir. 1961).

12. *Estate of Henry S. Downe*, 2 T.C. 967 (1943).

13. *Central Trust Co. v. United States*, 167 F.2d 133 (6th Cir. 1948).

14. See cases cited in notes 4 through 9 *supra*.

Trust B so as to make the property transferred includible in the decedent-grantor's gross estate under section 2038.<sup>15</sup> If, however, Trust B had been created in a jurisdiction in which inter vivos trusts were made revocable by virtue of state law, the entire value of the property transferred *would* be includible under this section.<sup>16</sup> Thus, the taxable power to alter, amend, revoke, or terminate is not invoked under the statute when (1) someone other than the decedent-grantor revokes or terminates; (2) the revocation or termination is contingent upon the happening of a certain event; (3) the alteration or amendment may take form solely by virtue of the grantor's suggestions regarding investments or administration; or (4) the grantor reserves the right to alter or amend by adding to corpus. The simple distinction between the two trusts is that in Trust A the decedent-trustee reserved for himself all of the significant powers which could affect economic interests, while in Trust B the decedent-grantor reserved for another the significant powers, only retaining an inconsequential economic power or one that could only operate to the advantage of the beneficiaries. In other words, these two trusts distinguish, basically, between what is and what is not a sufficient reserved power to invoke taxability under section 2038 of the Code.

#### *Historical Background*

Prior to 1924 revocable transfers were not made specifically taxable by statute, but from 1916 to 1924 they were gathered into the gross estate under the possession or enjoyment section of the Code.<sup>17</sup> Transfers intended "to take effect in possession or enjoyment at or after death" were held to embrace revocable transfers made in trust or otherwise.<sup>18</sup> This statute was held to have a retroactive reach in a case decided in 1929. *Reinecke v. Northern Trust Company*<sup>19</sup> concerned an inter vivos revocable trust created prior to the enactment of the possession or enjoyment section of the Code which was effective between 1916 and 1924. When an estate tax was assessed against the trust under this section, it was contended that the tax was unconstitutional and void because it was retroactive. The Court, however, held that as the power of revocation was terminable only upon the transferrer's death it would not be complete until his death; that as the transferrer was still living subsequent to 1916, the year of enactment of the statute, it was not retroactive as to him. The date of death rather than the date of the creation of the trust determined the applicability of the statute.

15. See cases cited in notes 10 through 13 *supra*.

16. *Vaccaro v. United States*, 149 F.2d 1014 (5th Cir. 1945).

17. See discussion of sections 401 and 402 of the Revenue Act of 1921 in *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929).

18. *Ibid.*

19. 278 U.S. 339 (1929).

In 1924 revocable transfers were made specifically taxable.<sup>20</sup> In 1936 the statute was amended and took its present form.<sup>21</sup> In fact there are today two sections of the statute, section 2038(a)(1) which is applicable to transfers made after June 22, 1936, and section 2038(a)(2) which is applicable to transfers made prior to June 22, 1936, and which embodies the provisions of the 1924 statute.

The amendments of 1936 were prompted by the Supreme Court's decision in *White v. Poor*,<sup>22</sup> rendered in 1935. In that case the decedent had created a revocable inter vivos trust with herself as one of the trustees. She resigned as trustee, but later, upon resignation of another trustee, she once again assumed that position by virtue of a vote made by the remaining trustees. The Court held the trust not includible in the gross estate on the ground that her power of control over the enjoyment of the transferred property had not been retained by her but rather had been conferred upon her by action of the other trustees.

Following the decision in *White*, the statute was amended in three places.<sup>23</sup> The amendment provided that the power held by the decedent at the date of death, "in whatever capacity exercisable," to alter, amend, revoke, or "terminate" would render the estate taxable "without regard to when or from what source the decedent acquired such power." Later in *Jennings v. Smith*<sup>24</sup> the phrase "in whatever capacity exercisable" was held to be declaratory of existing law rather than a substantive change. Likewise, the word "terminate" was not held to be a substantive change.<sup>25</sup> The third alteration, however, represented a substantial change and was a direct reaction against the decision in the *White* case.

Today, transfers made prior to June 22, 1936, in which the decedent-grantor acquires a measure of control by appointment rather than by retention will still be governed by the *White v. Poor* rule.<sup>26</sup> Transfers made after that date, however, must comply with the statutory language embodied in the phrase "without regard to when or from what source the decedent acquired such power."<sup>27</sup> In other words, if the transfer was made after June 22, 1936, after-acquired powers over the enjoyment of the trust property by the decedent-grantor will render the estate taxable under section 2038.

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20. See Reg. § 20.2038-1(d) (1958).

21. Revenue Act of June 23, 1936.

22. 296 U.S. 98 (1935).

23. CODE § 2038(a)(1).

24. 161 F.2d 74 (2d Cir. 1947).

25. *Commissioner v. Estate of Holmes*, 326 U.S. 480 (1946).

26. CODE § 2038(a)(2).

27. CODE § 2038(a)(1).

*The Taxable Powers: Alter, Amend, Revoke, Terminate*

Where the decedent, at the date of his death, has retained the power to alter, amend, revoke, or terminate a transfer of property so as to affect the enjoyment of that property for the benefit of himself or another, the value of the property transferred will be includible in his gross estate.<sup>28</sup> The reach of these four powers affecting enjoyment in the aggregate is extensive, and when it is remembered that the existence of any one of the four powers will invoke taxability under the statute, respect for the statute is specially called for.<sup>29</sup>

These taxable powers affecting enjoyment have been held to embrace a wide variety of transfers. Thus, broadly classified, a transfer in which the following powers have been reserved by the grantor have rendered the transfer taxable: (1) the power to the grantor to revest himself with beneficial ownership, (2) the power to shift interests among designated beneficiaries, (3) the power to change beneficiaries, and (4) the power to accelerate beneficial interests.

*Power to Revoke*

There has never been any question about the power to revoke. In *Reinecke v. Northern Trust Company*<sup>30</sup> the creation of a gratuitous revocable transfer was held taxable even before there was a specific provision for such a tax in the Code. The tax was based on the enjoyment and possession section of the earlier Code section until revocable transfers were specifically designated as includible in the gross estate by the statute of 1924.

*Power to Alter or Amend*

In *Porter v. Commissioner*<sup>31</sup> the decedent-donor reserved to himself the power to alter or modify the trust at any time, (he could change beneficial enjoyment by changing beneficiaries), but expressly excepted any change in favor of himself or his estate. The contention was made that as the donor did not have the power to revoke the trust in favor of himself, he could not then have the power to alter or modify (amend), and thus the estate should not be includible. In other words, it was contended that "alter" and "amend" were synonymous for "revoke." The Court, however, held that

... the disjunctive use of the words "alter," "modify" and "amend" negatives that contention. We find nothing in the context or in the policy

28. CODE § 2038(a) (1), (2).

29. *Porter v. Commissioner*, 288 U.S. 436 (1933). See discussion in text regarding note 31 *infra*.

30. 278 U.S. 339 (1929).

31. 288 U.S. 436 (1933).

evidence by this and prior estate tax laws or in the legislative history . . . to suggest the conjunctive use of these words was intended, or that "alter" and "modify" were used as equivalents of "revoke" or are to be understood in other than their usual meanings. We need not consider whether every change, however slight or trivial, would be within the meaning of the clause. Here the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect of the creation of the trusts even to the extent of taking the property from the trustees and beneficiaries named and transferring it absolutely or in trust for the benefit of others. So far as concerns the tax here involved, there is no difference in principle between a transfer subject to such changes and one that is revocable.<sup>32</sup>

Thus, the power affecting enjoyment may be retained for the benefit of someone other than the donor, and there is a distinction between the power to alter and amend as opposed to the power to revoke. Because of the use of the disjunctive, the presence of any one of the named powers may render the transfer taxable.

#### *Power to Terminate*

In *Commissioner v. Estate of Holmes*<sup>33</sup> the meaning of the word "terminate," which had been added to the statute in 1936, was given judicial interpretation. Here, the settlor had irrevocably conveyed to himself property in trust, but he had reserved the power to terminate the trust and distribute the principal to the named beneficiaries, his sons. This trust had been created in 1935 before the word "terminate" had been added to the statute as a power affecting enjoyment. The Court held that the addition of the word was merely declaratory of existing law and that the reserved power of termination, which was here a power to accelerate enjoyment among designated beneficiaries, could not therefore escape liability from the estate tax merely because the trust was created one year before the word "terminate" had been added to the statute.

#### *Testamentary Power of Appointment*

The exercise of one of these powers affecting enjoyment at the time of the decedent's death renders the transfer taxable if exercised by way of testamentary power of appointment. In *Commissioner v. Chase National Bank*<sup>34</sup> the decedent created an irrevocable inter vivos trust but reserved a power to alter proportions of property which her descendants should take. The court held the trust corpus includible in the gross estate:

32. *Id.* at 443.

33. 326 U.S. 480 (1946).

34. 82 F.2d 157 (2d Cir.), *cert. denied*, 299 U.S. 552 (1936).

The power she reserved was not to change the trust provisions in a trivial way, but went right to the heart of them and gave the decedent a substantial though qualified control over the trust property until her death.<sup>35</sup>

### *Scope of the Powers Affecting Enjoyment*

Furthermore, the statute is not to be considered as confined in its reach to touching only such basic powers over economic interests as would be affected by a clear power to revoke or change beneficiaries or to conclude the interests of particular beneficiaries. The line of demarcation between what is and what is not includible for tax purposes is not so clearly drawn.

For example, in *Commissioner v. Hager's Estate*<sup>36</sup> the decedent-trustee retained no power to terminate, but he did retain a power to allocate investment gains either to income for the benefit of the life tenants or to corpus for the remaindermen. It was contended that if the retained power was one to alter and amend, it nevertheless only encompassed a control over certain profits made by the trust so that only the value of these profits should be includible in the gross estate. The court held, however, that the power here retained was certainly one to alter and amend in a substantial sense, that the interests of the beneficiaries could be greatly altered though not completely cut off so as to constitute a termination, and that the value of the entire estate was includible for tax purposes.

More important in demonstrating the extensiveness of the statute, however, is *Commonwealth Trust Company v. Driscoll*.<sup>37</sup> Here, the decedent-settlor deposited in trust certain securities but retained the right to withdraw them and substitute in their place other securities from time to time as he might deem proper. In disputing the imposed tax, the contention was made that the substitution securities would always be of equal value to those withdrawn; thus there could be no taxable alteration, amendment, or revocation by virtue of the reserved power. The court found that the right to substitute was a right to alter and amend in that there was no stipulation in the indenture requiring that the substituted securities be of equal value with those withdrawn. Although it has been held that additions to corpus are clearly not taxable, it is doubtful that even had the indenture required that the substituted securities be of equal value, a power to alter or amend would not have been found. Had the securities been of equal value at the time of substitution, those substituted might later decline in value to such an extent that the

35. *Id.* at 158.

36. 173 F.2d 613 (3d Cir. 1949).

37. 50 F. Supp. 949, *aff'd*, 137 F.2d 653 (3d Cir.), *cert. denied*, 321 U.S. 764 (1943).



existence of a power to alter or amend might later be discovered by a court.

Taxable powers affecting enjoyment have been found in a variety of other kinds of transfers of property. For example, if a state statute makes a transfer revocable, the value of the property transferred is includible in the gross estate. In *Vaccaro v. United States*<sup>38</sup> a husband gave his wife an inter vivos gift which by terms of a Louisiana statute was made revocable. The gift was taxable though the donor died without having exercised his power to revoke and the property donated had been changed in form long before the donor's death. Or again, it has been held that a retained power, even though conditional, is taxable. In *In re Field's Estate*<sup>39</sup> the settlor reserved the right to reduce or cancel the amounts of gifts by trust to his wife and issue. After the death of the wife, the entire amount of the trust was included in the gross estate even though the settlor could not have exercised his retained power as to the issue, having died without issue. Finally, it might be mentioned that an attempt to delay the exercise of a taxable power to a period subsequent to the testator's death will not avoid the taxation. Artful drafters have attempted to avoid the tax by providing in the indenture that revocation requires thirty-days notice so that if the decedent died without giving the notification, there existed at his death no taxable power.<sup>40</sup> The Regulations now state, however, that the powers "to alter, amend, revoke, or terminate will be considered to have existed at the date of the decedent's death even though the exercise of the power was subject to a precedent giving of notice."<sup>41</sup>

### *Transfers Not Taxable Under Section 2038*

The following transfers are excluded from the estate tax by section 2038 and its appropriate Regulations: (1) transfers of real property situated outside of the United States,<sup>42</sup> (2) transfers by bona fide sale for an adequate consideration in money or money's worth,<sup>43</sup> (3) transfers in which the property is not transferred by the decedent,<sup>44</sup> (4) transfers in which the decedent's reserved power could be exercised only with the consent of all parties interested,<sup>45</sup> (5) transfers made by the decedent wherein the powers are held by someone other than the decedent,<sup>46</sup>

38. 149 F.2d 1014 (5th Cir. 1945).

39. 143 F. Supp. 520 (S.D.N.Y. 1956).

40. *Mellon v. Driscoll*, 117 F.2d 477 (3d Cir.), cert. denied, 313 U.S. 579 (1941).

41. Reg. § 20.2038-1(b) (1958).

42. CODE § 2038(a).

43. *Ibid.*

44. *Ibid.*

45. Reg. § 20.2038-1(a)(2) (1958).

46. Reg. § 20.2038-1(a)(3) (1958).

(6) transfers made prior to June 22, 1936, wherein the decedent's power over enjoyment is after-acquired rather than retained,<sup>47</sup> and (7) transfers wherein the decedent relinquishes his powers prior to and not in contemplation of death.<sup>48</sup>

In addition to the foregoing exclusions, the cases have generally held that administrative powers over investments are non-taxable. As early as *Reinecke v. Northern Trust Company*,<sup>49</sup> the Supreme Court held that "powers of management" do not "save the decedent any control over the economic benefits or the enjoyment of the property."<sup>50</sup> In *Estate of Henry S. Downe*<sup>51</sup> the grantor reserved "the option to direct in writing the Trustee to issue voting proxies on and to retain, sell, exchange, invest and reinvest any of the trust property . . . in such manner as he may direct and without liability to the Trustee for any resulting loss."<sup>52</sup> The Tax Court held that the retained power was merely a power to direct investments and as such the trust was not includible in the gross estate.

There are two other important areas wherein transfers escape the 2038 tax which will be treated separately in the following sections of this note. They are (1) transfers made by reciprocal or crossed trusts where there is no *quid pro quo* between the parties and (2) a transfer made by the decedent when the power retained is held in a fiduciary capacity and its exercise is governed by an adequate external standard rather than by the discretion of the decedent.

### SPECIAL PROBLEMS

#### *Decedent's Power Held in Conjunction with Another*

In *Reinecke v. Northern Trust Company*<sup>53</sup> certain trusts created before the Revenue Act of 1924 were held to be not includible in the gross estate because the power of change reserved by the grantor could only be exercised with the consent of the beneficiary. The Court held:

Since the power to revoke or alter was dependent on the consent of the one entitled to the beneficial, and consequently adverse, interest, the trust, for all practical purposes, had passed completely from any control by the decedent which might inure to his own benefit as if the gift had been absolute.<sup>54</sup>

47. CODE § 2038(a)(2); Reg. § 20.2038-1(c) (1958).

48. Reg. § 20.2038-1(e) (1958).

49. 278 U.S. 339 (1929).

50. *Id.* at 346. However, see discussion in text regarding *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

51. 2 T.C. 967 (1943).

52. *Id.* at 972.

53. 278 U.S. 339 (1929).

54. *Id.* at 346.

Since 1924, however, the statute has provided that the power reserved is taxable "whether held by the decedent alone or in conjunction with any other person." Today a power held in conjunction with a party having an adverse interest is only taxable if the transfer in question was made prior to June 22, 1924. Section 20.2038-1(d) provides that

. . . if an interest in property was transferred by a decedent before the enactment of the Revenue Act of 1924 . . . and if a power reserved by the decedent to alter, amend, revoke, or terminate was exercisable by the decedent only in conjunction with a person having a substantial adverse interest in the transferred property, or in conjunction with several persons some or all of whom held such an adverse interest, there is included in the decedent's gross estate only the value of any interest or interests held by a person or persons not required to join in the exercise of the power plus the value of any insubstantial adverse interest or interests or a person or persons required to join in the exercise of the power.

*Helvering v. City Bank Farmers Trust Company*<sup>55</sup> was decided by the Supreme Court after the words "alone or in conjunction with any other person" were added to the statute in 1924. Here, the trust was established in 1930, the grantor reserving the power to revoke or modify in conjunction with the beneficiary and the trustee. The Court held the value of the corpus includible in the gross estate and stated:

The purpose of Congress in adding Clause (d) to the section as it stood in an earlier act was to prevent avoidance of the tax by the device of joining with the grantor in the exercise of the power of revocation someone who he believed would comply with his wishes.<sup>56</sup>

Decided at the same time with the *Farmers Trust* case was *Helvering v. Helmolz*.<sup>57</sup> In this latter case, the power reserved permitted the trust to be terminated upon delivery to the trustee of a writing signed by the settlor and all of the beneficiaries, including contingent beneficiaries (other than testamentary appointees). The Commissioner contended that the power here reserved was one to alter or revoke. The Court, however, held:

This argument overlooks the essential difference between a power to revoke, alter or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.<sup>58</sup>

Furthermore, section 20.2038-1(a) of the Regulations now provides that section 2038 does not apply

55. 296 U.S. 85 (1935).

56. *Id.* at 90.

57. 296 U.S. 93 (1935).

58. *Id.* at 97.

... if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law.

A word of caution at this point. In the *Estate of A. Frank Seltzer*<sup>59</sup> it was provided that the trust could be revoked by the consent of all of the then living beneficiaries. Upon the death of the grantor the trust estate was to be paid to his wife if she survived him and upon her death to the grantor's son, if living, otherwise to the son's living children per stirpes or their issue. If no children or issue survived, the estate was to go to the son's spouse, if living, otherwise to a designated hospital. The laws of Ohio, the state in which the trust was created, permitted the termination of a trust by consent if "... all the parties who are or may be interested in the trust property are in existence and *sui juris*."<sup>60</sup> The court held the estate not includible for tax purposes on the ground that the trust could not be terminated under state law, for the contingent interests could not be determined and adjusted until the happening of certain events.

The general rule is that section 2038 applies to a power exercisable by the decedent alone or by the decedent in conjunction with any other person except when all parties having an interest in the transferred property consent to the exercise of the power. The exception has two requisites: (1) the consent of *all* interested persons must be obtained and (2) there must be a provision of local law which would allow such persons to alter the terms of the trust in any event.

#### *Reciprocal Trusts: Decedent's Power Over Another's Transfer*

Section 2038 requires that the decedent must make a transfer and that he must retain over it one of the powers affecting enjoyment in order for the transfer to be taxable. Where the decedent makes a transfer and grants absolutely and irrevocably the powers over it to another, the estate is clearly not taxable under the section.<sup>61</sup> Likewise, if a decedent merely retains a power over another's transfer the statute is not applicable unless consideration was paid for the transfer and the power acquired.<sup>62</sup> It is because of this latter qualification that certain trusts which have the attributes of reciprocal or crossed trusts have created problems under section 2038.

Where clear cut reciprocal trusts are created the statute is applicable. In *Lehman v. Commissioner*<sup>63</sup> the decedent created a trust made up of

59. 10 T.C. 810 (1948).

60. *Id.* at 817.

61. *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).

62. Reg. § 20.2038-1(a) (3) (1958).

63. 109 F.2d 99 (2d Cir. 1940).

securities for his brother for life, remainder to his brother's children, the brother to have the power to withdraw from principal at anytime \$150,000.00. In turn decedent's brother created a similar trust for the benefit of decedent for life, remainder to decedent's issue, with a similar power in decedent to withdraw \$150,000.00. The court held that the decedent's power to withdraw was a power affecting enjoyment and that since the decedent had in reality furnished the consideration for the trust over which he exercised a power, he was the settlor of the trust even though it had in fact been created by another. In other words, the decedent by paying a *quid pro quo* (by transferring and granting a power affecting enjoyment to another) had in turn received a transfer and power of enjoyment. As the decedent had bought and paid for the transfer and power, it was in substance a transfer by the decedent with a power affecting enjoyment, and as such was includible in decedent's gross estate.

Where the crossed trusts are created between husband and wife, it may be impossible to find a *quid pro quo* for their existence sufficient for tax purposes. In *Newberry's Estate v. Commissioner*<sup>64</sup> the husband created two trusts, each consisting of 2,500 shares of stock in his company, one for the benefit of his son, the other for his daughter. He and his wife were both named trustees, but the powers affecting enjoyment were granted only to the wife. Originally these powers were very broad but by later amendments were limited to the shifting of economic interests only between Newberry issue, the remaindermen. In no event could principal or income be revested in the husband. The wife created simultaneously with her husband similar trusts with a similar power affecting enjoyment vested in the husband. When the wife died, the Tax Court held the trust over which she enjoyed a power as includible in her gross estate under the *quid pro quo* principle of reciprocal trusts, the doctrine of the *Lehman* case. On appeal the Third Circuit held the trust not includible.

The Third Circuit found that there was in fact no *quid pro quo* in the *Lehman* sense. The court accepted the testimony of the husband that he would have created his trust regardless of whether his wife had created hers; that the ultimate purpose in the creation of both trusts was to benefit the children and not the spouses. The court stated:

The "unity" of action of husband and wife and the "interdependent" character of their transactions which the Tax Court found are not such circumstances as the *Lehman* doctrine comprehends. Spouses in mutual confidence and common interest work out together what each is going to do with his own money to provide for their children. In the normal case, which this appears to be, it is a distortion of meaning to say

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64. 201 F.2d 874 (3 Cir. 1953).

that the action of one spouse is a quid pro quo inducing the action of the other.<sup>65</sup>

The court also felt that although the trusts were undoubtedly created for purposes of tax avoidance and that between a husband and wife a "bargain and exchange, within the meaning of the *Lehman* doctrine may exist, yet be unprovable," that in the absence of legislation to the contrary

. . . when on the facts the conclusion is inescapable that each spouse by a distinct and bona fide transaction has dispensed of his own separate estate in accordance with his own personal desires and without receiving a quid pro quo from the other, we think a court cannot justifiably refuse to recognize each spouse as the real transferor of the trust he has formally created.<sup>66</sup>

Where the *quid pro quo* of reciprocal or crossed trusts is definite and provable, the estate transferred over which the decedent has a power will be taxable. Where, however, the consideration becomes enmeshed with love and affection the 2038 tax can be avoided.

### *The Adequate External Standard*

The most perplexing problem that arises under section 2038 involves the question of whether the power affecting enjoyment reserved by the decedent-trustee is a power which can be exercised by him in his absolute discretion or whether the power is one limited by an adequate external standard. As will be shown, if the decedent-trustee has absolute discretion in the exercise of his retained power, section 2038 is applicable. If his fiduciary power is limited by an adequate external standard which can be controlled by an equity court, the estate tax may be avoided. What is and what is not an adequate external standard under section 2038 is not a settled question, and it is in this area that tax planners have their greatest opportunity.

In the *Estate of Budlong v. Commissioner*<sup>67</sup> a power was reserved to the decedent-trustee to invade corpus in the event of sickness or emergency occurring with regard to the beneficiary. The condition precedent had not occurred nor was there any invasion of corpus prior to decedent's death. Sickness or emergency was held by the Tax Court to be an adequate external standard governing the discretion of the trustees, a standard which an equity court could use to compel compliance on the part of the trustees. Furthermore, the court held that as the standard had not been invoked by the occurrence of the contingency which it embraced prior to the death of the decedent, there was no enjoyment of a power to alter, amend, or revoke which would render the estate taxable. Here,

65. *Id.* at 877.

66. *Id.* at 878.

67. 7 T.C. 756 (1946).

of course, the limitation imposed upon the power was a narrow one and easily susceptible to equitable enforcement.

But in *Jennings v. Smith*<sup>68</sup> the limitation imposed upon the powers reserved was not so readily determinable, yet the court found it to be an adequate external standard and excluded the tax. Next to the early case of *Reinicke v. Northern Trust Company*,<sup>69</sup> which developed the historic basis for taxing revocable transfers, the *Jennings* decision is perhaps the most important under section 2038. It will be considered in some detail.

In *Jennings* the decedent set up two identical trusts, one each for the benefit of the families of his two sons. The decedent together with his two sons were the trustees of both trusts. The trusts were irrevocable and to be enforced in accordance with Connecticut law, the decedent retaining no beneficial interest in either trust. There were, however, two powers of enjoyment reserved to the trustees, one over income, the other over corpus. Income was to be accumulated and added to capital on a yearly basis, but it could be invaded each year for the benefit of the son or his issue if the trustees "in their absolute discretion" determined "that such [a] disbursement is reasonably necessary to enable the beneficiary in question to maintain himself and his family, if any, in comfort and in accordance with the station in life to which he belongs."<sup>70</sup> The other power reserved permitted the trustees to invade capital if the son or his issue "should suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary."<sup>71</sup> Income for the years 1935 and 1936 was paid to one of the sons, the trustees having unanimously decided that such income was necessary to support and maintain the son "in accordance with the station in life to which he belongs." No other disbursements were ever made to either son under the reserved powers prior to decedent's death.

The court followed the *Budlong*<sup>72</sup> decision as regards to the doctrine of a fiduciary power connected to an adequate external standard. There was no problem about the invasion of corpus in the event of prolonged illness or financial misfortune. The court merely followed the decision in *Budlong*, where a similar condition was imposed, and held the limitation to be an adequate external standard which could be controlled by an equity court:

Since the trustees were not free to exercise untrammelled discretion but were to be governed by determinable standards, their power to invade

68. 161 F.2d 74 (2d Cir. 1947).

69. 278 U.S. 339 (1929).

70. *Jennings v. Smith*, 161 F.2d 74, 75-76 (2d Cir. 1947).

71. *Id.* at 77.

72. *Estate of Budlong v. Commissioner*, 7 T.C. 756 (1946).

capital, conditioned on contingencies which had not happened, did not in our opinion bring the property within the reach of section 811(d) (2) [now section 2038(a) (2)].<sup>73</sup>

Then the court stated that "similar reasoning leads to the same conclusion with respect to the trustees' power over net income."<sup>74</sup> It will be recalled that the reserved power over income permitted invasion so that the beneficiary could maintain himself and his family "in comfort and in accordance with the station in life to which he belongs." It will also be recalled that income *had* been invaded for the benefit of the elder of the sons, but not for the younger, and that the decedent had died in 1936. Consequently, the only enjoyment subject to a change at decedent's death under this limitation was the power to invade income for the year 1936 for the benefit of the younger son. The court held that as the contingency which would invoke the limitation here concerned had not occurred in 1936 prior to the decedent's death, the income for that year was not includible in the decedent's gross estate. In effect, then, both limitations were held to be adequate external standards which could be controlled by an equity court. The powers reserved were not discretionary with the trustees.

Thus, when the power to invade income or corpus is governed by determinable standards of support and the contingency which would justify such an invasion has not occurred prior to the decedent's death, the reserved power over enjoyment is not in fact exercisable at the time of the decedent's death and the transfer is not taxable.

A host of decisions followed *Jennings* in which a wide variety of outside determinable standards were created and found acceptable. In *Wilson v. Commissioner*<sup>75</sup> the decedent was not a trustee, but he retained the right to change the trustee at his discretion. The power over enjoyment held by the trustee was to accelerate payments of interest or principal in case of need for educational purposes, illness, or for any other good reason. The court held that the decedent had no power to terminate the trust, that the limitation was governed by an adequate external standard, and that thus the estate was not taxable. In the *Estate of Robert W. Wier*<sup>76</sup> the Tax Court held the limitation sufficiently connected to an outside determinable standard where distributions of income or corpus could be made for "education, maintenance and support" and "in the manner appropriate to the beneficiary's station in life." Likewise, in the *Estate of John A. Lucey*<sup>77</sup> the limitation providing for the invasion

73. *Jennings v. Smith*, 161 F.2d 74, 77-78 (2d Cir. 1947).

74. *Id.* at 78.

75. 13 T.C. 869 (1949), *aff'd*, 187 F.2d 145 (3d Cir. 1951).

76. 17 T.C. 409 (1951).

77. 16 P-H Tax Ct. Mem. 1002 (1947).



of corpus in the event of accident, illness, or other emergency was found acceptable.

Certain limitations on reserved or retained powers have, however, not been found adequately connected to an external standard. In *Hurd v. Commissioner*<sup>78</sup> the decedent created a trust with himself and wife as trustees authorizing the trustees to invade corpus for the benefit of the wife if the "circumstances so require." In this case the decedent became incompetent before his death but was never removed as trustee. The court conceded that the decedent might have been limited by his incompetency, but that the incompetency could not affect the exercise of the retained power, for under the law of Massachusetts he could have been removed so that the power could have been exercised by another under the auspices of an equity court. With regard to the limitation, the court stated:

The word "circumstances," as used in the trust instrument, is as wide as the world and to say that it imposes a legal limitation, or imports a controlling contingency, is to stretch it far beyond good sense. We entertain grave doubts that an equity court would harken to the complaints of a disaffected cestui who might interpose objections to the decedent's invasion of the principal for the use of his wife, irrespective of the "circumstances" . . . . The clause is not restricted to "her" circumstances, but rather to "the" circumstances. It is difficult to think of a much broader reservation of powers than that contained in Clause III [of the trust].<sup>79</sup>

Likewise, other similar standards have been found inadequate: payment of such income as the trustees deemed necessary for the beneficiary's best interests,<sup>80</sup> payment of principal as the trustees considered "suitable and necessary in the interests and for the welfare of such beneficiary,"<sup>81</sup> and income to be "accumulated or distributed in the sole discretion" of the trustee.<sup>82</sup>

Thus, it can be seen that retained powers to invade income or corpus are attached to an adequate external standard if made for purposes of education, support, maintenance, or a fixed standard of living. Conversely, retained powers dependent upon a standard required by circumstances, best interests or welfare of beneficiary, or sole discretion of the trustee are not adequately connected to an outside determinable standard which can be enforced by equity. The support and maintenance powers of enjoyment have the effect of making the decedent-trustee a ministerial officer of the equity court while the powers held which do not meet

78. 160 F.2d 610 (1st Cir. 1947).

79. *Id.* at 612-13.

80. Estate of Cyrus C. Yawkey, 12 T.C. 1164 (1949). The case was, however, decided under section 2036.

81. Estate of Albert Nettleton, 4 T.C. 987 (1945).

82. Estate of James D. McDermott, 22 P-H Tax Ct. Mem. 450 (1954).

the adequate external standard give to the decedent-trustee such wide discretion that his transfer is taxable under section 2038. This distinction has been criticized as violating both the intent of section 2038 and the substantive law of trusts.<sup>83</sup> It is contended that section 2038 taxes all powers to change beneficial interests, including powers retained by the grantor as a trustee. Furthermore, fiduciary powers held subject to an outside determinable standard, according to the Restatement of Trusts,<sup>84</sup> do not take away all discretion from the trustee; in fact such powers may embody great discretion. Conversely, fiduciary powers not subject to a specific outside standard are not all discretionary with the trustee, but rather are still under the control of equity. Perhaps the proper question to be answered is not whether there is an outside determinable standard but whether there is in fact real discretion in the trustee.

It might also be mentioned at this point that in a recent decision, *State Street Trust Company v. United States*,<sup>85</sup> the First Circuit by implication has challenged, for the first time, the adequate external standard doctrine advanced by the *Jennings* case. In the *State Street Trust* case the grantor retained several administrative powers previously exempt from taxation: power to classify receipts as income or corpus, power to deduct depreciation or amortization, power to invest in high yielding securities, and power to exchange one kind of property for another. The powers were to be exercised for the beneficiaries' comfortable maintenance and support. The court held the estate includible, not under section 2038 but under section 2036:

Perhaps no single power conferred by the decedent on the trustees would be enough to warrant inclusion of the corpora of the trust in his estate. But we believe that the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trusts between the life tenants and the remaindermen. We therefore conclude that under the trusts the decedent as long as he lived, in substance and effect and in a very real sense, in the language of § 811(c)(B)(ii) [now section 2036(a)(2)], 'retained for his life . . . the right . . . to designate the persons who shall possess or enjoy the property or income therefrom . . .'.<sup>86</sup>

The dissenting opinion would have held all of the retained powers non-applicable under the *Jennings* decision. The point is that although the case was decided under section 2036, the court is looking at the actual

83. See Pedrick, *Grantor Powers and Estate Taxation: The Ties that Bind*, 54 NW. U.L. REV. 527 (1959).

84. RESTATEMENT (SECOND), TRUSTS § 128, comment e (1957).

85. 263 F.2d 635 (1st Cir. 1959). See generally Pedrick, *Grantor Powers and Estate Taxation: The Ties that Bind*, 54 NW. U.L. REV. 527 (1959).

86. *State Street Trust Co. v. United States*, 263 F.2d 635, 639-40 (1st Cir. 1959).

discretion conferred in the retained powers rather than at the adequate external standard of comfortable maintenance and support. It is true that discretion is found in the over-all battery-like effect of the aggregate of these administrative powers rather than to the effect of any single power which if present alone might well have fallen under the *Jennings* rule. The decision in *State Street Trust* intimated that the emphasis might shift from a consideration of the adequacy of the imposed standard to the reality of the discretionary power.

No such shift has yet occurred. In the most recent case in which the issue arose of whether the powers reserved were discretionary or determinable by an adequate external standard, the issue was avoided on the ground that the powers reserved were conferred on a non-grantor trustee. In *United States v. Winchell*<sup>87</sup> the grantor created a trust and appointed a corporate trustee to pay her income from the principal for life with a power reserved to the trustee to invade capital not exceeding \$20,000.00 which the trustee in its absolute discretion might deem necessary for her comfort or to help her in meeting emergencies. A series of administrative powers were reserved to the trustee: to sell and transfer securities, to appraise assets, to determine questions regarding income and principal, and to exercise conversion and subscription rights in connection with any securities. The grantor in this case was not a trustee, but she did retain two significant powers: (1) the right to confer additional powers on the trustee and (2) the right to appoint a successor trustee in the event of resignation of the first appointed trustee. The Commissioner contended that the right to confer additional powers fell within the purview of a power to alter, amend, revoke, or terminate. The court held that such a right was limited to conferring only management and administrative powers, but that as the power could only be conferred on a trustee other than the grantor, the grantor did not, in effect, retain a power affecting enjoyment, and the estate was not includible. The court also stated that the grantor's power to appoint a successor trustee was dependent upon the resignation of the original trustee and that as this contingency had not occurred prior to decedent's death, such a power to appoint was not one affecting enjoyment. It was not, in other words, such a power that could connect the grantor with the office of trustee so as to bring the retained power of the grantor "to confer additional powers" within the confines of a taxable power to alter, amend, revoke, or terminate. Thus, the trust was not includible for tax purposes on the ground that the grantor was not a trustee. The question remains, however, whether the power to confer additional administrative and management powers in addition to those already reserved

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87. 289 F.2d 212 (9th Cir. 1961).