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SELECTING A TRUSTEE: INCOME TAX AND ESTATE TAX CONSIDERATIONS†

by

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All too frequently the decision of who shall serve as trustee of a client’s inter vivos or testamentary trust is handled as another routine mechanical detail, rather than being recognized as one of the most important aspects of the trust creation process. Many times the selection of a trustee is made almost as an afterthought, as the attorney and client are concluding their planning conference. The hasty or careless selection of a trustee, however, might render a meticulously planned dispositive arrangement completely ineffective because of overlooked tax considerations. This Article attempts to identify and discuss in depth the income and estate tax considerations that are critical to the selection of a proper trustee. Its purpose is to acquaint the reader with the trust provisions that most often disrupt the anticipated smooth operation of a trust or give rise to unexpected tax liabilities, and to suggest techniques for avoiding this result with minimal sacrifice to the original dispositive intent of the grantor/settlor.

I. GENERAL TAX CONSIDERATIONS

There are numerous traps for the unwary in the provisions of any trust instrument. Failure to locate and provide for such traps can undermine an estate plan by inadvertently triggering taxation of the trust income to the grantor himself or by causing the trust property, or portions thereof, to be included in the grantor’s estate at his death. The following is a general discussion of the income and estate tax provisions encountered when selecting a trustee.

A. Identification of the Grantor

The definition of the term “grantor” is nowhere to be found in the Internal Revenue Code;¹ that, in itself, should signal danger. In ordinary usage the term means the creator of the trust, the settlor who originated the entity

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¹ 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.04 n.15 (1975).
and defined its limits. This is also the sense in which it is used for income tax purposes. For estate tax purposes, "grantor" means a transferor, in trust or otherwise, for less than adequate and full consideration; it means, in other words, any donor. This is an important distinction. For example, a grandfather creates a trust for his daughter and her children. The trust instrument is carefully drafted to avoid any income or estate tax consequences to the grandfather. Many years later the daughter decides to make a contribution to the trust herself, taking advantage of the standard provision that empowers any person to make such a contribution. For estate tax purposes she has just become a grantor of the trust to the extent of the value of her contribution. This same result, the conversion of a donor into a grantor, may also come about via an inadvertent contribution. In one case the Tax Court, relying on Internal Revenue Code section 2036(a)(1), included part of a trust in the estate of a life beneficiary because a state court ruled, after her death, that she had been entitled to certain stock splits and stock dividends retained by the trust. The creator of a reciprocal trust may be considered the grantor of the trust established by another for his benefit. Moreover, the nominal creator of a trust may not be the grantor for estate tax purposes if the property was in fact contributed by a third party. In community property jurisdictions, if community property is used to fund the trust, each spouse is considered a grantor to the extent of one-half of the transferred asset. The moral underlying these examples is an important one: the trust instrument and the underlying circumstances must be carefully scrutinized to ensure that all potential and hidden grantors are planned for.

B. Income Taxation of Grantor Trusts

The reason that identification of the grantor or deemed grantor is crucial to the selection of the trustee rests largely with the income tax laws pertaining—
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Sections 671 through 677 of the Internal Revenue Code determine when the grantor will be deemed the owner of an inter vivos trust for income tax purposes and to what extent he will be taxed on its income as though there were no trust. The purpose of these sections is to tax the grantor on the income from a trust he has created during his lifetime if he retains the right to control or enjoy the income from such trust. Section 678 outlines the instances in which a person other than the grantor will be deemed owner of the trust and to what extent he will be taxed on the trust's income. The income tax consequences of a transfer by a grantor to an inter vivos trust are often inconsistent with the estate tax consequences. The grantor should be apprised of these possible inconsistencies so that he may best achieve his dual goals of avoiding estate tax and shifting income away from himself.

Generally, when either the grantor or a nonadverse party to the grantor holds a power over the beneficial enjoyment of the corpus or income of a trust the exercise of which does not require the consent of an adverse party, the grantor will be treated as the owner of the trust property to the extent it is subject to that power; thus he will be subject to taxation on that income. Section 672(a) defines an adverse party as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.” For purposes of this section, a general power of appointment is deemed to be a beneficial interest. A substantial interest is one that’s value in relation to the total value of the property subject to the power is not insignificant. The regulations provide no insight as to what will constitute a “not insignificant” interest, but a corollary perhaps can be

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13. I.R.C. § 678(a) states:
   (a) General rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
   (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
   (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671-677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

14. For example, under I.R.C. § 674(d) a grantor may retain a power that affects the beneficial enjoyment of trust income or corpus and yet not be subject to taxation on the income from the trust if the retained power is exercisable only with the consent of an adverse party. For estate tax purposes, however, retention of a power to control beneficial enjoyment will result in inclusion of the trust property in the grantor’s estate whether or not the consent of an adverse party is required. Treas. Reg. § 20.2036-1(b)(3) (1958). See also J. Peschel & E. Spurgeon, Federal Taxation of Trusts, Grantors and Beneficiaries § 4.05[A], [C] (1978).

15. I.R.C. § 672(a).

16. Id.

drawn to section 2037(a)(2), which treats a reversionary interest that exceeds five percent of the value of the transferred property as substantial enough to be included in the gross estate.\footnote{See Paxton v. Commissioner, 520 F.2d 923 (9th Cir.) (holding that a 3.84% interest in a trust did not make the beneficiary an adverse party), \textit{cert. denied}, 423 U.S. 1916 (1975).}

The Code, with typical circularity, defines a “nonadverse party” as any person who is not an adverse party.\footnote{I.R.C. § 672(b). For a discussion of the meaning of “adverse party,” see Brogan, \textit{supra} note 12.} A trustee, by virtue of his fiduciary responsibilities, is not necessarily an adverse party,\footnote{A trustee who has no personal beneficial interest in the trust property itself is not deemed to be an adverse party. Treas. Reg. § 1.672(a)-1 (1960); \textit{see} J. Peschel & E. Spurgeon, \textit{supra} note 14, § 4.02[C].} but a beneficiary of a trust frequently is. Further confusion occurs when a person is an adverse party as to only a part of the trust. For example, an ordinary income beneficiary who holds a power over the corpus of a trust has an interest adverse to the appointment of ordinary income, but does not have an interest adverse to the appointment of income allocable to corpus, and a remainderman is not adverse to the exercise of a power over any ordinary income.\footnote{I.R.C. § 672(c); \textit{see} Treas. Reg. § 1.672(c)-1 (1960).}

Generally, when a nonadverse party, whether or not related to the grantor, serves as trustee, the powers held by such a trustee will be attributable to the grantor, and any adverse tax effects that would result if the grantor held a power will result when a nonadverse party holds that same power. Vesting the same powers in an adverse party, however, will insulate the grantor from these consequences, although that plan may raise income tax problems for the party holding the power.\footnote{See Rev. Rul. 66-160, 1966-1 C.B. 164 (director of corporation is not per se an employee within ambit of § 672(c)).}

As if the adverse/nonadverse distinction were not sufficiently confusing, section 672(c) creates a third category of trust power holders, “related or subordinate parties.”\footnote{I.R.C. § 672(c).} A related or subordinate party is a nonadverse party who is either: (1) the grantor’s spouse living with the grantor, (2) the grantor’s father, mother, issue, brother, or sister, (3) an employee of the grantor,\footnote{\textit{See} note 77 \textit{infra} and accompanying text.} (4) a corporation or an employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or (5) a subordinate employee of a corporation in which the grantor is an executive.\footnote{I.R.C. § 672(c).} A person included in one of these categories is presumed to be subservient to the wishes of the grantor regarding the use of any trust powers he or she may hold, although that presumption can be overcome by a preponderance of the evidence.\footnote{\textit{Id}.} Whether a person is related or subordinate is especially important to the application of section 674(c), which protects the grantor from taxation on trust income if certain powers are held only by “independent trustees,” no more than half of whom are related or subordinate parties subservient to
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the grantor.27

By definition, a grantor’s spouse or child, for example, can be an adverse party rather than a related or subordinate party. This situation shields the grantor from income taxation, provided that the beneficiary’s interest in the trust is substantial and would be adversely affected by the grantor’s use of his powers regarding the trust. The Commissioner has often argued that, regardless of such a person’s interest in the trust, family solidarity removes him from the adverse party category.28 A number of courts have been unwilling to agree, however.29 In Laganas v. Commissioner,30 for example, the grantor’s wife had a ten percent interest in the trust income and corpus as a trust beneficiary. She served as cotrustee with her grantor-husband. Although ninety percent of the trust income was taxable to the grantor because of the powers he had retained as trustee over his ninety percent interest in the trust, the remaining ten percent, representing his wife’s interest, was not taxed to the husband. The court stated that the preferable rule is that “each wife stands on her own feet” and therefore can hold interests that are truly adverse to those of her husband.31 Although courts can be expected to scrutinize such situations closely, the family relationship should not, in itself, disqualify an otherwise adverse party.

C. Estate Taxation

The grantor’s selection of a trustee and determination of the powers and limitations of the trustee must be made with great care. If the grantor is deemed to have retained a right to control the beneficial enjoyment of an inter vivos trust, no matter how inadvertent the retention the value of the trust corpus will be included in the grantor’s gross estate at his death pursuant to section 2036 or 2038.32 Moreover, section 2042 may trigger inclusion if the grantor retains incidents of ownership in life insurance policies held in a trust.33 Even if a testamentary trust is created with the value of the corpus included in the grantor’s estate, care should be exercised to make certain that part or all of the corpus is not subsequently included in the estate of the trustee-beneficiary because of the powers or potential powers that he holds in the trust. Section 2041, which includes trust corpus subject to general powers of appointment in the estates of holders of such

27. Id. § 674(c); see text accompanying notes 71-74 infra.
28. See Commissioner v. Katz, 139 F.2d 107 (7th Cir. 1943); Commissioner v. Prouty, 115 F.2d 331 (1st Cir. 1940); Lillian M. Newman, 1 T.C. 921 (1943).
29. But see Altmaier v. Commissioner, 116 F.2d 162 (6th Cir.), cert. denied, 312 U.S. 706 (1940), in which the court stated that a wife’s interest may not be considered adverse to that of her husband.
30. 281 F.2d 731 (1st Cir. 1960).
31. Id. at 735.
32. See Brogan, supra note 12, at 70-71 (analysis of I.R.C. §§ 2036, 2038).
33. I.R.C. § 2042. “Generally speaking, the term [incidents of ownership] has reference to the right of the insured or his estate to the economic benefits of the policy.” Treas. Reg. § 20.2042-1(c)(2) (1958); see 2 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION ¶ 17.10 (1959).
powers, frequently is the most troublesome provision for a trustee-beneficiary. Section 2042, however, can also give rise to inclusion, especially in jurisdictions in which the trustee has certain fiduciary powers over life insurance policies on his life owned by the trust.35

Section 2036(a) includes in the decedent’s gross estate the value of property that he transferred during his life but over which he retained certain powers.36 The powers falling within section 2036(a)(1), the retention of possession or enjoyment of the corpus or the income therefrom, are outside the scope of this discussion as the selection of a trustee has little effect on the ultimate question of estate tax liability.37 More pertinent is the power that triggers inclusion under section 2036(a)(2): the right to designate who shall possess or enjoy the property or the income therefrom.38

Overlapping section 2036 is section 2038, which includes in a grantor’s estate any trust property the enjoyment of which was subject to change at the date of his death through the exercise of a power to alter, amend, or revoke, either by the grantor alone or in conjunction with any other person.39 Section 2038 also includes trust property if the decedent relinquished any such power in contemplation of death.40 For transfers made after June 22, 1936, section 2038(a)(1) provides that property subject to powers in whatever capacity exercisable and without regard to their source

34. I.R.C. § 2041.
36. I.R.C. § 2036(a) states:
The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

1. the possession or enjoyment of, or the right to 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.

37. But see discussions of income in discharge of a support obligation, accompanying notes 160-62 infra, and retention of voting rights of corporate stock, accompanying notes 180-81 infra.
40. If a power to alter, amend, revoke, or terminate would have resulted in the inclusion of an interest in property in a decedent's gross estate under section 2038 if it had been held until the decedent's death, the relinquishment of the power in contemplation of the decedent's death within 3 years before his death results in the inclusion of the same interest in property in the decedent's gross estate, except to the extent that the power was relinquished for an adequate and full consideration in money or money's worth.

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is included in the decedent's estate. 41 At least one court, however, has refused to read that language literally. In Estate of Reed v. United States 42 the decedent had made an irrevocable, fee simple transfer of family stocks to his daughter. Several years later, on the eve of her marriage, the daughter created an inter vivos trust with the stocks as corpus and named her parents as cotrustees, giving them flexible fiduciary powers. The court refused to include the stocks in the estate of the decedent-trustee, holding that section 2038(a)(1) applies only when the power derives from a direct reservation retained by the decedent at the time of transfer or from the conditions of the original transfer. 43 Since the decedent had not retained any powers, the fact that he held some fiduciary power as a result of a totally unrelated reconveyance was irrelevant.

In addition, the gross estate of a grantor or, at least in the Fifth Circuit, of a trustee, 44 will include the value of life insurance proceeds payable on his death if the insured possessed at his death any of the "incidents of ownership" under the policies, whether exercisable alone or in conjunction with another. 45 Incidents of ownership include the right to change beneficiaries, to surrender, cancel, or assign the policy, or to borrow against the cash surrender value. 46 The retention of only one incident of ownership is sufficient to cause inclusion of the full value of the proceeds in the decedent's estate. 47

Finally, under section 2041 a decedent's gross estate includes the value of assets over which the decedent held a general power of appointment, even though he did not own the assets during his lifetime. 48 With certain exceptions, a general power of appointment is a power to appoint trust property to one's self or one's creditors, estate, or estate's creditors. 49 Section 2041 will not operate to tax the grantor of a trust; to the extent he has retained a power of appointment, the property will be included in the grantor's estate under sections 2036(a)(2) and 2038. 50 Section 2041 will operate, however, to tax a trust beneficiary or a trustee who holds a general

41. I.R.C. § 2038(a)(1).
42. 75-1 U.S. Tax Cas. ¶ 13,073 (M.D. Fla. 1975).
43. Id. at 87,480. Section 2038 applies to any power over enjoyment of the property or income, even though the income beneficiary and remainderman are identical. Treas. Reg. § 20.2038-1(a) (1958).
44. See text accompanying notes 170-76 infra.
45. I.R.C. § 2042(a).
47. See Rev. Rul. 61-123, 1961-2 C.B. 151, in which it was held that retention of a right to change the beneficiary of an airline passenger accident insurance policy caused inclusion of the proceeds in the passenger's gross estate despite the inability of the insured actually to exercise that right.
49. Id. § 2041(b)(1); Treas. Reg. § 20.2041-1(c) (1958). The most important exception to this definition of "general power of appointment" is the existence of an "ascertainable standard" limiting the distributive power of the power holder. Examples of powers limited by the requisite standard include "powers exercisable for the holder's 'support,' 'support in reasonable comfort,' [and] 'maintenance in health and reasonable comfort.'" Id. § 20.2041-1(c)(2).
50. See notes 77-84 infra and accompanying text.
power of appointment by virtue of provisions in the trust instrument. The property subject to the general power will be taxed to the power holder's estate whether the power was exercisable inter vivos or by will and whether or not it was actually exercised, as long as no preconditions prevented the decedent from exercising the power.51

II. TAX CONSEQUENCES OF POWERS GIVEN TO TRUSTEES

The preceding overview of income and estate taxation is intended to serve as the background for a closer examination of the pitfalls and hidden dangers lurking in typical trust provisions. When a client and potential grantor insists on maintaining the greatest possible measure of control over the trust property without incurring adverse income or estate tax consequences, several questions arise: Which powers can the grantor safely be given alone? Which must he share with an independent trustee? Which may be given to a close relative as trustee or to a beneficiary? Which should no interested party hold in any event?52

A. Power to Control Beneficial Enjoyment

Income Tax Consequences. Creating a tax-safe inter vivos trust when the grantor is anxious to retain control over the selection of beneficiaries and the amounts they are to receive is fraught with possible pitfalls. The rules are particularly complex regarding the income tax consequences of holding a power over beneficial enjoyment. Section 674(a) states the general rule that the grantor will be treated as the owner of any portion of the trust over which he, or a nonadverse party, or both of them in conjunction have a power to control the beneficial enjoyment of the trust corpus or income, unless the exercise of that power is subject to the approval of an adverse party, as defined in section 672(a).53 If section 674(a) applies, income of the trust will be deemed income of the grantor. Section 674(a) encompasses the power to distribute income among income beneficiaries or remaindermen, as well as the power to allocate corpus among remaindermen or to use it for an income beneficiary; thus, every power to accumulate income and invade corpus may constitute a taxable power, unless strictly limited.54 Section 674(a) also applies if the grantor or a nonadverse party has the power to add to the beneficiaries under the trust, except when such power is available solely to provide for after-born or after-adopted children or when a beneficiary has the power to substitute other beneficiaries to succeed to all or a part of his interest.55

The catchall rule of section 674(a) is mitigated by the exceptions enu-

52. See notes 16-18 supra and accompanying text.
55. I.R.C. §§ 674(b)(5), (6), (7), 674(c), (d); Treas. Reg. § 1.674(d)-2(b) (1960).
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merated in sections 674(b), (c), and (d). Section 674(b) powers can be held without income tax consequences to the grantor by any person in any capacity, including the grantor or a member of his immediate family. These powers include:

1. The power to apply income for the support of a dependent. The exercise of this power may give rise to income taxation to the holder under section 677(b), but mere possession of the power has no effect on the holder. For purposes of this exception to section 674(a) only, if the grantor holds a power to apply income for a dependent's support, he must hold it as a trustee or cotrustee. The other section 674(b) exceptions are applicable regardless of whether the powers are held as a trustee or in an individual capacity.

2. The power to affect beneficial enjoyment only after a ten-year period. If the trust is drawn within the bounds of section 673, merely having the power will not cause the grantor to be taxed on the trust income during the specified period. At the end of the ten-year period, however, the grantor will be treated as the owner of the trust unless his power is relinquished.

3. The power to allocate among charitable beneficiaries. As long as all beneficiaries are charitable entities and their interests in the trust are payable for purposes specified in section 170(c), the grantor or any other person may hold the power to determine the beneficial enjoyment of trust corpus or income without income tax consequences to the grantor.

4. The power to distribute corpus. The grantor or any other party may have the power to allocate the corpus among the trust beneficiaries (whether income or corpus beneficiaries) if the power is limited by a "reasonably definite standard." Acceptable standards include distributions for health, education, support, or maintenance of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency. The grantor may also dis-
tribute corpus to a current income beneficiary even without such a standard, but the distribution must be chargeable to that beneficiary's share of the corpus.\textsuperscript{67}

(5) \textit{The power to withhold income temporarily.\textsuperscript{68}} The grantor may retain the power to postpone enjoyment of the ordinary income of the trust by the current income beneficiaries, as long as any accrued income must ultimately be payable to those beneficiaries or their estates.\textsuperscript{69} If any current income beneficiary is a minor or is under some other legal disability, the grantor may accumulate the income payable to that beneficiary and add it to the trust corpus without attributing the accumulation to the beneficiary's share.\textsuperscript{70}

In addition to the powers discussed above, any trustee except the grantor or his spouse, if living with the grantor, may hold without adverse tax consequences the power to distribute, apportion, or accumulate income to or for the beneficiaries or within a class of beneficiaries if the power is limited by a "reasonably definite standard which is set forth in the trust instrument."\textsuperscript{71} The trustee may be empowered to act alone or in conjunction with other trustees, and need not secure the approval of any other person.\textsuperscript{72} Moreover, the trustee need not satisfy the conditions of sections 674(b)(6) or (7) concerning the accumulation of income for current income beneficiaries and the allocation of income distributions to separate shares.\textsuperscript{73} There is no requirement that the trustee be an adverse party; presumably a child of the grantor could exercise the power if appropriately limited, whether or not that child has an interest in the income. If the child does have an interest, however, and that child alone holds the power to distribute income, he may be taxed on the trust income, or a portion thereof, under section 678(a). This power to allocate income may also be held by the grantor or his spouse as trustee as long as its exercise requires the consent of an adverse party.\textsuperscript{74}

Independent trustees may hold the power to distribute, apportion, or accumulate income or to pay out corpus to or for the beneficiaries or among a class thereof.\textsuperscript{75} If section 674(a) is applicable, it should override section 674(c), allowing the grantor to hold such a distribution power if the

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which the I.R.S. ruled that an invasion power created "to continue the donee's accustomed standard of living" was not a sufficiently ascertainable standard to avoid inclusion under I.R.C. § 2041(b)(A).

68. I.R.C. § 674(b)(6); Treas. Reg. § 1.674(b)-1(b)(6) (1960).
69. I.R.C. § 674(b)(6); Treas. Reg. § 1.674(b)-1(b)(6) (1960).
70. I.R.C. § 674(b)(7); Treas. Reg. § 1.674(b)-1(b)(7) (1960).
71. I.R.C. § 674(d); see text accompanying notes 65-66 supra.
73. Id.; see notes 68-70 supra and accompanying text.
74. I.R.C. § 674(a); see Bromberg & Fortson, \textit{Selection of a Trustee: Tax and Other Considerations}, 19 Sw. L.J. 523, 540 (1965).
75. I.R.C. § 674(c); Treas. Reg. § 1.674(c)-1 (1960). An independent trustee is defined as "a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor." I.R.C. § 674(c).
power can be exercised only with the consent of an adverse party.\textsuperscript{76}

Consideration should be given to the operation of section 678 any time a grantor contemplates naming a trust beneficiary as a trustee or successor trustee or giving the beneficiary any power that would subject a grantor to income taxation if he himself held it.\textsuperscript{77} That section treats any beneficiary as the owner of the trust corpus, provided that the grantor is not otherwise deemed the owner, if the beneficiary holds a power, exercisable by him alone, to vest either trust corpus or income in himself.\textsuperscript{78}

\textbf{Estate Tax Consequences.} Under sections 2036 and 2038, retention by the grantor of the right to control the beneficial enjoyment of the corpus or income of a trust may cause inclusion of the trust property subject to such power in his gross estate.\textsuperscript{79} If the grantor names himself trustee and, as trustee, retains unlimited discretion to distribute income among the beneficiaries or to accumulate it for the remaindersmen, the value of the trust corpus is included in the grantor's estate.\textsuperscript{80} Moreover, if an independent trustee holds the power, and the grantor has the right to control the trustee or to remove the trustee and substitute himself, the value of the trust corpus is includable in the grantor's estate.\textsuperscript{81} In contrast to the income tax treatment, the estate tax result is the same whether the grantor retains his power as trustee or otherwise, whether he retains such power alone or only in conjunction with another, whether the other party has an interest adverse to the exercise of the power, and even if the power was exercisable only upon a contingency beyond the grantor's control that did not occur before his death.\textsuperscript{82}

It is well established that even though no reservation of a power over enjoyment is explicitly included in the trust instrument, the grantor is deemed to have retained that power if at, or prior to, the time of transfer either a legally enforceable side agreement existed accomplishing the same result or the grantor is dealing with a related party in a predetermined manner.\textsuperscript{83} Nevertheless, the existence of an ascertainable standard controlling the exercise of the power of the grantor to vary the interests of

\textsuperscript{76} I.R.C. § 674(a); see Bromberg & Fortson, \textit{supra} note 74, at 540.

\textsuperscript{77} I.R.C. § 678; see Burch, \textit{Powers to the People: The Use of Discretionary Powers in Estate Planning}, 114 Tr. & Est. 450, 499 (1975).

\textsuperscript{78} See Rev. Rul. 67-241, 1967-2 C.B. 225 (section 678(a) treats widow with power to vest in herself certain amounts from corpus of trust as owner of that part of corpus subject to power).

\textsuperscript{79} I.R.C. §§ 2036, 2038.

\textsuperscript{80} Id. § 2036(a)(2); see Biscoe v. United States, 148 F. Supp. 224 (D. Mass. 1957).

\textsuperscript{81} I.R.C. § 2036(a)(2); see Rev. Rul. 73-21, 1973-1 C.B. 405, in which it was held that if a trustee has the power to determine the distribution of income and the decedent-grantor had the power to appoint himself successor trustee, the value of the trust corpus is included in the decedent's estate. \textit{See also} Estate of O'Brien v. Commissioner, 37 T.C.M. (CCH) 457 (1978), in which the court admitted parol evidence to determine whether the decedent intended to appoint herself as successor trustee.


\textsuperscript{83} Id. § 20.2036-1(a); Estate of Skinner v. United States, 316 F.2d 517 (3d Cir. 1963); Fitzsimmons v. United States, 222 F. Supp. 140 (E.D. Wash. 1963); Estate of Marie J. Nichol, 56 T.C. 179 (1971).
others in the trust will prevent inclusion of the trust corpus in the grantor’s estate, provided the grantor retains no right to alter or amend the trust. 84

If the grantor retains no right at the date of his death either to name himself as trustee or to control the trustee, the trust property will not be included in the grantor’s estate, even if the trustee’s power to govern the enjoyment of the income or corpus is unrestricted by any standard. 85 The grantor’s spouse or a child can be named as trustee without triggering inclusion under section 2036. 86 If the family-member-trustee is also a beneficiary, however, his power as trustee to control beneficial enjoyment of the trust corpus should be carefully drawn to avoid the operation of section 2041(a)(2). Section 2041 provides that any person having a power, not limited by an ascertainable standard, to appoint trust property to himself, his estate, his creditors, or his estate’s creditors holds a general power of appointment; 87 the value of all trust property subject to such a power is included in the power holder’s gross estate. 88 The language of a standard limiting the exercise of the power should be carefully chosen to prevent a general power of appointment from inadvertently being created, 89 as the courts have revealed a tendency to scrutinize closely all limitations of distribution standards. 90 The Internal Revenue Service also construes “ascertainable standards” narrowly. The Treasury Regulations list “support in his accustomed manner of living” as an ascertainable standard and state that “support” and “maintenance” are synonymous and not limited to the bare necessities. 91 Yet in Revenue Ruling 77-60, 92 the Service determined, after looking at state law, that the standard “to continue the donee’s accus-

84. See Estate of Robert W. Weir, 17 T.C. 409 (1951); Estate of C. Dudley Wilson, 13 T.C. 869 (1949), aff’d, 187 F.2d 145 (3d Cir. 1951); Estate of Walter E. Frew, 8 T.C. 1240 (1947).
85. Treas. Reg. §§ 20.2036-1(b)(3), 2038-1(a)(3) (1958); see Rev. Rul. 73-142, 1973-1 C.B. 405 (state court determined decedent’s power to appoint himself as trustee was invalid, resulting in value of trust corpus not being included in decedent’s estate).
87. I.R.C. § 2041(b)(1); see notes 49-51 supra and accompanying text.
89. “A power is limited by [an ascertainable] standard if the extent of the holder’s duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them).” Treas. Reg. § 20.2041-1(c)(2) (1958).
92. 1977-1 C.B. 282. But see Rev. Rul. 78-398, 1978-2 C.B. 237 (sole trustee-beneficiary who had power to apply as much of trust corpus as he determined to be necessary for his maintenance and medical care did not have general power of appointment as that power was limited by ascertainable standard); National Office Technical Advice Memo, Letter 7914036 (Jan. 3, 1979) (same result reached with surviving spouse-trustee having power to distribute corpus to herself to maintain standard of living to which she had been accustomed); Private Letter Rul. 7838116 (June 26, 1978) (Service concluded that limitation “as may be necessary for her reasonable comfort and support” was an ascertainable standard; therefore, widow’s power was not a general power of appointment and property subject to that power did not qualify for marital deduction).
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It is not sufficiently objective to come within the ambit of section 2041(b)(1)(A). If, however, a power, unlimited by any ascertainable standard, can be exercised only in conjunction with either the creator of the power or a person with a substantial interest adverse to its exercise, it will not be considered a general power of appointment.

In addition to examination of the problems raised by sections 2036, 2038, and 2041 that are encountered when choosing an individual to serve as trustee, careful examination must also be given to the impact of the new generation-skipping transfer tax rules. Any individual, not necessarily one related to the grantor, who is given discretionary power to alter the

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93. The Service reasoned that this “standard of living may include customary travel, entertainment, luxury items, or other expenditures not required for meeting the donee’s ‘needs for health, education or support.’” 1977-1 C.B. at 283.

94. I.R.C. § 2041(b)(1)(C); see Rev. Rul. 79-63, 1979-8 I.R.B. 41, in which the Service found that a trust beneficiary’s power of appointment is a general power even though its exercise is subject to veto by any of several remaindermen. This Ruling thus illustrates the “adverse interest” concept of § 2041.

95. I.R.C. §§ 2601-2622. Prior to 1976, it was possible for a family to pay estate taxes on a piece of property only once every several generations by creating successive life estates in children and grandchildren. See Horn, Planning Suggestions to Minimize the Effect of the Generation-Skipping Tax, 5 EST. PLAN. 130 (1978). Chapter 13 of the Internal Revenue Code was added by the Tax Reform Act of 1976 to correct this perceived abuse. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1879. For an introduction to the generation-skipping tax, see J. Peschel & E. Spurgeon, supra note 14, ¶ 10.04; Weinstock, The A-B-C’s of Generation Skipping Trusts, 52 TAXES 68 (1974). While the generation-skipping tax is extremely complex and defies general summary, the following excerpt from the House Committee’s report is useful:

Under your committee’s bill, a new chapter 13 is added to the Internal Revenue Code, which imposes a tax in the case of generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor’s grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust. The generation-skipping tax would not be imposed in the case of outright transfers. In addition, the tax would not be imposed if the grandchild had (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

The tax is to be substantially equivalent to the estate tax which would have been imposed if the property had been actually transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor’s grandchild, with remainder to the great-grandchild, then, upon the death of the grandchild, the tax is to be computed by adding the grandchild’s portion of the trust assets to the grandchild’s estate, and computing the tax at the grandchild’s marginal transfer tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under the bill as a ‘deemed transferor’ of the trust property.

The grandchild’s marginal estate tax rate would be used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild’s estate would not be liable for the payment of the tax. Instead, the tax would generally be paid out of the proceeds of the trust property. However, the trust would be entitled to any unused portion of the grandchild’s unified transfer tax credit, the credit for tax on prior transfers, the charitable deduction (if part of the trust property were left to charity), the credit for State inheritance taxes and a deduction for certain administrative expenses.
beneficial enjoyment of the income or corpus of a trust has a "power" over the trust and, therefore, is a "beneficiary" for purposes of imposing the generation-skipping tax. Prior to the passage of the Revenue Act of 1978, if the individual trustee was of a younger generation than the grantor and there was no other younger generation beneficiary of the same generation as the trustee, a generation-skipping tax was imposed.

The Revenue Act of 1978 amended section 2613(e) to exclude from the term "power" a distribution power held by an individual trustee who has no interest in the trust, is not related or subordinate to the grantor, and has no present or future power in the trust other than that of disposing of income or corpus to designated beneficiaries. Although eliminating one drafting problem, this amendment raises another. While incorporating the section 672(c) income tax concept of related or subordinate parties, section 2613 broadens this category of tainted persons to include any trust beneficiary's spouse, parent, siblings, or lineal descendants. The amended section 2613, unlike section 672(c), also includes the stock holdings of any beneficiary in determining whether a corporate trustee or corporate employer of the trustee is controlled to a significant extent by interested persons. Moreover, section 2613 now labels as subordinate any employee of a corporation in which a beneficiary is an executive. The resulting inconsistency between income and estate taxation and the generation-skipping tax means that, for example, although the grantor's son-in-law, the spouse of a trust beneficiary, can hold, as trustee, a power to distribute, apportion, or accumulate income or corpus without engaging income or estate tax to the grantor, possession of that same power can now trigger generation-skipping tax liability.

Even before the Revenue Act of 1978, section 2613(e) provided an important exception to the definition of a "power." If the individual trustee's sole substantive power is the disbursement of trust income or corpus to beneficiaries who are lineal descendants of the grantor and who are all of a generation younger than the individual trustee, then the trustee's power is not treated as a "power" for generation-skipping purposes. This exception is quite narrow, however, as it will not apply if there is a younger...

96. I.R.C. § 2613(d)(2).
97. Id. § 2613(c)(3).
101. See text accompanying note 23 supra.
103. Id. (iii).
104. Id. (iv).
105. Id. § 2613(e).
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generation beneficiary who is a nonlineal descendant of the grantor, for example the spouse of a lineal descendant.

B. Power to Revoke or Terminate the Trust

Income Tax Consequences. Section 676 provides that the grantor of an inter vivos trust will be treated as the owner of the corpus, and thus taxed on the income attributable to such corpus, if either he or a nonadverse party has the power to revoke the trust and vest title to the trust property in the grantor.106 If the grantor cannot exercise that power for a period of at least ten years from the inception of the trust, the trust income for that period will not be attributed to the grantor.107 Unless the power is relinquished at the expiration of the ten-year period, however, the grantor will then be taxed on the trust income.108 Because an independent trustee is not per se an adverse party in interest for purposes of sections 671 to 677,109 lodging a power to revoke with an independent corporate trustee has an effect identical to that of giving the power to the grantor. If the power is held by an adverse party, however,110 the possession and exercise of the power will not result in trust income being attributed to the grantor.111

Although vesting the power to revoke in an adverse party will effectively shield the grantor from income tax liability, it may give rise to liability for the holder of the power if revocation would serve to vest title to the property in the holder.112 Section 678(a) provides that, to the extent the grantor is not deemed the owner, the person who alone holds the power to vest income or corpus in himself will be deemed the owner of the trust for the purposes of sections 671 to 677.113

Estate Tax Consequences. When a grantor of an inter vivos trust holds the power at his death, as trustee or otherwise, to revoke the trust, or when he has released such a power within three years of death, the portion of the trust property subject to the power will be included in his gross estate.114

106. Id. § 676; see Osterberg, Current Trends and Techniques in the Use of and Drafting of Revocable Trusts, 47 J. TAX. 332 (1977).
107. I.R.C. §§ 676(b), 673(a). It is immaterial that the power to revoke is vested in the grantor at the time of the transfer, as long as the power cannot be exercised for at least 10 years. Treas. Reg. § 1.676(b)-1 (1960).
108. I.R.C. § 676(b).
109. "A trustee is not an adverse party merely because of his interest as trustee." Treas. Reg. § 1.672(a)-1 (1960); see Fulham v. Commissioner, 110 F.2d 916 (1st Cir. 1940).
110. See notes 15-21 supra and accompanying text.
111. I.R.C. § 676(a).
113. I.R.C. §§ 676(a); Treas. Reg. § 1.678(a)-1(a) (1960).
114. I.R.C. § 2038(a)(1); see, e.g., Cohn v. United States, 371 F.2d 642, 645 (2d Cir. 1967). Contrary to many other state statutes, the Texas Trust Act provides that a trust is revocable unless specifically declared to be irrevocable. Tex. Rev. Civ. Stat. Ann. art. 7425b-41 (Vernon 1960). In Texas, therefore, the irrevocable nature of the trust must be expressly set out in the instrument, lest the grantor be deemed to hold the power of revocation at his death by operation of law. Estate of Alvin Hill, 64 T.C. 867 (1975), aff'd, 568 F.2d 1365 (5th Cir. 1978).
The identical result obtains even if the grantor holds the power only in conjunction with another, and even if it can be exercised only for another's benefit.\textsuperscript{115} Even though the power to revoke is vested in a trustee who is not the grantor, if the grantor has an unrestricted power to remove the trustee and appoint himself, the property subject to the power to revoke will be included in the grantor's estate.\textsuperscript{116} On the other hand, if the power can be exercised by the grantor only with the consent of all parties having a vested or contingent interest in the property, that property will not be included in the grantor's estate regardless of whether he is serving as trustee.\textsuperscript{117}

Since the income tax distinction between adverse and nonadverse parties plays no part in estate tax treatment, presumably the grantor can give a family-member-beneficiary the power to revoke without the corpus being included in the grantor's estate, even if upon revocation the property would revert to the grantor.\textsuperscript{118} Although vesting the power to revoke in a beneficiary would shield the grantor from estate tax, the disposition of the assets upon revocation may cause the property to be included in the power-holder's estate. If the power effectively allows the holder to appoint assets to himself, such property over which he alone has that power is included in his estate.\textsuperscript{119} But if several beneficiaries whose interests are all substantially adverse to one another hold the power and can only exercise it jointly, property subject to such power is not included in the estates of either the decedent or any of the power holders.\textsuperscript{120}

Trust instruments frequently contain a provision allowing the trustee to terminate the trust if the amount of the corpus does not warrant the cost of continuing the trust or if its administration would otherwise be impractical.\textsuperscript{121} Such a provision is deemed to be based upon an objective, external standard outside the control of the grantor or the discretion of the trustee and, therefore, does not constitute a power to appoint, possess, or enjoy for the purposes of sections 2036, 2038, or 2041.\textsuperscript{122} If the trustee is given the power to terminate in his sole judgment and discretion, however, no ascertainable standard exists.\textsuperscript{123}

\textsuperscript{115} I.R.C. § 2038(a)(1); Hauptfuhrer v. Commissioner, 195 F.2d 548 (3d Cir. 1952).
\textsuperscript{116} Treas. Reg. § 20.2038-1(a)(3) (1958); see Mathey v. United States, 491 F.2d 481 (3d Cir. 1974).
\textsuperscript{118} Id. § 20.2038-1(a)(3); Estate of Anna Ball Kneeland, 34 B.T.A. 816 (1936). As long as the power is held by an adverse party, the result will be consistent with the income tax ramifications of I.R.C. § 676(a) and totally shield the grantor from both income and estate tax.
\textsuperscript{120} I.R.C. § 2041(b)(1)(C)(ii); Treas. Reg. § 20.2041-3(c)(2) (1958).
\textsuperscript{121} See, e.g., E. Belsheim, Modern Legal Forms § 9273 (1968); J. Hellmuth, Modern Trust Forms No. 3.05 (1969).
\textsuperscript{122} See, e.g., Estate of McCoy v. United States, 374 F. Supp. 1321, 1324 (W.D. Tenn. 1974), aff'd, 511 F.2d 1090 (6th Cir. 1975).
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C. Power to Become or Change the Trustee

Income Tax Consequences. If the grantor has an unrestricted power to remove the trustee and substitute any person, including himself, as trustee, the income of the trust will be attributed to him. Section 674(b), however, enumerates certain powers that a grantor can possess without triggering income taxation to himself; if the trustee's only powers are included within the section 674(b) list, the fact that the grantor can substitute himself as trustee is without consequence for income tax purposes. Section 674(c) allows an independent trustee, not related or subordinate to the grantor, to exercise certain powers without triggering income recognition to the grantor. If the grantor's power to remove a trustee vested with such powers is limited by the requirement that he must substitute another independent trustee for the removed one, whatever exceptions from income taxation that would have applied to the trust if the grantor had no removal power are preserved despite his limited power.

If a beneficiary of the trust has the unrestricted right to remove the independent trustee and substitute himself, for income tax purposes he will be regarded as the trustee, whether or not the power is exercised. Moreover, if the trustee subject to removal has sole discretion in making distributions of trust corpus or income to the beneficiary, the beneficiary who is deemed a trustee via his removal power will be taxed on the trust income that could have been distributed to him or on the income allocable to trust corpus that could have been so distributed, whether or not distribution is actually made. If the beneficiary becomes or is deemed to be a cotrustee, however, and the trustees can act only in conjunction in making distributions of trust property, income of the trust will not be attributed to the beneficiary.

Estate Tax Consequences. Retention by the grantor of a power to remove or change the trustee has no estate tax significance in and of itself. According to Revenue Ruling 73-21, however, if such a right is coupled with an unrestricted power to appoint anyone as trustee, including himself, the grantor is deemed to hold all the powers of the trustee, even though the power to name a successor trustee is conditioned on the death, resignation, or removal of the independent trustee.
or incapacity of the original trustee and in fact is never used. Moreover, the prior conduct of the grantor in exercising a replacement power apparently is insufficient to override the presumption that the grantor intended to reserve the right to appoint himself as successor trustee. In *Estate of Farrel v. United States* the grantor created an irrevocable trust for her grandchildren, retaining the right to appoint a successor trustee upon the death or resignation of either cotrustee. The trustees had wide discretion in making distributions from the trust income and principal. On two separate occasions before her death, the grantor exercised her power by appointing third persons as successor trustees. Despite this show of good faith, the Court of Claims concluded that the value of the trust property was includable in the grantor’s gross estate under section 2036(a)(2) as she had retained a power to control enjoyment, even though that power would not cause inclusion under section 2038 because it was not exercisable by the grantor at the moment of her death. Contrast *Farrel* with Revenue Ruling 77-182, in which the grantor of an inter vivos trust retained the power to appoint a successor corporate trustee if the original trustee resigned or was judicially removed. The Service determined that the qualified power to appoint only a corporation as successor trustee was not sufficient to trigger inclusion under section 2036, as it “did not amount to a power to remove the original trustee that, in effect, would have endowed the decedent with the trustee’s discretionary control over trust income.”

A further limitation on the scope of section 2036(a)(2) requires that the grantor must have actually retained the replacement power; de facto control of the administrative powers of the trustee by virtue of the trustee’s acquiescence will not cause inclusion.

What is the tax significance of a power retained by the grantor to appoint anyone other than himself as successor trustee? Revenue Rulings 73-21 and 77-182 do not provide the answer, neither does case law. Both a commentator and a court, in a dictum, have separately reasoned that if the trustee’s discretion is absolute, retention of this power should result in inclusion of the trust corpus in the grantor’s estate, as it effectively empowers the grantor to shop around for a trustee that will accede to his wishes. As neither the Code nor the regulations specifically address such a power, however, the question of whether it can be used without adverse tax consequences is apparently still open.

The determination of whether a grantor actually has the power to

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132. 553 F.2d 637 (Ct. Cl. 1977).
133. Id. at 642-43. The court justified this discrepancy between results by noting that § 2038(a) “looks at the problem from the decedent’s death,” while § 2036(a) “looks forward from the time the decedent made the transfer.” 553 F.2d at 640.
135. Id.
change trustees is made under applicable state law. In *James v. United States*138 the three grantors of a trust retained the joint right to change trustees. Applying Nebraska common law, the court held that the joint right had terminated with the earlier death of one of the grantors.140 Since the right to change trustees had been extinguished before the decedent’s death, the trust assets were not included in her estate. In *Durst v. United States*141 the decedent-grantor created an irrevocable trust, reserving to himself the power to appoint individual trustees to serve with the corporate trustee. After reviewing the trust instrument as a whole, as well as examining extrinsic evidence of the grantor’s intention, the court concluded that, under Ohio law, the grantor did not intend to allow himself to be appointed trustee.142

The possibility of the grantor becoming a trustee causes inclusion of the trust corpus in the grantor’s gross estate even if the grantor, as trustee, can exercise the power to control beneficial enjoyment only in conjunction with an adverse party.143 If the use and enjoyment of the property is fixed by the trust instrument, however, or if the discretionary powers of the trustees to determine beneficial enjoyment are measured by an objective, ascertainable, and enforceable standard, and provided that the grantor retains no right to amend or alter the trust instrument, he may become a trustee with no adverse estate tax consequence.144 The value of a trust corpus will be included in the gross estate of a beneficiary who has the unrestricted power to remove a trustee and appoint himself as successor-trustee if the trust instrument empowers the trustee to make distributions, not subject to an ascertainable standard, to beneficiaries including himself.145

**D. Power to Allocate Receipts and Disbursements**

*Income Tax Consequences.* For administrative convenience a trustee will frequently be given the discretionary power to allocate trust receipts and disbursements between income and corpus to avoid the necessity of seeking court approval as to doubtful allocations.146 Section 674 states that any party, including the grantor, may have this power, “even though expressed in broad language,” without trust income being attributed to the grantor.147

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140. *Id.* at 179.
142. 409 F. Supp. at 1048.
146. See, e.g., E. Belsheim, *supra* note 121, § 9205(c)(21); J. Hellmuth, *supra* note 121, No. 10.01, at 1002.
Estate Tax Consequences. The courts have concluded that retention of a power of allocation by the grantor does not cause the trust property subject to that power to be included in the grantor’s estate under section 2036.\(^{148}\) With regard to trusts creating charitable remainders, the Service has argued that the power to allocate permits the trustee to allocate capital gains to income, defeating the rights of the charitable remaindermen.\(^{149}\) Where state law requires capital gains to be allocated to corpus\(^{150}\) or requires a trustee to act fairly in representing the interests of all beneficiaries,\(^{151}\) however, the remainder is ascertainable and thus deductible.\(^{152}\)

E. Power to Have Income or Principal Applied to Discharge Legal Obligations

Income Tax Consequences. Authority of a trustee to make distributions of trust income or principal for the support of persons whom the grantor is legally obligated to support (other than the grantor’s spouse) will cause the income to be taxed to the grantor only to the extent that it is so distributed.\(^{153}\) The result is the same even if the power is exercisable only with the consent of an adverse party, and even if the grantor is not a trustee.\(^{154}\) On the other hand, if a trustee has authority to distribute trust income to either the grantor or the grantor’s spouse without the approval of an adverse party, that income is attributed to the grantor regardless of whether or not it is so distributed.\(^{155}\) If the power is exercisable by the grantor in a nonfiduciary capacity, the income of the trust will be taxed to the grantor as it is earned rather than as it is distributed.\(^{156}\) Section 678(c) accords the same treatment to a person other than a grantor who is deemed an owner of the trust under section 678(a).\(^{157}\)

The fact that the trust instrument authorizes distributions to a person the grantor is legally obligated to support does not create a presumption that the distributions actually made are for support, as long as the trust instrument either is silent as to the purposes for which distributions may be

\(^{148}\) See, e.g., Estate of Pardee, 49 T.C. 140, 146-47 (1967).


\(^{151}\) See, e.g., Hughes v. Coffey, 263 S.W.2d 689, 690 (Ark. 1954); In re Estate of Weiss, 309 A.2d 793, 800 (Pa. 1973). See also Restatement (Second) of Trusts §§ 170, 183, 232 (1959).


\(^{154}\) I.R.C. § 677(b). While the application of the general rule of § 677(a) can be avoided if income distribution requires the participation of an adverse party, § 677(b) contains no such exception.


\(^{156}\) Section 677(b) brings the grantor within the adverse party exception only if he holds such discretion as trustee or cotrustee; otherwise, the grantor’s discretionary power falls within § 677(a) and that subsection’s constructive distribution rules. See Treas. Reg. §§ 1.677(a)-1(c), .677(b)-1(e), T.D. 7148, 1971-2 C.B. 251.

\(^{157}\) I.R.C. § 678(c).
made or allows them to be made for any purpose. The questions of whom a given individual is legally obligated to support and what constitutes support are generally answered under state law.

Estate Tax Consequences. The retention by a grantor, individually or as trustee, of the power or right to have trust income used to discharge his legal obligations, including support, constitutes the retention of the right to income under section 2036(a)(1) and the value of the entire trust property, less the value of any portion not subject to the power, will be included in the grantor's gross estate. Unlike the income tax provisions, if trust income may be applied to discharge the grantor's legal obligations, but the grantor has not retained the right to do so, the value of the interest is not includable.

F. Power to Invest in and Manage Life Insurance

Income Tax Consequences. Section 677(a)(3) provides that the income of a trust will be attributed to the grantor to the extent that it may be applied, without the consent of an adverse party, to the payment of premiums on policies insuring the life of the grantor or the grantor's spouse. Thus, if the trust instrument provides that trust income can be used to pay the premiums on policies that insure the grantor or his spouse, the grantor is taxed on the amount of trust income equal to such premiums. The grantor is taxed even though the policy was purchased directly by the trustee after the creation of the trust. Although a literal reading of section 677(a)(3) would result in the grantor being taxed on trust income any time the grantor or a nonadverse party, without the consent of an adverse party, may apply trust income to the payment of premiums on policies insuring the life of the grantor or the grantor's spouse, the courts have continually held that attribution of trust income to the grantor is conditioned on the presence of insurance policies in the trust corpus upon which the premiums might have been paid. If a trust owns no policies, the power of a trustee to invest in policies on the life of the grantor or his

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164. Edward E. Rieck, 41 B.T.A. 457, 460-61 (1940), aff'd, 118 F.2d 110 (3d Cir. 1941).
166. Frank C. Rand, 40 B.T.A. 233 (1939), aff'd, 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941); Genevieve F. Moore, 39 B.T.A. 808 (1939); Lorenz Iversen, 3 T.C. 756 (1944).
spouse should not be presumed merely because broadly worded provisions do not expressly prohibit such investment.\textsuperscript{167} To protect the grantor fully from the unintentional application of section 677(a)(3), if anyone other than an adverse party is trustee, the trust should be drawn expressly to prohibit such trustee from purchasing insurance on the life of the grantor or his spouse.

\textit{Estate Tax Consequences.} The power to purchase life insurance, coupled with other broad administrative powers, has been held insufficient to constitute a power to alter, amend, or revoke the trust within the scope of section 2038.\textsuperscript{168} Where the insured is also a trustee, however, problems may arise, especially in the Fifth Circuit. The three other circuits that have addressed the issue have found a critical distinction between general fiduciary powers that the trustee-insured could exercise over the policies held by the trust and fiduciary powers that could be exercised for the fiduciary's own personal benefit.\textsuperscript{169} Unfortunately, in \textit{Rose v. United States}\textsuperscript{170} the Fifth Circuit Court of Appeals unexpectedly and inexplicably disagreed with this distinction. In \textit{Rose} the decedent had been trustee of three trusts created by his brother for the benefit of the decedent's three children and funded with a life insurance policy on the decedent's life. As trustee, the decedent had the power to borrow against the policies, to withdraw dividend accumulations and to convert the whole-life policies to endowment or limited-payment life policies. The district court held,\textsuperscript{171} and the Fifth Circuit affirmed,\textsuperscript{172} that the mere possession of any incidents of ownership is sufficient to invoke inclusion under section 2042, even though those incidents are held only in a fiduciary capacity and are not exercisable for the fiduciary's benefit. In a second case, \textit{Terriberry v. United States},\textsuperscript{173} the Fifth Circuit compounded the problem by following \textit{Rose} in a situation in which the decedent-insured as cotrustee was expressly prohibited from exercising any incident of ownership except to elect a settlement option, and even that incident was expressly limited so that the decedent could not benefit from its exercise. In light of \textit{Rose}, \textit{Terriberry}, and the Internal Revenue Service's nonacquiescence\textsuperscript{174} with the other circuits' holdings in \textit{Estate of Skifter v. Commissioner}\textsuperscript{175} and \textit{Estate of Fruehauf v. Commissioner},\textsuperscript{176} the safest route to follow is to draft instruments that ex-

\textsuperscript{167} Corning v. Commissioner, 104 F.2d 329 (6th Cir. 1939). \textit{But see} Nora C. Todd, 32 B.T.A. 1067 (1935), \textit{aff'd}, 82 F.2d 1020 (2d Cir. 1936).
\textsuperscript{168} United States v. Powell, 307 F.2d 821 (10th Cir. 1962).
\textsuperscript{169} Estate of Connelly v. Commissioner, 551 F.2d 545, 549 (3d Cir. 1977) ("where the requisite powers over policies on his life have been transferred to a decedent, with no beneficial interest therein, 'such arrangement can hardly be construed as a substitute for testamentary disposition on decedent's part'"); \textit{Estate of Skifter v. Commissioner}, 468 F.2d 699, 702-04 (2d Cir. 1972); \textit{Estate of Fruehauf v. Commissioner}, 427 F.2d 80, 86 (6th Cir. 1970).
\textsuperscript{170} 511 F.2d 259 (5th Cir. 1975).
\textsuperscript{172} 511 F.2d at 264-65.
\textsuperscript{173} \textit{151 F.2d 286} (5th Cir.), \textit{cert. denied}, 424 U.S. 977 (1975).
\textsuperscript{174} Rev. Rul. 76-261, 76-2 C.B. 276.
\textsuperscript{175} 468 F.2d 699 (2d Cir. 1972).
\textsuperscript{176} 427 F.2d 80 (6th Cir. 1970).
pressly vest all incidents of ownership in an independent fiduciary and prohibit the insured from dealing with them.

G. Power to Vote Corporate Stock

Income Tax Consequences. Section 675 states that the grantor will be subject to taxation on the income from the trust if any person in a nonfiduciary capacity has the power, without the consent of a fiduciary, to vote or direct the voting of the stock of a corporation in which the grantor and the trust, combined, have significant voting control. The two elements of the section, voting control and fiduciary responsibility, operate independently of one another. Therefore, the grantor or any other person can hold a "controlling" voting rights power without the grantor being treated as owner of stock subject to that power as long as the power is held in a fiduciary capacity. Conversely, a grantor or any other party in a nonfiduciary capacity can safely vote the trust's stock if his holdings and those of the trust are not significant in terms of voting control.

Estate Tax Consequences. In United States v. Byrum the Supreme Court ruled that the grantor's retention of voting rights in family corporation stock that he had transferred to a trust was not sufficient to cause inclusion of the transferred shares in his estate under section 2036. In response to the Byrum decision, the Tax Reform Act of 1976 amended section 2036(a) to provide that the retention of voting rights in stock that a decedent has transferred shall be considered, per se, the retention of enjoyment of such stock and, therefore, will cause the value of the stock to be included in the decedent-grantor's gross estate. This congressional reaction to Byrum went beyond the facts of that case, for the statute encompassed the retention of voting rights in large, publicly held corporations as well as small, closely held companies, resulting in estate taxation to the grantor even when his voting rights could in no way be equated with control of the corporation. The Revenue Act of 1978 modified this Draconian measure, amending section 2036 to require inclusion of stock in the grantor's gross estate only where the decedent-grantor constructively owns twenty percent or more of the voting stock of the corporation.

H. General Administrative Powers

In recent years numerous disputes have arisen over the substantive nature and effect of supposedly purely administrative powers. Courts have

183. See Kuney v. United States, 448 F.2d 22 (9th Cir. 1971), rev'd 69-1 U.S. Tax Cas. ¶ 9306 (E.D. Wash. 1969).
ruled, however, that no aggregation of purely administrative powers should result in the taxation of property subject thereto.\textsuperscript{184}

\textit{Income Tax Consequences}. Section 675 is the primary income tax section dealing with administrative powers.\textsuperscript{185} Section 675(4) identifies three powers that will be regarded as purely administrative, regardless of who holds them, as long as the powers are exercisable only by or with the approval of a person in a fiduciary capacity: the power to vote or direct the voting of stock in a controlled corporation, the power to control the investment of trust funds, and the power to substitute trust assets. The power to borrow from the trust without adequate interest or security and the power to deal with the corpus or income for less than adequate and full consideration verge on being substantive rights and, therefore, under section 675(1) and (2), can be exercised by the grantor or a nonadverse party only under certain circumstances\textsuperscript{186} without subjecting the grantor to taxation on income attributable to the corpus subject to these powers.

\textit{Estate Tax Consequences}. The Supreme Court has held that administrative and managerial powers are not, for the purposes of estate tax, powers to control beneficial enjoyment.\textsuperscript{187} In the estate tax area the following powers are generally deemed to be nonsubstantive, even if held by the grantor: the power to limit the liability of a trustee;\textsuperscript{188} the power to amend administrative provisions having no estate, gift, or income tax significance;\textsuperscript{189} the power to assist the trustee in investment decisions;\textsuperscript{190} the power to invest in "nonlegal" investments;\textsuperscript{191} and the power to invest in mutual funds.\textsuperscript{192}

\textbf{III. SOME SUGGESTIONS FOR THE FINAL DRAFTING STAGE}

Considering all of the factors that must be taken into account, along with the ramifications that result if a mistake is made, the selection of the trustee is likely the most critical phase of the trust creation process.\textsuperscript{193} The task is not completed once the choice has been made, however. It then

\textsuperscript{184} Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970); Estate of Edward E. Ford, 53 T.C. 114 (1969), \textit{aff'd per curiam}, 450 F.2d 878 (2d Cir. 1971).

\textsuperscript{185} I.R.C. § 675; see Brogan, \textit{supra} note 12, at 72 (discussion of statutory and case law pertaining to retained administrative powers).

\textsuperscript{186} Section 675(2) creates an exception to the general rule "where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security."


\textsuperscript{188} Greer v. United States, 448 F.2d 937 (4th Cir. 1971); Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970).

\textsuperscript{189} \textit{See} United States v. Winchell, 289 F.2d 212 (9th Cir. 1961).

\textsuperscript{190} \textit{See} Estate of Herbert L. Johnston, 2 T.C.M. (CCH) 299 (1943).

\textsuperscript{191} Estate of Ralph Budd, 40 TC. 468 (1968); Estate of Willard V. King, 37 T.C. 973 (1962).

\textsuperscript{192} \textit{See} State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959).

\textsuperscript{193} For an excellent analysis of the nontax factors to be considered in appointing a trustee, see Bromberg & Fortson, \textit{supra} note 74. \textit{See also} Moore, \textit{Choosing a Trustee}, 8 ABA L. NOTES 81 (1972).
becomes the further duty of the attorney to draw up an instrument that will effectuate, as precisely as possible, the desires of the grantor. The following suggestions are offered as examples of planning and drafting techniques for completing the trustee selection process.

**Appointment of Trustee as Coexecutor.** The trustee of a testamentary trust who succeeds an executor may become liable for the malfeasance or nonfeasance of his predecessor if he fails to redress such conduct. As a result of this potential liability, many corporate trustees now refuse to accept trusteeships until they have fully examined the records and accountings of the executor and have assured themselves that they are inheriting no fiduciary breaches. The costs of this initial investigation are, of course, borne by the trust. If the grantor has chosen a corporate trustee or co-trustee, naming that trustee as coexecutor may ease and even hasten the activation of a testamentary trust at little or no additional cost, assuming the charge for serving as coexecutor parallels the charge for the nonexecutor-trustee's initial examination. Even when the corporate trustee is named as executor, it frequently recommends that a spouse or close family member be named as coexecutor, for two reasons. First, the transition required by the death of a family member is often easier to bear for a person who is actively engaged in the process of administering the estate and distributing the decedent's property. Secondly, there are numerous small tasks required of an executor, such as locating documents, making calls to creditors and debtors of the estate, and contacting insurance companies, that can be done far more expeditiously and inexpensively by a family member. The presence of a family member as coexecutor thus can speed up administration while making it less costly to the estate.

**The Distribution Standard.** Often the choice of a standard for distribution of trust income and corpus will turn on tax consequences. Whatever standard is to be used, it should be described as fully as possible, either in the trust instrument itself or in contemporaneously executed memoranda that will be passed on to the trustee. One noted authority suggests that the ideal flexible trust uses an independent trustee with the power to distribute in his sole discretion. While such a limitless standard does allow for utmost flexibility, the realities of fiduciary administration must be taken into account. Many corporate trustees, when presented with a "sole discretion" standard of distribution, choose instead to follow a conservative disbursements policy as a precaution against potential liability for abuse of discretion. If the sole discretion standard of distribution is coupled with precatory language of the grantor precisely expressing his wishes, a cautious trustee may be far more willing to distribute the trust property with a free hand, as the grantor intended.

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Division into Shares. The fee schedules of some banks treat every share within a trust as a separate trust for administration purposes, resulting in duplicate fees to a trust in which assets are divided into separate shares before the final termination date. Other corporate trustees charge a separate fee only when the shares within a trust require distinctive handling. Early division of the trust property into separate shares also may result in each share having a value less than the minimum that a corporate trustee is willing to accept, whereas division upon termination would maintain the trust value above the acceptable value level. A representative of the prospective corporate trustee should be consulted before execution of the trust instrument so that these problems may be anticipated and dealt with without doing irreparable damage to the grantor's intentions.

Particularized Powers. If the trust property includes an asset that will require particular management or handling, a power outlining the extent of the trustee's power and responsibility with regard to that asset should be included in the trust instrument. If the grantor desires the trustee to manage certain business entities included in the trust corpus, he should so provide, setting forth the scope of the trustee's duty in as much detail as is feasible. The same should be done for the handling of any trust asset about which the grantor is particularly concerned, for example, an heirloom, an art collection, or stock in a family corporation.

Removal Power. Vesting an unrestricted power of removal in the trust beneficiaries may be of tremendous psychological and practical value. A surviving spouse or descendant will feel far less threatened by the trustee simply because of the existence of such power. The power also becomes advantageous if either the trust property or beneficiary changes location and the original trustee cannot continue to operate effectively. The removal power must be drawn carefully, however, to avoid adverse tax consequences. If the successor can be only a corporate trustee or a predesignated independent individual, even a "removal without cause" provision should be tax-safe.

A frequently used successor trustee clause provides that a trustee can be replaced only by a corporate trustee with assets of at least "X" million dollars. While the restriction is a wise one, it certainly does not circumvent all potential trustee replacement problems. If a corporate trustee refuses or is unable to serve because the value of the trust property has decreased to the point that it can no longer do so profitably, turning to an alternate corporate trustee of the same size may raise the same problem. If the grantor does not want the successor trustee selection left to the courts, he should designate individuals who either will serve as successor trustees or

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197. See notes 124-45 supra and accompanying text.

198. But see Burch, supra note 77, at 498-99.
SELECTING A TRUSTEE

who will select a successor individual trustee in the event that a corporate successor becomes unavailable.

Investment Advisor Rather Than Trustee. A grantor may be concerned about the initial investment decisions that a trustee will make upon his death, yet feel strongly that his spouse or some other individual is competent to manage the trust property. In this case consideration might be given to appointing a bank, a broker, or a professional investment analyst as an interim or permanent investment counselor. This is a relatively new concept, but such services are being offered by progressively more financial institutions, and temporary use of the collective corporate wisdom might be the ideal compromise between a corporate trustee and an inexperienced family member trustee. An interim advisor appointment is also practical for a trust in which the asset value does not permit long-term corporate management, either because a bank will decline to serve or because the depletion by administrative costs outweighs the benefits advanced by professional investment advice. A one-time fee for investment counseling may be profitable for the trust under those circumstances.

Termination of Powers/Savings Clause. As income and estate tax laws change rapidly, it is difficult for an estate planner to foresee what repercussions the provisions he drafts today may have in even the near future. The inclusion in the trust instrument of a provision terminating a power of the trustee or rendering it void if its existence or exercise defeats the allowability of a deduction or causes the inclusion of otherwise excluded assets will be given effect if such a provision is valid under local law and not against public policy. 199

IV. CONCLUSION

Every client and every trust agreement require a different combination of the powers outlined in this Article, along with others not mentioned. Too often a client becomes overeager at the mention of a tax savings; from that point on he gives but scant attention to the nontax consequences of his choice of trustee or to how life under the trustee will be for those who have to live it. The importance of the tax consequences attending the appointment of a trustee cannot be overemphasized; nonetheless any attorney drafting a trust should seriously attempt to convince the client to consider adequately the nontax consequences of his or her choice of trustee.

There are crucial factors to be considered both in choosing a trustee and in deciding what powers to give the trustee. If the grantor retains too many powers over the trust property, he may be liable for income tax on the trust income, and the trust property may be attributed to his estate at his death. The tax consequences of estate planning are further complicated because income tax consequences and estate tax consequences are

often inconsistent; the settlor-grantor may be considered the owner of the property for one tax purpose but not for the other.

The possibility of adverse tax consequences mandates a careful analysis of the income tax and estate tax provisions before drafting any trust agreement. Because this area of tax law is traditionally subject to frequent change, constant review of these laws is essential to good estate planning.