Draftsmanship Problems of Testamentary and Inter Vivos Trusts

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In 1926 the Federal Estate Tax on an estate of $200,000 was $1,500. Today it is $32,700. A half-million dollar estate in 1926 paid a tax of $12,500 and today it is $145,000. Income tax-wise, we have the the same contrast. The married man with two children and an income of $10,000, paid a tax of $40 a year in 1926. Today it is a little closer to $40 a week. This heavy impact of taxation has revolutionized the way in which wills are drawn so that the 1926 will looks as outmoded today as the 1926 Ford does. What I plan to do this morning is to review with you some of the changes that have come about in the drafting of wills because of the tremendous impact of federal taxation. I want to talk about a few cases from my personal experience, as well as a number of the decided cases.

Precatory Trusts

The first thing I want to talk about is the old precatory trust. A precatory trust, as you know from law school days, is not really a trust at all, but is a bequest in which the testator imposes a moral rather than a legal obligation. It was thought of as a happy device if you wanted to give some member of the family the whip hand over another member and not harass him with the possibility of being called into court for an accounting. In one case there were two sisters who inherited the father's department store. Over the years the department store interest grew in value so that each one had about $500,000. One of these sisters never married. The other married and had a son who in turn married and had three children. He was a worthless fellow who drank all the time, so when the married sister died she left a will in which she bequeathed everything to her sister, "with the confident expectation, but without

* See Contributors' Section, p. 284, for biographical data.

imposing any legal obligation, that she will take care of my son and his family." So the spinster received this $500,000, stock of the company, put it away, never thought of it as being hers, and took care of the family over a period of 12 to 15 years. The only time she realized this money was hers was in March or April when she got around to filling out her income tax returns. Then the income from this stock was added to her income and about half of it went to the federal government. As she got to be in her early seventies, she began to worry about the estate taxes on this additional bequest. So, when the youngest child became 21, she made an equal division into five parts—to the son, his wife, and to each of the three children. She paid a gift tax of about $100,000. Then she began to worry that she would not live long enough to get beyond the three year statutory protection against gifts in contemplation of death. As it turned out, she died before the three years were up, so the issue was then raised whether this was a transfer in contemplation of death. The point I am making is that to the unmarried sister the moral obligation was as real as the legal obligation. But if the will had said, "to my sister to be used by her for the support of my son and his family," then none of the income would have been taxed to her; since it was used for these five persons it would have been spread among five tax entities. When she got ready to make her distribution she would have avoided any gift tax because she would have held it as a trustee; she would not have been making a gift, and hence would not have had to be concerned with a gift in contemplation of death. But the mere fact that it was a precatory trust imposed tax burdens that were well in excess of $200,000, with substantially no greater powers on her part than if an informal trust had been created.

Another Supreme Court case that is quite similar is the *Mississippi Valley Trust Co.* case.[1] There a testator in his will left a million dollars to his sons and in one paragraph said, "I make no bequest to charity. I discussed my charitable desires with my sons and I am perfectly confident they will carry out my wishes." Then the residue went into a trust for the sons. The sons, again because they felt the moral obligation as keenly as the legal obligation, gave a million dollars to the University of St. Louis. The executors attempted to deduct this in the Federal estate tax return, but the deduction was disallowed on the grounds that the sons were the absolute owners of the property, and hence, this was not a charitable bequest. The effect of that was to cost the estate something better than $400,000, which might well have been completely avoided if the will had said, "I give $1,000,000 to my sons to be used as gifts to such charities as they may determine." They would not have felt under any greater compulsion because of the legal obligation to make the distribution than

[1] Mississippi Valley Trust Co. v. Commissioner, 72 F.2d 197 (8th Cir. 1934).

they did with simply the moral obligation. So precatory trusts can be extremely expensive things.

Compensation Bequests

With respect to compensation bequests, the statute says that a bequest shall be exempt from income tax. But this means a gratuitous bequest—a gift bequest. In a case in Louisiana, a bachelor died with remote next of kin, and left no will. Three of his business associates, who had been with him for twenty years, brought an action alleging that he had made a contract with them that he would leave the business to them if they would continue in his employ during his life. They set up a beautiful cause of action, but when it was suggested to them that if they in fact recovered, the recovery would constitute taxable income, they lost their enthusiasm. The business was valued at about $600,000. Each of the three would have gotten $200,000 in bricks and mortar and would have had a tax of $150,000 to pay on the income, with no money with which to pay it. So they were perfectly happy to withdraw the suit if they were given some assurance of continued employment. This illustrates a perfectly ruinous kind of bequest, with no ability to spread the cost over the years.

In the Tax Court case of *McDonald v. Commissioner*,[2] the decedent left his entire estate to Miss McDonald, who was his nurse, "In recognition of her long and faithful service to me." Fortunately, he added "Miss McDonald has comforted me in my sorrow and bereavements." The Commissioner assessed a tax on the entire estate as ordinary income to Miss McDonald, taking the position it was additional compensation to her. Miss McDonald, however, casting all modesty aside, testified that she had lived with the deceased for eight years before his death. The Tax Court fortunately found that the relationship had far more family than commercial flavor about it, and so they held in favor of the taxpayer. But don't we often in wills unduly stress the compensatory aspects of these bequests to household servants, and employees and business associates, when we set forth that the bequest is because of the long and faithful service? That, in effect, is simply raising a red flag that it may be taxable compensation. There is no benefit to the estate, even though it may be found to be compensation, since it is all done without a binding legal obligation, and therefore not deductible for estate taxes. But it may well constitute income to the recipient if the predominating motive is the

[2] 2 T.C. 840 (1943).

desire to compensate, rather than the desire to make a gratuitous gift at death arising out of love and affection. I've been talking about cases with a whole lot of money, I suppose the reason being that it's only the cases with a lot of money that get up into the upper courts, but the doctrine is equally applicable to smaller amounts.

Dollar Amount Bequests

Another pitfall is represented by the *Kenan*[3] case. Here, the decedent, a very wealthy man, left his entire estate in trust for his son for life, with a direction that the trustee distribute to his son, at age 40, five million dollars. The trustee satisfied this bequest with a million eight hundred thousand dollars worth of bonds, and three million two hundred thousand dollars worth of stocks. The three million two hundred thousand dollars of stock had a cost basis to the executor of a million two hundred thousand dollars. It was held that the estate had incurred a long term capital gain of two million dollars on the distribution. In other words, the executor had satisfied a three million two hundred thousand dollar obligation with assets that had a cost to him of one million two hundred thousand dollars. And wherever you satisfy an obligation with a low-cost-basis asset, you have capital gain. If you have some stock that cost you $100 and you deliver it in satisfaction of a $300 dental bill or rent bill or any other obligation, you have a $200 capital gain. That is exactly what happened in the *Kenan* case. On the other hand, if this testator had provided in the will that the income was to be paid to the son until age 40, at which time one-third of the principal would be distributed to him, or one-half of the principal, then there would have been no capital gain, because then there would be no dollar amount due. So it is particularly important in bequests of any size, if the distribution is to be delayed for any substantial period, to use language which makes the gift in terms of a fractional share, rather than a stated dollar amount.

Income Bequests

The next item I want to talk about relates to income in respect of decedent items. There are a whole lot of items in an estate which get no cost basis and which are taxable as income in full to the beneficiaries. I suppose the best example is the insurance agent who dies with ten years of renewal commissions coming in. These commissions are taxed as part of his estate at their present value. They don't get a basis. Each dollar collected on these renewals, since it's compensation income, will

[3] Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).

be taxed to the executor if he receives it and doesn't distribute it, or to the beneficiary if the cause of action is distributed to the beneficiary. When lawyers, doctors, and accountants die, a very large portion of their estates will consist of unrealized receivables, and these again are income in respect of decedent items. A good many business executives will have rights to receive deferred compensation that will continue after death. Up to 65, the executive may take a lesser salary, if the company agrees to continue him at $10,000 a year as long as he lives, and his wife thereafter at $5,000 a year. If he dies before age 65, the payments for the wife may go on for a longer period of time. Now those are again taxable as part of his estate, but get no new basis because they are classified as income in respect of the decedent.

Particularly, for a charitable bequest this type of income ought to be used. A Californian left the university out there $50,000. The executor attempted to satisfy this with the monies that were coming due to the estate from the decedent's company, but the court taxed the executor on this amount as income in respect of the decedent. They said that the will had made a *capital bequest* of $50,000. But if such provisions are worded differently, if instead of giving to charity $25,000, a capital bequest, you would give the charity "one-fifth of my renewal commissions," in an insurance case, or "the first $25,000 out of my deferred compensation," then what the charity gets is taxable income, which doesn't concern it since it doesn't pay a tax, and the legatees get the capital which is free of income tax.

Now for a variation of that, suppose the decedent wants to give $25,000 to five separate charities, $5,000 to each. If he says "$5,000 to *A* charity, $5,000 to *B* charity, $5,000 to *C* charity, etc., the residue to my wife," the wife is going to have the taxable income, the charity is going to get the capital amount. If he sets up a testamentary trust which provides that "the first $25,000 of income is to go to the following five charities," then the widow will receive no income for a period of a year or two years, whatever time may be required; the charities will receive the income, but will pay no tax on it. He might well make a compensating bequest of $25,000 to the wife earlier in the will to offset the loss of income. The wife will then receive the $25,000 and will keep the whole amount instead of half of it. The income goes to the charity.

Residuary Bequests

Now, so much for general bequests. When we come to the residuary bequests, I suppose mostly you'll be dealing with community property, so let's talk about that half of the community over which the husband

has the power of disposition. He may, of course, leave all that to the wife. Let's assume an estate of $200,000. If he leaves his entire interest in the community, amounting to $100,000 for his half, to his wife outright, he'll pay a federal tax of $4,800. But the wife will now have $200,000, and on her death she will pay a tax of $32,700. If, instead of giving the wife his interest in the community outright, he gives it to her for life, then you pay the same tax at his death, but on the later death of the wife she will have an estate of only $100,000 and pay a tax of $4,800, a difference of better than $27,000 through giving her the life estate rather than the fee. Of course, he wants to give her the complete use of the money—she's the primary object of his benefit. So the problem of the draftsman is to what extent he can avoid the $27,000 of unnecessary taxes—more than 25% of the overall estate—as well as the additional costs of executor's fees and attorney's fees on her death. To what extent can we give the widow the benefits of this $100,000 without the burdens? To what extent can we approach absolute ownership and still keep the property within the concept of the life estate for purposes of death taxes?

Here, the federal law is, I think, extremely liberal in the powers of appointment section.[4] First, of course, you'd give the widow the income from this, his half of the community, which is normally what she would expect. Then, under the powers of appointment section she may be given an absolute power to withdraw 5%, or $5,000, of the corpus each year, a non-cumulative right. This means that if she fails to withdraw one year, the next year she can still withdraw only the $5,000, or 5%. It doesn't accumulate from year to year. Congress said in 1951, when they were revising the powers of appointment statute, that it was desirable to permit flexibility in smaller trusts and to permit small withdrawal privileges. They didn't think they were opening too wide a door when they permitted this $5,000 invasion privilege. Next, they defined a general power of appointment (which is the only power that attracts an estate tax) as not including a power of invasion measured by a substantial, objective standard relating to health, education, maintenance, or support. Consequently, in addition to giving the widow the income, and the $5,000 withdrawal privilege, she (not the trustee) may be given the privilege of invading the corpus to whatever extent necessary to maintain her accustomed standard of living. And that, I think, is a fairly well accepted case law standard. If we get into a depression, if she has extraordinary medical expenses, if there are real needs in order for her to maintain her accustomed standard of living, then she may not merely ask the trustee, but demand from him, whatever amounts in excess of the income and in excess of the $5,000 may be needed. That gives her the maximum

[4] INT. REV. CODE OF 1954, § 2041.

kind of protection. She wouldn't invade it without needing it. If she wants a European trip, she can take the $5,000 out, but she wouldn't go to much larger amounts unless she had some real need for them.

We can, of course, in addition, give the trustee the absolute power to pay out in his discretion so that he may, if she can persuade him, give her larger amounts without regard to a need. Then we can also give her a special power of appointment by deed to appoint the property to and among the children, and that tax free, any time during her life. If the daughter gets married and the mother wants to give her a house, she can direct the trustee to distribute $20,000 to the daughter in the exercise of this special power of appointment without attracting any gift tax. If the son wants to go into business and needs money to invest, she can direct the trustee to make a distribution to him, whatever amount of capital she desires. The only limitation is that she can't pull out more for herself than this $5,000, or 5%, of the corpus unless it's needed to maintain her standard of living. And lastly, we can give her a special power of appointment by will which will enable her to appoint the property to anybody she likes, so that she's got the complete, absolute, testamentary disposition over it provided she's willing to forego the doubtful pleasure of being able to give it to her creditors. That's the only limitation imposed on her. Now, hasn't she got something very close to practical ownership, without paying this $27,000 extra in federal taxes—for she has the income, the right to withdraw the $5,000 at her whim and pleasure, the right to demand more (an equitably enforceable right) if she needs it, the power of appointment by which she can make distributions to the children during her life (free of any gift tax), and the complete testamentary disposition of it at her death?

Trust as Income Saving Device

The trust is not only a device for the saving of estate taxes; it's a tremendously useful device for the reduction of income taxes. The trust is a second tax pocketbook. It is a tax entity and it pays an income tax on some of the trust income. Even a trust that directs all the income to be paid to the life beneficiaries will nevertheless serve to reduce taxes because a portion of income will nevertheless be taxed to the trust. The reason is this: What is income in the trust sense or the local law sense is totally different from what is income in the tax sense. I suppose the most obvious illustration of that is in the capital gain area. If we give this lady the $100,000 outright, and she has a $10,000 or $12,000 long-term capital gain, she puts 50% in her ordinary income and has it taxed at whatever her top bracket happens to be. If it's a trust, with the same assets and the same capital gain incurred, the capital gain is not

distributable, since under the trust law it is not income. It is therefore taxed to the trust and the trust takes half of the gain into its ordinary income. But it begins at a 20% bracket; whereas if the widow had taken it, it would be taxed at whatever her top bracket happened to be.

Now in addition to that, we can create a number of tax pocketbooks through the device of creating separate trusts. This is an extremely useful device and something which Congress is now trying to deal with, but is finding it extremely difficult to reach the tax-avoiding opportunities in this area. If I have three children I may, either by will or by an inter vivos transaction, deliver $100,000 to a trustee and tell him to hold it, invest it and reinvest it, collect the income, and pay one-third of the income to each of my three children; and as each child gets to age 40, distribute to him one-third of the corpus. There I have a single trust. However, with some different phraseology—for practical purposes it's very largely phraseology—I may say to the trustee, "Here's $100,000. First, divide it into three separate shares, and hold each share as a separate and distinct trust, share *A* for child *A*, share *B* for child *B*, and share *C* for child *C*." Then I have three separate trusts. Moreover, these three trusts may own undivided interests in the same asset. It's well settled that the trustee might buy 100 shares of General Motors and allocate one-third of it to each of the trusts.[5] If he subsequently sells the asset with a $12,000 capital gain, we have, because of the three trusts, three gains, each in the amount of $4,000. We carry over half of each gain. What we do is tax the capital gains three times at a third, rather than once in the full amount, as would be necessary if we had one trust with the children having separate shares. What you have to do is to make it clear that the trustee is to hold each share as a separate and distinct trust and then to carry out in the instrument the phraseology that clearly shows that you have three trusts rather than one trust in which the children share. Most of the litigation in this area has arisen because the draftsman wasn't quite sure what he was doing and sometimes it looked as though there were separate trusts, and sometimes as though it was a single trust with each beneficiary having a partial interest.

I learned this morning that in Arizona you have the problem of a Rule Against Perpetuities that is different from the common law rule, in that you are limited to two lives. I do not suppose that it would be advantageous, wholly aside from this, to go beyond this limit. If you had three children, you would have to create three separate trusts if you wanted the widow to have the income for life, and then each child to have income for his life. New York had that problem until a year ago.

In addition to the separate trusts we may in some limited number of cases authorize the trustee to accumulate income. The income that is

[5] United States Trust Co. v. Commissioner, 296 U.S. 481 (1936).

distributable is taxable to the beneficiary, while the income that is accumulated is taxed to the trust. In a large estate where there is more income than needed, it is a tax waste to distribute all to the widow. If you say the trustee may in his discretion pay out or accumulate, then to the extent the trustee decided to accumulate the income, the tax is on him (the trust) and what he pays out is taxed to the wife. He may well take taxes into consideration, as well as the needs of the widow, in determining what the distribution shall be. The only limitations on that since 1954 are the throwback rule which taxes to the beneficiary any amount of accumulated income up to a five-year period, so that the trustee can't accumulate this year, as he used to do, and then pay out in January of next year as a capital interest. But the accumulation rule is full of exceptions that still make it an extremely handy device.[6] It doesn't apply wherever the amount of distribution of prior accumulated income does not exceed $2,000. It doesn't apply to accumulations during a minority, so that you can accumulate until the child is 21 and then pay it all out, having had it taxed to the trustee. It doesn't apply on the termination of a trust, and it doesn't apply to accumulations that are paid out on an objective standard where there are some emergency needs—I think these are the statutory words. But in most cases people won't be interested in the trustee doing too much accumulating because most people need income annually and most people hate to spend the principal. However, they may have two trusts and let one of them accumulate all the income and have it taxed to the trust, and then have the trustee pay out of the other trust not only the income but a corresponding amount of capital. And you can show how you build up one trust as you diminish the other.

Now, let's assume that we have a client who doesn't want to dip into capital and doesn't want to use this accumulation device. He can sprinkle the income under what's called the "spray" or "sprinkle" trust. Let's assume that we have a trust, with the half of the community going to the wife, and on her death to the son. The son is 23 (let's get him over 21 to avoid a minority problem) and he's going to medical school. The instrument may authorize the trustee to pay the income to mother or to son; or, if it's a trust for the son, it may authorize the trustee to pay the income "to my son, John, or to any one or more of John's issue in such amounts or proportions as the trustee may determine." There the trustee has the power to distribute the income among a group in any amounts that seem to him to be wise. And this, incidentally, is not a tax gimmick. This is something the English lawyers devised two or three hundred years ago, partly to avoid the fact that in England you can't have a spendthrift trust, and they needed a way of keeping the property away from creditors. But if we have John, now, the father, and if he's to get $4,000 of trust

[6] 1 BOWE, ESTATE PLANNING AND TAXATION § 4.19 (1957).

income under the instrument and he's a 50% bracket taxpayer, he gives $2,000 to Uncle Sam and he has $2,000 left for son John's medical education this year. The trustee may pay the income in his discretion either to John or to any one or more of John's issue. If the trustee, with an eye to the ultimate use and the tax burden, distributes the $4,000 to the son, then the son is the taxable beneficiary, and since he has a $600 exemption and a $400 standard deduction, assuming no other income at all, then he has $3,000 that's subject to tax. The tax is about $600 which means that there's $3,400 from the same gross income available for his medical expenses during the year, instead of $2,000.

A useful provision that I suppose ought to be in all wills is a kind of indirect accumulation clause. It is a power in the trustee to invest in life insurance on the lives of any of the beneficiaries. It's not a direction to do it, but an authorization to buy such life insurance. To the extent that the trust buys insurance on the lives of the beneficiaries, the income is taxable to the trust because it is accumulated income. It is income that is non-distributable. Now, if John is a 50% taxpayer and he gets $4,000 of trust income, he gives Uncle Sam $2,000 and he has $2,000 left for premiums on insurance. If the trust buys the insurance, the trust pays the tax on $4,000 at the 20% and 22% level. The trust will have something like $3,300, so the trust can buy something better than one and a half times as much insurance. Instead of a $40,000 policy on John's life, the trustee can buy $60,000. The trustee would own the policy and name itself beneficiary, so that there are no tax consequences to John. If, however, the trustee has $60,000 on the life of John, then John doesn't need any insurance because the trustee can use this money to serve normal insurance objectives on John's death. Once the trustee collects the proceeds and has the liquid cash, he can be authorized to buy assets in John's estate, or he can lend the money, or you can have a distribution clause that will distribute something on John's death. There's no problem about getting the liquid funds over to the executor to serve normal insurance needs. And in addition to that, the trustee owns the policy and it is not a part of John's estate, so you not only have one-and-a-half times as much insurance, but the whole face amount escapes any death tax. John would not only have bought a lesser amount had the income been distributed to him, but then the federal government would also have taken another crack at it at his death. Generally, wherever there are any insurance needs, it will be far more desirable to have the insurance purchased through the trust.

Marital Deduction Bequests

Now let's talk a little about the marital deduction problems. I'm sure you have some of them since a lot of Eastern people come out here to live

and they bring with them a good bit of separate property. I suppose that to a considerable extent they like to keep the property separate, so you, like the lawyers in common law states, have to familiarize yourselves with marital deduction formula clauses. There is no answer other than the use of a formula clause. Let's assume that some Easterner comes out here with $200,000, of which $120,000 is in stocks in his own name. $50,000 is the face amount of his life insurance, and some $30,000 is in jointly owned property in Illinois where he paid the whole purchase price. Now, the insurance is part of his estate and, of course, so are the stocks and the whole of the jointly owned property. They are all separate property. Out here he may or he may not acquire other property which becomes community. If he leaves all of this property to his wife outright, he is going to get the marital deduction, but you are going to have a tremendous tax on her death. If he puts it all in trust, and in the same way disposes of his half of the community interest, then you are going to lose the marital deduction. On this assumption you will be paying a tax on his death of $32,000 instead of a tax of $4,800.

Now if we were sure the assets were going to stay just the way they are, then his will ought to give $20,000 to his wife outright and the remainder in trust, because the $20,000 outright, plus the insurance, plus the jointly owned property, would give you the exact amount of the marital deduction. But the trouble is that assets don't remain static—some life insurance agent may come to him and suggest that he ought to have the insurance paid in installments to his wife over the years, with the secondary beneficiary, the daughter, thereby disqualifying the proceeds for the deduction. They might sell the property in Illinois and he might take all that in his own name, or he might split it up so that she's got half, and he's got half, or he might give it all to her. All kinds of things could happen to make the assets held differently at death than they are at the time you're drawing the will.

The only solution that has been found is the marital deduction formula clause by which I give that fractional share of my estate that is equivalent to the maximum allowable marital deduction. It may be put exactly that way or, as I have it in the will here, "my executor shall set aside one half of my adjusted gross estate, etc." This is then defined as the gross estate less death and administration expenses, but less the value of all assets that pass outside the will and that qualify for the marital deduction. If you want to look at the clause, it's on page 2 of the model will. The first paragraph on that page sets forth how the executor shall determine the amount of the marital deduction. If, in the case put, the husband still had exactly the same assets at death—first get his gross

estate—we'll say he had $200,000 community and the $200,000 separate property, his gross estate then would be $300,000; but you exclude from the gross estate, to get the adjusted gross, the community property plus the debts of administration expenses. Now if we exclude the $100,000 community, and then if we take off $20,000 for debts and administration expenses, that would leave us an adjusted gross of $180,000, and a maximum marital deduction of $90,000. So the executor would immediately set aside $90,000 as a tentative figure and from that he subtracts the value of all interests in other property which passes or has passed to the wife under the will, or otherwise, if they qualify for the marital deduction; so that he would subtract from the $90,000 the $50,000 insurance and the $30,000 jointly owned property. Thus, under this paragraph the wife would be entitled to $10,000. If, however, after the will was drawn he changed his insurance in such a way that it no longer qualified for the marital deduction, then under this paragraph we'd set aside the $90,000 and subtract the $30,000 jointly owned property. Then under this paragraph we'd get $60,000 to which the wife would be entitled. If he had also changed the jointly owned property so that it no longer qualified, then under this paragraph $90,000 would pass.

This is a self-adjusting paragraph that always assures you the maximum marital deduction without getting too much of it and without regard to how the testator shifts his assets after the drawing of the will, the only exception being that you can't control and can't get the exact maximum where the assets passing outside the will exceed more than a half of the tax estate. There's just nothing you can do if 80% of the assets passed outside of the will other than to keep after him every year to see that he didn't disqualify too much of that, or qualify too much of this. But so long as 50% of the tax estate passes under the will, this clause will adjust it so that you get the exact amount of the marital deduction—not too much, not too little. And it's just as costly taxwise to give more to the wife outright or to give more to the wife in such a way as to qualify it for the marital deduction, as it is to give her too little.

You get the marital deduction if the wife gets the bequest outright, or if she gets it for life with a general power of appointment; and that may either be through a legal life estate or through a trust. If the bequest is in trust for the wife, the regulations require that the wife be entitled to all of the income for her life and that the trust must be designed to be income-producing. This is an unfortunate pitfall because generally when we're drafting instruments—I suppose ever since the depression—we customarily put in a provision that the trustee may invest in unproductive property or may hold cash uninvested. We give him broad powers

both as to buying stocks and with respect to buying other assets that are not designed to produce the normal amount of income. There we vary from what would be permissable under the trust law. The way I've set this up here, we have, third, the marital deduction trust, and fourth, the residuary trust; and then we come over to page 12 where the first clause is the normal investment powers of the trustee under which he may hold cash uninvested in whole or in part, hold marketable securities of little or no yield—powers that make a whole lot of investment sense today. However, the presence of this clause is enough to disqualify the marital deduction bequest unless you add to your marital deduction bequest what I have on page 3 in the second full paragraph: "notwithstanding anything to the contrary contained in this my will, I direct that in establishing this trust there shall not be allocated to the trust any property or the proceeds of any property that does not qualify for the marital deduction and the trustees of this trust shall not retain beyond a reasonable time any property which may be or become unproductive, nor shall they invest in unproductive property." So what you do in the general powers is give him this broad power; but as to the marital trust he may not hold cash unproductive, nor may he invest in property of little or no yield.

The marital deduction cases, many of them, have been extremely strict, and I think the legal life estate cases are also causing a lot of trouble. First of all, I suppose we have to realize that most of these revenue agents aren't lawyers at all, and if we don't want the matter to go to the courts, we must make the will painfully clear to them. We had a case when I was in Tennessee—a nontax case—where the widow was given the land for her life with the power to sell and consume. The widow gave the property to a nephew, and on her death the executor moved to set it aside on the ground that she had no power to make a gift of the property. She had the right to sell it and consume it, but not to make a gift of it, and the Tennessee court upset the deed. Now such a bequest would not qualify for the marital deduction because she doesn't, under that interpretation of the language, have a general power of appointment. And most of our traditional clauses in legal life estates with powers to consume would not give a general power of appointment because we say "to my wife for life, with the power to consume for her health and welfare or for her needs." All that type of thing where the power isn't absolute, *i.e.*, to do anything she likes with it including the power to give it away, will cause a loss of the marital deduction. So it seems to me the only safe way to draft these clauses is to say "to my wife for life and then to such person or persons including her estate or her creditors as she may by last will and testament appoint." You spell it out in the words of the statute and then the agent will know what it is—he had to read those words to get his job. After that, you can put down

anything you like—she may consume it for her health and welfare and happiness, she may sell it. You may say anything you like as long as you've got in there the general power by will.

Revocable Trusts

I want now to mention the revocable trust because it seems to me you might have some use for that. It is an excellent way, I think, to keep the separate property separate. You get a lot of people who come out here with separate property and they want to keep it that way. If they let it get mixed up with the community at all, you have the presumption that it's all community. The revocable trust is a wonderful device as a will substitute. If property is put in a revocable trust, you've got it separated. The great advantage of the revocable trust is the continuity it gives you; you avoid all the delays of administration and you avoid a good many administration expenses. I think we lawyers are beginning to realize that in the administration of an estate we ought to charge about as much for a revocable trust as we do for the assets that come through the hands of the executor, because they cause about as much trouble and take as much time. However, a revocable trust has a tremendous continuity. Suppose that the income is to go to the grantor for his life and upon his death to his widow, or upon his death to his child. If he dies on the 15th of March, he got his check on the first of that month, and the child gets her check on the first of the next month. You don't have any interruption. Or suppose that the trustee was about to execute a long-term lease on some property and the negotiations were going on during the month of March. If the grantor died on the 25th, the trustee could sign the lease on the 26th. But if he has the assets in his own name, then all these negotiations are up in smoke and everybody's got to wait till you get an executor appointed and then you start the whole process all over again.

The revocable trust is an excellent device to avoid will contests. Although the gift may still be set aside for fraud or undue influence, there is very much less chance of this. As you know, a will contest is a kind of happy hunting ground. All of the heirs have been waiting around for a week to see what the will says, and they've rushed down to court, and they've built up their hopes, and now they're disappointed. If there has been a revocable trust in operation for years, as a practical matter they just don't get too upset over it. Another reason I wanted to mention the revocable trust is that you may qualify it for the marital deduction through the same type of formula clause we use in wills.

Inter Vivos Trusts

Now just a few words on the draftmanship of inter vivos intruments.

Gifts during life will obviously reduce the estate tax, particularly if the settlor lives for a minimum of three years so that we get behind the protection of the contemplation of death statute. He must not reserve a life estate in the property and that means he may not reserve what's called a secondary life estate; that is, he may not have the income "payable to my wife for her life and if I survive back to me until my death." He may not have the income payable to his wife and then to the children, with the proviso that it may be paid to him if he needs it, because that's a secondary life estate. He's got to divorce himself completely from the property. He may not keep any substantial possibility of reversion; he may not say "to my wife for life, or to my wife in fee, but if she predecease me, to come back to me." There are pitfalls here.

In the *Spiegel* case[7] the grantor said, "income to my three children and if any be dead, to their issue," with final distribution at his death. He failed to say what would happen if all the children and grandchildren died before he did, and that was a conceivable possibility. He might have chartered a plane to bring them all up to Maine for his birthday in the summer, and the plane might have blown up. Then all the beneficiaries would be gone and by operation of law the property would have come back to him. He died without any of this happening. All the children, all the grandchildren were alive. It was a million dollar trust, and the whole million was included in his estate because of this remote possibility of reverter. Actuarially, his chances of ever getting it back were regarded as worth $70, but the Supreme Court said that's enough to require inclusion. Now the present federal act[8] says that there shall be no inclusion in the estate if the possibility of reverter is not worth at least 5%; that is, there must, as of the date of the grantor's death, be at least one chance in twenty of the reversion taking effect. But you can't always count on people dying in the right order. You may set up a trust where his chances are only one in forty, but some grandchild dies, or a son dies, and they may jump up and get over the 5%. It's a little better, unless there's a substantial reason for keeping the remote possibility in him, to vest it in the estate of the last surviving beneficiary; for if he outlives his beneficiaries, the property will probably come back to him by operation of law under the intestacy statutes. At any rate, he won't have retained anything.

Another requirement is that he may not have any power of disposition, or power of revocation or alteration or amendment. In the *Lober* case[9]—I think the most extreme one on this point—the father set up the trust to pay the income to his son. The income was to accumulate until

[7] Spiegel's Estate v. Commissioner, 335 U.S. 701 (1949).
[8] INT. REV. CODE OF 1954, § 2037.
[9] Lober v. United States, 346 U.S. 335 (1953).

the son was 21, then the son was to receive the income, with the corpus to be paid to him at 30. But the old man, as trustee, had the wise discretionary power of being able to pay out capital in his discretion. The court held that was enough to require inclusion of the fund in the old man's estate because they said he had a power to terminate prematurely. The court's argument has real substance to it. The father didn't really give the property to the child in possession or enjoyment when he set up the trust—what he did was say, "I'm going to decide at what point to give it to you; maybe I'll give it to you at 18, maybe at 21, maybe at 25;" but he held back that substantial power.

There was another case just decided last month, the *State Street Trust Company* case,[10] which would seem to make it almost impossible, if the case is sound, for a grantor to be a trustee or to be one of twenty trustees (since the statute in every section says, where the grantor has the power alone or in conjunction with another). In the *State Street* case the grantor was one of several trustees. They had a power to allocate receipts between income and principal, and they had a power to control investments. These were powers that up to then had not been regarded as enough to require inclusion in the estate of the settlor. But the treasury attacked it on the ground that the grantor had a right to change the beneficiaries. They said that if he got mad at the income beneficiary, he might have invested in unproductive property. If he wanted to pay to the income beneficiary at the expense of the remainderman, he might have invested in property that was speculative but produced a large amount of income. Up to then it was thought enough if you excluded the grantor from any decisions with respect to dispositive provisions. But now you've got to restrict him, if the *State Street* case is sound, from any control over the administrative provisions. And that in effect means that you just can't make him trustee.

[10] State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959).