DISCUSSION

Comment by George Read Carlock*

Mr. Bowe has given us what seemed to me very fine words of wisdom regarding the preparation of wills and trusts and the tax questions involved. There is a provision in his model will, which has been distributed to you, which I believe is worthy of some attention as having important and substantial tax aspects, as well as non-tax aspects, of concern both to the fiduciaries who are struggling with the administration of an estate and to the beneficiaries. I invite your attention to item FIRST and Item SECOND in Mr. Bowe's model form, dealing with "The dispositions of tangible personal property and disposition of the residence of the testator and his wife." Probably all of us have seen wills—I'm sure all of the trust officers here have worried with wills—in which all of the testator's assets were bequeathed to the trustee, with directions that the trustee invest the property and do so-and-so with the income. The trustee then finds itself as the owner of all, or with a community interest in a house, automobile, a lawn mower, furniture, pots and pans, electric iron—things which are difficult to administer, and difficult to make any sense out of from an investment viewpoint.

Obviously, if the question had been thought of, the testator would have wanted his wife to be entitled to use these assets without the payment of any rent for them and to treat them as her own. So what is the trustee going to do? What are the trustee's duties to the residual beneficiaries of the trust? If the widow is permitted to use assets without compensation, without charge, in the absence of specific authority in the trustee to permit that, then what about the will, or the will and trust? Obviously then, there is some merit in leaving residence and personal effects outright to the widow or to other beneficiaries, rather than leaving them to the trustee to worry with. We then have the question of how that is to be accomplished. With respect to personal property, Mr. Bowe's model will leaves to the widow "tangible personal property except property being used by any business in which I may be interested." I believe that the executor's problem in segregating assets, whatever the description, is going to be a difficult one whether this language or any other language is used, when the problem is to separate personal type assets from business type assets. The problem is of particular concern in cases where the testator operated a business as a sole proprietorship. In that event we might

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want to consider the wisdom of expanding the directions to the executor and trustee so as to give them authority to continue to operate the business at the risk of the estate or the trust, and not at the risk of the executor or trustee individually.

Finally, if we're going to have so much difficulty in segregating the kind of assets that can pass under this item FIRST of the model will from the kind of assets that are to pass to the trustee, why don't we leave it up to the statute which in Arizona would permit the setting aside to the widow of the probate homestead and the personal property which is exempt from execution, and which might come at least very near to accomplishing the objective of the testator? Or is there a sound tax reason for making a specific bequest of this personal property rather than leaving it to be distributed by the executor because of the operation of law? Mr. Bowe, I believe all of us would appreciate it if you would expand on your reasons for this item FIRST, with some attention to the tax reasons for doing it this way, rather than leaving it to the operation of law.

MR. BOWE: It would seem to me that prior to 1954 it was extremely sensible to put everything into the residuary trust with a power in the trustee to make distributions of capital to the widow, and then the trustee could turn over all this property to her use (your statute would have achieved the same result). But the taxation of estates changed very radically in 1954, as most of you know. Prior to 1954 a distribution from the executor to the residuary legatee could be labeled either as a distribution of income or of principal when you sent the widow a check for $5,000 in six or eight months after the death of the decedent. You could tell her that this was a principal payment and then it was capital to her and income to the estate. But that opened the door to a tremendous amount of avoidance; people would keep estates open twenty years in order to have a separate tax entity, and they were always making capital distributions. To get away from that, Congress in 1954 said that the income to the estate shall be taxed to the estate, if not distributed; income shall be taxed to the beneficiary, if distributed; and then they said that every distribution from the estate shall be income to the distributee to the extent of the estate's income. There are two exceptions to that—a bequest of specific property, and a general bequest of a sum of money payable in not more than three installments.

This 1954 rule can have an unfortunate effect. Suppose that the decedent dies, let's say in June, and we close the estate tax year as of December 31st. During the remainder of the year—the short tax year of the estate—we collect some seven or eight thousands of dollars in dividends or income in respect of a decedent item. No distributions are made to the widow at all, except that the automobile that was registered in his name now has been registered in her name and all the household furnishings which he owned are now left in the house and she has assumed complete dominion and control over them. In effect she has received a distribution of an automobile, and the distribution of a lot of household effects from the estate. She is the residuary legatee; and so, when the executor in his return fills out the income received, eight thousand dollars, and comes to the line, "distributions," he has got to put down four, or five, or six thousand dollars, whatever the market value of those things is, and she is subject to the income tax on those receipts. It's a very unfortunate rule. You may have an estate that's received twelve, fifteen, or twenty thousand dollars of income. Toward the end of the year you make a partial capital distribution. You distribute 5,000 shares of X stock. That is income. Receipt of that capital item under the current statute is income to the widow to the extent of the estate's income. Now you can avoid that completely where you have a specific bequest of these items, because a specific bequest comes within the exception to the rule. There is a present proposal before the Mills Committee which would, in effect, go back to the pre-1954 practice in spite of the avoidance opportunities, because of the tremendous administrative difficulties that this thing has caused.

Comment by Arthur M. Davis*

One item in this draft will that particularly took my attention was the provision whereby the powers and duties, with respect to the estate, that are normally given to the trustee are also specifically and clearly given to the executor because there are many times when the discretionary powers that everybody is thinking about the trustee exercising may need to be exercised before you have distribution.

Two other matters occurred to me which I wonder if Mr. Bowe could comment briefly on—the first is the confusion that results from the inaccurate choice of terms, such as using *heir* and then in the same context later on using *issue*, and not making a clear distinction through the use of any particular rules that are helpful to the average practitioner; and secondly, the situation that we're finding more common where a substantial part of the assets of a person consists of life insurance and they desire to establish a life insurance trust. What about the desirability or nondesirability of the will providing just a pour over clause that whatever assets belong to the testator at his death be delivered to the trustee under the life insurance trust, and administered as a part of that, rather than setting up a separate trust?

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Mr. Bowe: I don't know whether the practice is getting at all prevalent here, but in a number of states there has been legislation or proposed legislation that would enable you to make the life insurance payable to the testamentary trustee. Have you had any of that? You can have, as I have suggested, a revocable life insurance trust which is simply a typical revocable trust. Then, as regards the insurance policy, the beneficiary is changed to the trustee. The settlor retains the ownership of the policy, the right to the cash value, he keeps the physical possession of the policy, he can go borrow on it. On his death, though, the proceeds are paid to the trustee under the terms of the revocable trust. You have an immediate trust because the trustee, as of the day of the execution of the trust and the change of beneficiary, becomes the owner of the unmatured claim against the insurance company. That hasn't presented any problems.

But rather than create the separate trust, a number of lawyers have, with the approval of a number of insurance companies, made the designated beneficiary the trustee under the terms of "my will." Now that has caused a lot of technical difficulty because a trust requires a present conveyance; you've got to create it right now. But Wisconsin has a statute which permits this way of doing it; we have one before our legislature in Colorado; Pennsylvania recently passed such a law; and there's some split in the case law. It seems to me it may be a dangerous practice where you haven't either a statute or the case law to support you, unless, under conflict of laws, about which I know very little, the fact that you have a Northwestern policy and a statute in Wisconsin, or a Penn Mutual policy and a statute in Pennsylvania, is going to make this sort of thing good. Now the alternative to that and the safe way of doing it is to create the revocable insurance trust. Then under the will, a short one-page will, give all the rest, residue, and remainder to the trustee under the trust created on such-and-such a date.

Again, you may run into uncertainties in case law. Some courts have said that this violates the rule against incorporation by reference. That, to some extent, can be avoided if you refer to the existing trust and you are very careful not to make any amendments without also changing the will, or if you create an irrevocable insurance trust. There may be some wisdom in the irrevocable insurance trust. But I think there's some uncertainty in that whole area that makes it difficult unless you have a well-established law in your jurisdiction. I don't want to take any business away from the local trust companies, but if I had the client here and that's what he wanted to do, and that looked like the sensible thing to do, I would create the revocable trust in Illinois or Pennsylvania or some place where I had case law that made it good. One of the advantages of the revocable trust is that it gives you a choice of state law. You may create a revocable trust in New York now and get away from your limitations on the Rule Against Perpetuities and you might also get away from these problems. Or the safest thing, I think, is to get legislation validating the pour over, though they're probably good without it, since the whole trend of opinion in the varying states has been toward sustaining them, and all the leading authorities do. Professor Scott had an excellent article in *Trusts and Estates* on pour overs.[1]

Comment by C. A. Carson, III*

There's a peculiar little question that has presented itself to quite a segment of our corporate fiduciaries and bar. Assume a marital deduction trust consisting of a half of the adjusted gross estate as finally determined for federal estate tax purposes with the usual reduction substantially in the form of the clause in Mr. Bowe's form under item THIRD, with the last sentence, a common one, reading as follows: "All values shall be those finally determined for federal estate tax purposes." This marital deduction portion, if you wish to call it that, is to be in the marital deduction trust. Further assume that on the date which is used for valuation for federal estate tax purposes the adjusted gross estate is a million dollars, and that on the date you're ready to distribute the estate it is worth a million-and-a-half dollars. The question is: Under the federal estate tax law and, perhaps more importantly, under the provisions of this clause of the will, what can the executors allot or contribute to the marital deduction trust? Must it be half of the adjusted gross estate as finally determined for federal estate tax purposes, using those values; or can it be $750,000, which is one-half of the value of the estate on the date of distribution?

Mr. Bowe: I think the allotment clearly must be both on the basis of $750,000 and in properties that had a value of $500,000 at the date of death. I think the trouble is that we tend to think of the tax law as being something that's completely remote from our ordinary law. The executor is a fiduciary. If I may vary your facts a little bit, perhaps the problem can be put more clearly. Suppose the estate consisted of $500,000 of General Motors and $500,000 of Chrysler stock. The General Motors went up to $1,200,000 and the Chrysler went down to $300,000. Now since the executor is to use the values

[1] A. W. Scott, *Pouring Over*, 97 Trusts & Estates 189 (1958).

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at the date of death, he could literally fulfill the clause here by taking the Chrysler, the $300,000, and giving it to the widow and saying, "Now you've got property that was worth $500,000 at the date of death." Or if he happened to be squiring the widow around town, he could take the General Motors and give her $1,200,000 and say, "Now you've got property worth $500,000 at the date of death, the tax value which I'm supposed to give to you." But it's inconceivable that the local probate judge would say that the executor had that power. He's a fiduciary; he's got to deal fairly with everybody. And the only way to deal fairly with everybody is to look at the values as of the date of distribution, as well as the values as of the date of death.

I think there's one New Jersey case—these problems are just getting into case law—there was a New Jersey case and, I think, one surrogate opinion in New York. The problem was whether the fiduciary obligation of the executor to deal fairly with each of these people meant that he had to give them equivalency of value. I don't think there's any possibility of any court holding that. If a court should hold it, then you wouldn't get the marital deduction; that was the original argument that was urged on this problem. Also, if the state law was such that the executor could make the distributions arbitrarily as of the date of death, then he has the equivalent of the general power of appointment, or a special power of appointment, I should say. But I think that is not so. We've had the marital deduction with us now for better than ten years. These formula clauses haven't caused any of the trouble that people originally thought they would. The federal law doesn't change our probate law. I think we can rely on our state judges to insist on fairness to all of the residuary legatees.

Comment by Thomas B. Hargis, Jr.*

Thank you, Mr. Bowe. I know that we all appreciate not only your excellent discussion, but also the valuable model instruments which you have given us. Just how valuable they will be can best be illustrated by a few examples of the unexpected tax consequences that can result when such instruments are drafted without such a guide.

Let's assume that we are drafting the wills disposing of an estate consisting solely of community porperty valued at $200,000. In order to avoid the second tax, we have placed the husband's share of the property in trust with income to his wife for life. We have also provided that the wife has power to invade the corpus of the trust in an amount not to exceed $5,000 per year, and in such other amounts

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as may be necessary for her health, education, maintenance, and support. Now, however, our client comes in and says he wants his wife to be happy after he is gone and wants her to have enough money from his share to make sure she is happy. Without further thought we add the words "and/or happiness" to our invasion clause so that now the trustee may pay to the wife such amounts as are necessary for her health, education, maintenance, support, and/or happiness. By such an addition we have changed the entire tax consequences. Even though some of the standards are objective, the Internal Revenue Service holds that such a provision is not limited by an objective standard and constitutes a general power of appointment. Therefore, the value of the trust established by the husband would be includible in the wife's estate on her death and the tax consequences would be the same as though the husband had left all his property to his wife in the first place. Thus, the addition of one word to the invasion clause of the husband's will has resulted in additional estate taxes of approximately $27,000. Another expensive word!

Now, let us look at the model will which Mr. Bowe has given us. You will note that in item THIRD the wife is given the general power to appoint the corpus by will. Let us suppose, however, that our client wants his wife to be able to give part of the corpus to the children during her lifetime if she so desires. We, therefore, give her a special power of appointment by deed whereby she can do so. Ordinarily, the exercise or release of a special power has no gift tax consequences. The exercise or release of a general power, however, is a taxable gift. It is the view of the Treasury Department that if the wife exercises her special power she releases her general power and would be subject to gift tax to the extent of the amount released. Thus, by adding an additional clause, one may have subjected the estate to additional taxes without accomplishing a great deal. Thanks to Mr. Bowe, we can now avoid such costly mistakes.

Before I close, I would like to ask Mr. Bowe if he would be so kind as to give us his opinion as to the relative advantages taxwise of the marital deduction formula clause as used in his model will and the fractional share type clause referred to in the notes?

MR. BOWE: A dollar amount bequest may result in capital gain to the executor. Thus if a general legacy of $50,000 is given to *A* and the executor satisfies this bequest with property that has a cost basis to him of $35,000, he will incur a tax on a $15,000 capital gain. A fixed amount marital deduction bequest may be subject to this objection. A fractional share bequest never incurs capital gain, since there is no dollar amount indebtedness. However, in the formula amount bequest in the model will, it is not believed that any capital gain tax would be incurred because of increase in the value of the assets distributed to the wife, since her legacy is in terms of the values as finally determined for federal estate tax purposes. On the whole, the fractional share bequest may be preferable since it avoids the risk, however slight, that the deduction might be disallowed because of the possible power in the executor to give, at his option, assets that have either increased or decreased in value.