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ESTATE PLANNING: DRAFTING AND TAX CONSIDERATIONS IN EMPLOYING INDIVIDUAL TRUSTEES

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Although individual trustees, as opposed to corporate trustees, are now being employed more frequently than in the past, the tax problems that may arise from selecting an individual trustee are often not considered. In this Article, Professor Pennell demonstrates that an estate planner may safely select an individual trustee by using proper planning and precise drafting. The most effective means of eliminating tax exposure is use of standards to restrict the trustee's discretion. Although there is a lack of correlation within the Internal Revenue Code among the standards that qualify for various purposes, Professor Pennell identifies a common standard that qualifies under each provision. He also discusses other taxation issues that may accompany selection of an individual trustee, including problems involving discharge of legal obligations, revolving door powers and the reciprocal trust doctrine. Professor Pennell concludes by suggesting that because individual trustees can be safely employed, their use may become increasingly common in the future.

Selection of an individual trustee is often the result of a process of elimination or of designation by default, with many potentially suitable corporate fiduciaries being rejected or unwilling to serve. While it has been alleged that little thought is customarily¹ devoted to objective criteria² which might be

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1. It has been suggested that many people select a fiduciary with less sophistication than they use in buying a new car. See Weiss, *The Fiduciary: Guidelines for Selection, Powers and Succession*, 33 N.Y.U. Inst. Fed. Tax 273, 274 (1975).

2. Although a detailed discussion is beyond the scope of this Article, criteria, which might be applied in deciding which fiduciary would best serve, ought to include these: (1) what special skills does the fiduciary possess, or lack, and which skills are necessary or desirable to administer the particular trust (for example, investment capability and acumen or ability to operate a farm or other business); (2) what are the attitudes or philosophies of the fiduciary, does the fiduciary have a track record and, if so, does it portend difficulties or unsatisfactory treatment of the trust and its beneficiaries (for example, is the fiduciary loathe to retain closely held business stock, is it reputed to be too conservative in investing, does it tend to go overboard in restricting expenditures by or for the benefit of beneficiaries or, alternatively, would it have trouble denying inappropriate requests by profligates); (3) what unique problems or exposures does the fiduciary present (for example, conflicts of interest due to its other activities and the special nature of the trust or its beneficiaries, or special exposure to types of regulation such as is noted at text accompanying notes 115-17 *infra*); and (4) what special problems does the trust present (for example, assets located in several jurisdictions, some restricting or prohibiting involvement of certain fiduciaries). For a more expansive discussion of related nontax aspects of trustee selection, see Bromberg & Fortson, *Selection of a Trustee; Tax and Other Considerations*, 19 Sw. L.J. 523 (1965).

In a few states, an added factor to consider in selecting trustees is illustrated by the prohibition contained in New York's Estates, Powers and Trust Law, which prevents an individual

weighed in making any trustee designation, it is probably of greater concern that even less consideration is given to problems accompanying selection of either a beneficially interested trustee or an independent individual trustee. Because of numerous liabilities which may flow from the increasingly common resort to individual trustees,³ this Article focuses on tax and other problems that may arise due to selection of such trustees and offers specific estate planning techniques to minimize or eliminate potential exposure.

I. GRANTOR TRUST EXPOSURE

To the extent a grantor creates a trust during life and retains beneficial enjoyment thereunder, the income tax provisions of the Internal Revenue Code (Code) effectively ignore the trust, treating the grantor as owner of trust corpus and income.⁴ In such a case, it would be immaterial who, including the grantor, was selected as trustee. Similarly, if trustee selection is being considered in a testamentary plan, or otherwise for any period after the grantor's death, trustee selection is irrelevant in terms of income tax exposure of the grantor. If, however, the grantor makes an irrevocable inter vivos transfer to an individual trustee, retaining no form of interest attracting grantor trust income tax exposure (no reversion,⁵ no power to alter, amend, revoke or terminate the trust,⁶ no direct⁷ or indirect⁸ retention of beneficial enjoyment, nor

trustee from exercising discretion to make distributions of income or principal to himself or herself. N.Y. Est., Powers & Trusts Law § 10-10.1 (McKinney 1967). A similar prohibition may exist by judicial decision in other states. See, e.g., *Garfield v. United States*, 80-2 U.S. Tax Cas. ¶ 13,381 (D. Mass. 1980) (beneficiary, as one of several trustees, deemed unable to exercise discretion to make distributions to himself because trust document did not expressly grant permission so to act). There also exists extremely limited authority that a merger of the equitable and legal interests in the trust may occur if one of several beneficiaries acts as trustee of a trust. See 2 A. Scott, *Trusts* § 99.3 (3d ed. 1967). Because both positions are distinctly minority approaches, they will be ignored in this Article, both as criteria to be considered in the selection of trustees and as factors affecting the consequences of employing beneficially interested trustees.

3. For a number of reasons there has been a growing reluctance to name corporate trustees. Among the more commonly expressed reasons are: cost; a perception that corporate fiduciaries are too conservative, cautious and niggardly (an especially serious concern to adult beneficiaries, such as a surviving spouse, who fear becoming supplicants); a strong criticism of investment performance, including both comparative returns and an almost universal reluctance to experiment with such nontraditional investments as precious metals or gems, collectibles, options and other "sophisticated" investment strategies; restrictions, such as alien land laws, which corporate trustees may be more inclined to honor; and a more general sense that corporate trustees know or understand various laws better than others and often comply (to the trust's disadvantage) when another, less knowledgeable, trustee would not. Obviously some, and perhaps all, of these objections are ill-advised; nevertheless, the clear trend disfavors the corporate trustee. This is particularly true among farmers and ranchers who seem to have an inherent dislike for banks and who, in many cases, only recently have begun even to accept the trust as an attractive estate planning device.

4. See I.R.C. § 677(a) (1976).

5. Retention of a reversion could generate income tax exposure under Code section 673. See id. § 673.

6. Retention of any power to alter, amend, revoke or terminate the trust would pose Code section 676 exposure. Id. § 676.

7. Direct retention of beneficial enjoyment, either income or principal of the trust, would present Code section 677(a) liability. Id. § 677(a).

8. "Indirect" retention of enjoyment would include designation of any dependent (such as a spouse or child) as beneficiary of the trust; Code sections 677(a) and (b) would pose the risk of income tax liability to the grantor. See id. §§ 677(a), (b).

any administrative power⁹), improper selection of an individual trustee¹⁰ without drafting adequate safeguards into the trust agreement could, nevertheless, result in unanticipated income tax exposure to the grantor under Code section 674(a).¹¹ More specifically, if the trustee of an irrevocable inter vivos trust is a nonadverse party¹² who may act without the consent of an adverse party¹³ and who may affect beneficial enjoyment of trust income or corpus, income of the trust will be taxable to the grantor regardless of the manner in which it is actually applied, notwithstanding the grantor's divestment of all otherwise taxable interests and powers with respect to the trust. Avoidance of this grantor trust treatment is, however, possible.

One means of avoiding section 674(a) grantor trust liability is by selecting a trustee who qualifies as an adverse party as defined in Code section 672(a),¹⁴ which basically requires that a beneficiary be named as trustee, or by selecting an "independent" trustee as described in Code section 674(c),¹⁵ essentially meaning selection of an individual who is neither related nor subordinate to the grantor.¹⁶ If this first approach is chosen, the trustee may possess unlimited powers and discretion over trust income or corpus without risk of income taxation to the grantor.

In addition, if the trustee is a related or subordinate party not beneficially interested in the trust,¹⁷ and thus does not qualify for the adverse or independ-

9. Retention of administrative powers could yield Code section 675 exposure. See *id.* § 675.

10. The problem considered herein is almost never encountered when a corporate fiduciary is selected due to the independence of such a trustee and the resulting qualification for the Code section 674(c) exception to section 674(a). See *id.* § 674. See also text accompanying notes 15-16 *infra*.

11. I.R.C. § 674(a) (1976):

The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

12. See *id.* § 672(b) (defined as any person who is not an adverse party as defined in section 672(a)). See note 14 *infra*.

13. "Adverse party" is defined in Code section 672(a). See note 14 *infra*.

14. I.R.C. § 672(a) (1976):

[T]he term "adverse party" means 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. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

15. Code section 674(c) provides that section 674(a) shall not apply to powers "solely exercisable (without the approval or consent of any other person) by 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." *Id.* § 674(c). Thus, co-trustees may be named if at least half are not related or subordinate. See note 16 *infra*.

16. A "related or subordinate party" is one described in Code section 672(c) as any nonadverse party who is— (1) the grantor's spouse if living with the grantor; (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

I.R.C. § 672(c) (1976). For purposes of section 674(c), "subservience" of the related or subordinate party is presumed under the last sentence of section 672(c) although the presumption is rebuttable by a preponderance of the evidence. See *id.* § 674(c).

17. *Prima facie* by definition of a related or subordinate party under section 672(c), a nonad-

ent trustee exceptions to application of section 674(a), a second method for avoiding grantor trust liability is available by drafting the trust to limit the trustee's power or discretion. By Code sections 674(b) and (d), certain powers may be granted to certain individual trustees without generating grantor trust liability under section 674(a). While many of the section 674(b) powers are of slight or no use in a garden variety trust,¹⁸ the exceptions in sections 674(b)(5)(A) and 674(d) are of true value in many cases. By these provisions, respectively, any trustee may be given power to distribute corpus pursuant to a "reasonably definite standard,"¹⁹ and any trustee other than the grantor or the grantor's spouse may be given power to distribute income pursuant to a "reasonably definite external standard,"²⁰ without generating grantor trust consequences. Because both standards are regarded as being the same,²¹ notwithstanding the one word ("external") difference between them, the effect of these exceptions is to permit any party other than the grantor or his or her spouse to act as trustee if the grantor is willing to limit the trustee's powers over both income and corpus with the requisite standard. Thus, either by selection of an adverse or an independent party, or by selecting anyone except the grantor or his or her spouse and limiting the trustee's powers with the requisite standard, exposure to section 674(a) grantor trust income tax treatment may be eliminated.

II. USING STANDARDS TO LIMIT DISCRETION

As the foregoing illustrates to a limited extent, the most effective means of minimizing or eliminating exposure to each of the income, estate, gift and generation-skipping taxes, when employing individual trustees, is use of standards to restrict the trustee's discretion. Consequently, in selecting individual trustees and drafting in light of a selection made, it is frequently beneficial to consider available protections under such standards and to rely on the flexibility afforded thereby. Although the task of drafting standards is complicated by a regrettable lack of correlation within the Code among the standards that qual-

verse party as a beneficiary will never be related or subordinated with respect to any portion of the trust as to which the beneficiary's interest will be adversely affected by the trustee's powers.

18. E.g., I.R.C. § 674(b)(2), (3) (1976) (exceptions for powers exercisable only after the expiration of a ten-year period, or exercisable only by will); id. § 674(b)(4) (power applicable only with respect to charitable beneficiaries); id. § 674(b)(6), (7) (temporary powers).

19. Section 674(a) will not apply to "[a] power to distribute corpus . . . limited by a reasonably definite standard which is set forth in the trust instrument . . ." Id. § 674(b)(5)(A). Those provisions falling within the definition of a reasonably definite standard are described at text accompanying notes 41-46 *infra*.

20. Section 674(d) provides that section 674(a) will not apply to "a power solely exercisable . . . by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion or accumulate income . . . limited by a reasonably definite external standard which is set forth in the trust instrument." I.R.C. § 674(d) (1976). Those provisions falling within the definition of a reasonably definite external standard are described at text accompanying notes 41-46 *infra*.

21. See Treas. Reg. § 1.674(d)-1 (1960), which, rather than defining "reasonably definite external standard," simply refers to the definition of a "reasonably definite standard" as found in id. § 1.674(b)-1(b)(5)(i).

ify for various purposes,²² as well as by a dearth of consistent guidance from the courts,²³ it is possible to identify a common qualifying standard under each relevant provision.

A. Ascertainable Standards

Unquestionably the most commonly utilized and understood standard is the "ascertainable standard" which, pursuant to Code sections 2041(b)(1)(A)²⁴ and 2514(c)(1),²⁵ may prevent a power of appointment from being a taxable general power. If, for example, the trustee is a beneficiary and, as trustee, has power to make distributions of corpus to himself or herself, use of the requisite limitation on the trustee's discretion in making distributions will protect the beneficiary-trustee from both the estate and gift tax exposure otherwise flowing from that power.²⁶ For drafting purposes, the regulations for both sections²⁷ specify certain standards that qualify as ascertainable standards, along with several the Internal Revenue Service regards as not qualifying. The "safe harbor" provisions which qualify include "health," "medical, dental, hospital and nursing expenses and expenses of invalidism," "education, including college and professional education" and the terms "support" or "maintenance" used alone or in conjunction with the phrases "in reasonable comfort," "in health and reasonable comfort" or "in an accustomed manner of living." Designated as not qualifying are "welfare," "happiness" and the term "comfort" when used alone, as opposed to when used in the phrase "support/maintenance in reasonable comfort."

Beyond the safety provided by these regulations, case law interpreting the

22. See Alessandrini, *Tax and Other Implications of Powers Measured by a Definite or Ascertainable Standard*, 4 U. Miami Inst. Est. Plan. ¶ 70.900, at 9-1 (1970):

[T]he notion that perhaps there exists a correlation . . . among the various Code sections dealing with powers controlled by a standard expressed in the governing instrument . . . [is] a "triumph of hope over experience" . . . [T]he Code is a patchwork structure, with its diverse parts constructed at different times by changing architects with scant attention to an overall coordinated design.

23. See, e.g., text accompanying notes 28-39 *infra*.

24. I.R.C. § 2041(b)(1)(A) (1976): "A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment."

25. *Id.* § 2514(c)(1): "A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment."

26. Additional protection against adverse consequences under sections 2041 and 2514 is afforded by Treasury Regulation sections 20.2041-1(b)(1) and 25.2514-1(b)(1), which each provide that

mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Treas. Reg. §§ 20.2041-1(b)(1), 25.2514-1(b)(1) (1958). The foregoing is true even if exercise is not required to be in strict accordance with state laws governing allocation of receipts and disbursements between income and principal. See, e.g., *Robinson v. Commissioner*, 75 T.C. 346 (1980).

27. Treas. Reg. §§ 20.2041-1(c)(2), 25.2514-1(c)(2) (1958).

ascertainable standard creates several notable uncertainties for drafting purposes. For example, for another purpose under the gift tax, the regulations make reference to "a reasonably fixed or ascertainable standard which is set forth in the trust instrument." In giving examples of such a standard, the regulations state that

[a] clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or *to meet an emergency*, would be such a standard.²⁸

With the exception of the emphasized language, this regulation virtually parrots those regulations describing the safe harbors of an ascertainable standard under sections 2041 and 2514. A natural assumption might be that "to meet an emergency" would qualify under those sections as well. Nevertheless, the Internal Revenue Service (Service) has been affirmed in its position under sections 2041 and 2514 that "emergency" relates to the "timeliness" of a distribution, not to need in terms of health, maintenance, support or other ascertainable standards, and thus does not qualify as a section 2041 or 2514 ascertainable standard.²⁹ Consequently, "emergency" is not a term that may be used with safety if the ascertainable standard protection for a trustee-beneficiary is sought.

Similarly, several other terms have elicited varying treatment from the Service and the courts, making their use of questionable wisdom. The word "comfort," for instance, is acceptable when used within the phrase "support/maintenance in reasonable comfort,"³⁰ but it is not an ascertainable standard when used alone.³¹ Further, notwithstanding repeated admonitions in the regulations that the word "happiness" is not an ascertainable standard,³² one recent decision has held it to qualify.³³

Also unsettling is the disparity of treatment of seemingly comparable pro-

28. *Id.* § 25.2511-1(g)(2) (emphasis added). The regulations under section 674 contain an almost verbatim provision in describing a "reasonably definite standard." See notes 41-46 and accompanying text *infra*.

29. *Sowell v. Commissioner*, 74 T.C. 1001 (1980) ("illness or emergency," the former being ascertainable despite the latter). See also *Priv. Ltr. Rul. 7841006*, reprinted in 1978 IRS Letter *Rul. Rep. (CCH)*.

30. *Treas. Reg. §§ 20.2041-1(c)(2), 25.2514-1(c)(2)* (1958).

31. *Strite v. McGinnis*, 330 F.2d 234 (3d Cir. 1964), *aff'g* 215 F. Supp. 513 (E.D. Pa. 1963), *cert. denied*, 379 U.S. 836 (1964) (both "benefit and comfort" were used and deemed not ascertainable); *Stafford v. United States*, 236 F. Supp. 132 (E.D. Wis. 1964) (both "comfort and enjoyment" were used and deemed not ascertainable); *Whelan v. United States*, 3 Fed. Est. & Gift Tax *Rep. (CCH)* ¶ 13,393 (S.D. Cal. 1980) ("reasonable support, care and comfort" deemed not ascertainable). But see note 33 *infra* and compare *Tucker v. United States*, 74-2 U.S. Tax Cas. ¶ 13,026 (S.D. Cal. 1974) ("reasonable care, comfort and support" deemed ascertainable without discussion whether "comfort" was being regarded as a separate standard standing alone).

32. *Treas. Reg. §§ 20.2041-1(c)(2), 25.2511-1(g)(2), 25.2514-1(c)(2)* (1958).

33. *Brantingham v. United States*, 631 F.2d 542 (7th Cir. 1980) (both "comfort and happiness" were deemed to be ascertainable in a decision that, notwithstanding the court's protestations to the contrary, probably reflects the equities of the particular situation and is, therefore, not a reliable precedent).

visions. For example, a direction to a trustee to distribute "such amounts . . . as [she] . . . may require, she to be the sole judge" has been held to be not ascertainable,³⁴ whereas a similar provision to distribute such funds "as he may from time to time request, he to be the sole judge of his needs" has been regarded as ascertainable.³⁵ Moreover, "to continue the donee's accustomed standard of living" is not regarded by the Service as an ascertainable standard,³⁶ but "to maintain his standard of living"³⁷ or "to maintain his accustomed standard of living"³⁸ or distributions for "health, education, support and maintenance needs consistent with a high standard and quality of living"³⁹ are all regarded as ascertainable. Given the apparent similarity of these provisions, it seems almost nonsensical to suggest that there is indeed a difference in the settlor's intent; yet, exaggerated importance obviously attaches to proper drafting of such a provision. Consequently, substantial thought must be given to fine tuning a document if a beneficiary-trustee is to possess such powers. Indeed, at least for purposes of sections 2041 and 2514, the only apparently safe course in drafting a standard that is sure to qualify as ascertainable is to rely on the strict "safe harbor" provisions in the regulations. Those provisions, unlike any others, carry the imprimatur of the Service and, despite uncertainty concerning the outer expanses of the ascertainable standard, may be relied upon when drafting to grant flexibility to a beneficiary as trustee.⁴⁰

B. Reasonably Definite (External) Standards

A second set of standards appears in the grantor trust provisions of the Code. As an exception to section 674(a) grantor trust exposure, sections 674(b)(5)(A) and (d) effectively ignore trustee powers limited, respectively, by a "reasonably definite standard" and a "reasonably definite external stan-

34. *Peoples Trust Co. v. United States*, 412 F.2d 1156 (3d Cir. 1969) (based on a determination that the settlor intended the beneficiary to have unfettered right to receive funds).

35. *Pittsfield Nat'l Bank v. United States*, 181 F. Supp. 851, 852 (D. Mass. 1960) (tying distributions to "his needs" deemed by the court sufficiently to limit the bounds of any request). But see *Priv. Ltr. Rul. 8121010*, reprinted in 1981 IRS Letter Rul. Rep. (CCH), in which the Internal Revenue Service ruled that distributions by a decedent for "needs . . . in the broadest sense" was not an ascertainable standard, stating that

under [state] law, the term "needs" (standing alone) may impose an ascertainable standard upon the trustees We do not agree, however, that this limitation upon the trustees under state law imposes a standard which relates solely to the donee's needs for health, education, support or maintenance that is also required by statute.

Id. See also *Barritt v. Tomlinson*, 129 F. Supp. 642 (S.D. Fla. 1955) (distributions "as she may see fit" held to be an ascertainable standard because the court imputed the limitation "for her support or maintenance").

36. See *Rev. Rul. 77-60*, 1977-1 C.B. 282.

37. *Robinson v. Commissioner*, 75 T.C. 346 (1980) ("maintain her standard of living" deemed a sufficient limitation to make the total provision ascertainable); *Priv. Ltr. Rul. 7914036*, reprinted in 1979 IRS Letter Rul. Rep. (CCH). See also *Priv. Ltr. Rul. 8121010*, reprinted in 1981 IRS Letter Rul. Rep. (CCH).

38. *Treas. Reg. §§ 20.2041-1(c)(2)*, *25.2511-1(g)(2)*, *25.2514-1(c)(2)* (1958). These regulations all basically use this terminology in describing an ascertainable standard.

39. *Priv. Ltr. Rul. 7836008*, reprinted in 1978 IRS Letter Rul. Rep. (CCH).

40. See text accompanying notes 75-78 *infra*, however, for a discussion of one circumstance when use of an ascertainable standard will not protect against general power treatment.

dard."⁴¹ Although alleged to be no different than a qualified "ascertainable standard"⁴² limiting trustee discretion for purposes of sections 2041 and 2514,⁴³ the regulations under section 674 indicate that the two standards are slightly different.⁴⁴ To be sure, the terms "education," "support," "maintenance," "health" and "to maintain his accustomed standard of living" are safe under both sets of standards. However, "reasonable support and *comfort*" and "to meet an *emergency*," while clearly permissible under section 674, are not strictly ascertainable under sections 2041 and 2514.⁴⁵ Also, the terms ("pleasure, desire or happiness") noted as falling outside the safe harbors of sections 674(b)(5)(A) and (d) differ from those ("comfort, welfare or happiness") falling outside the safe harbors of sections 2041 and 2514. Further, with respect to section 674, "if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard."⁴⁶ No such limitation is found in the ascertainable standard provisions. Despite these differences, a strictly ascertainable standard under sections 2041 and 2514 will serve to protect a trustee-beneficiary for purposes of those sections and will also qualify for the section 674(b)(5)(A) and (d) exceptions to section 674(a) grantor trust treatment, so long as the trustee's exercise is not conclusive or uncontrolled.

In addition to the foregoing, the same standard providing estate and gift tax protection to a trustee-beneficiary and section 674 grantor trust income tax protection to a grantor will also provide income tax protection to an individual trustee who is also a trust beneficiary. Under section 678, a beneficiary as trustee is treated as the owner of any portion of a trust over which the beneficiary has a power to distribute income or corpus to himself or herself, even if no distributions are actually made. While authority for application under section 678 is scant, it has been held that the same standard defined in section 674 to prevent grantor trust treatment will serve to prevent section 678 treatment to a beneficiary-trustee.⁴⁷ Thus, an additional advantage may be gained by utiliz-

41. See text accompanying notes 19-21 *supra*.

42. Alessandroni, *supra* note 22, ¶ 70.911, at 9-14.

43. See text accompanying notes 24-40 *supra*.

44. According to the Service, notwithstanding the inclusion of the term "external" only in section 674(d), the two standards are the same. See note 21 *supra*. Under each,

[a] clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard . . . For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard.

Treas. Reg. § 1.674(b)-1(b)(5)(i) (1960).

45. See text accompanying notes 30-31 & 28-29, respectively, *supra*. It may be that the phrase "reasonable support and comfort" as used in Treasury Regulation section 1.674(b)-1(b)(5)(i) should be read in a fashion similar to "support/maintenance *in reasonable comfort*," but there is no assurance that courts would regard the two as being the same. See note 44 *supra*.

46. Treas. Reg. § 1.674(b)-1(b)(5)(i) (1960).

47. *United States v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960) (power to consume corpus limited by "needs, maintenance and comfort"; capital gains in trust not taxed to power holder);

ing such a standard to limit trustee discretion whenever a beneficiary serves as trustee. By giving proper attention to the drafting of a strictly ascertainable standard, a beneficiary may be appointed as trustee with discretion to distribute income and corpus to himself or herself and nevertheless avoid all section 678(a), 2041 and 2514 exposure flowing from such trustee discretion.⁴⁸

C. *Definite External Standards*

A third set of standards is important for trustee selection and trust drafting purposes for two reasons. The first reason is that, on occasion, the settlor of a trust will be treated as, or deemed to possess the powers of, the trustee.⁴⁹ Should this occur, use of this third set of standards will prevent inclusion of trust assets in the settlor's gross estate for estate tax purposes under Code sections 2036(a)(2)⁵⁰ and 2038(a)(1).⁵¹ The second reason relates to the genera-

Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950), rev'g 14 T.C. 198 (1949) ("needs" deemed a sufficient limitation); Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952), aff'd, 205 F.2d 518 (5th Cir. 1953) (power limited by "support, maintenance, comfort and enjoyment").

48. It may be wise estate planning to use such standards to limit trustee discretion when a beneficiary is not a trustee, in order to avoid any tax consequences flowing from the Service arguing that the beneficiary should be deemed to be or treated as if he or she were the trustee. For a discussion of several of the circumstances in which such an argument has been or could be made, see text accompanying notes 83-106 *infra*.

49. The most common example of when this may occur is illustrated by the last sentence of Treasury Regulation section 20.2036-1(b)(3): "[I]f the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee." Treas. Reg. § 20.2036-1(b)(3) (1958). For a discussion of a more invidious application of the same result, see text accompanying notes 83-87 *infra*.

50. See I.R.C. § 2613(c)(3) (1976) ("beneficiary" defined to mean any party with a present or future power in a trust); *id.* § 2613(d)(2) ("power" defined to include any ability to alter beneficial enjoyment of trust income or corpus). If the trustee is an individual assigned to a generation lower than the grantor, the generation-skipping tax consequences of acting as trustee and the inevitable termination through death or resignation must be considered unless the trust qualifies for either of the exceptions provided in section 2613(e). Under section 2613(e)(1), a trustee's powers are ignored if all the beneficiaries are lineal descendants of the grantor and all are assigned to generations lower than the generation of the trustee. *Id.* § 2613(e)(1). It is frequently the case that a trust will not qualify for this exception because, for example, spouses of descendants are beneficiaries or some beneficiaries are assigned to the same generation as the trustee. The second exception provided by section 2613(e) protects certain independent trustees. Under section 2613(e)(2), an individual trustee's powers will be ignored if he or she (1) has no interest or power in the trust other than as trustee or as a permissible appointee and (2) is not "related or subordinate" to the grantor, to his or her spouse, or to any beneficiary. *Id.* § 2613(e)(2). For purposes of determining relation or subordination, proposed Treasury Regulation section 26.2613-7(b) automatically regards a spouse, parent, sibling, descendant or employee of the grantor or any beneficiary as related or subordinate. Proposed Treas. Reg. § 26.2613-7(b), 46 Fed. Reg. 120, 129 (1981). In addition, any employee of a corporation or partnership in which the voting or operating control of the grantor or any beneficiary is significant, or in which the grantor or any beneficiary is an executive or partner, is again regarded as related or subordinate. *Id.* As a consequence, it seems likely that few individuals, other than professional fiduciaries, will possess the other requisites to act as trustee and still qualify as not related or subordinate.

As a practical matter, the exceptions provided by section 2613(e) may be of slight significance in most cases. If a beneficiary with a present interest in the trust is also trustee, exposure to the generation-skipping tax presumably already exists due to the beneficial interest; acting as trustee will not, in most cases, increase any exposure to generation-skipping tax attributable to that individual. Indeed, perhaps the greatest risk is if the trusteeship lasts after the status of beneficiary terminates and thus defers any tax consequences on termination of the beneficial interest under section 2613(b)(2)(B). Even then, deferral will result in harm only if a greater tax would be imposed (either because the trust increased in value, or because the deemed transferor's tax base for computation under section 2602(a)(1) had grown, during the deferral) and use of any tax dollars

tion-skipping tax and the fact that the trustee will normally possess powers making it a beneficiary of the trust for generation-skipping tax purposes.⁵² In determining the generation-skipping tax status of a trustee, proposed Treasury Regulation section 26.2613-4(d) states that "a power is a present power if the property subject to the power would have been included in the estate of the power holder under section 2036 or 2038 had the power holder been the settlor of the trust."⁵³ Though the proposed regulation does not expressly state that the converse is also true, (that is, that a power is not a present power if it would not have caused section 2036 or 2038 exposure), it seems fair to assume both sides of the coin are involved. The importance of this assumption is that the termination of a future, as opposed to a present, power is not a taxable transfer for generation-skipping tax purposes.⁵⁴ Thus, if powers of the trustee are limited so that they would not cause section 2036 or 2038 exposure if held by a settlor, termination of those powers will be a harmless termination of future powers under the generation-skipping tax.

For purposes of sections 2036 and 2038, and thus indirectly for purposes of the generation-skipping tax, two types of powers are immune. Powers of an administrative, managerial or ministerial nature will not cause section 2036 or 2038 exposure if they are limited by a fixed or enforceable fiduciary constraint.⁵⁵ Examples of powers falling within the scope of this exception include a power to allocate receipts between income and principal⁵⁶ and powers to direct or veto trust investments.⁵⁷ More important, distribution powers are

deferred does not offset the increase. Consequently, for generation-skipping tax purposes, trustee selection is significant only when (1) an individual is trustee; (2) he or she is assigned to a generation below the grantor and does not qualify under section 2613(e)(1) or (2); (3) he or she is not otherwise a present interest beneficiary of the trust; and (4) termination as trustee generates a tax that otherwise would not have existed. Because of the operation of the "one time only" rules of section 2613(b)(7)(B) and the deferral rules of section 2613(b)(2), the only time a significant tax is likely to be generated due to termination of the trustee's powers is when the trustee is the only individual assigned to a particular generation below the grantor, or if designation of the individual made the trust subject to the tax when it otherwise would not have been a generation-skipping trust.

51. The value of the trust property is included in settlor's gross estate if settlor "retained . . . the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom." I.R.C. § 2036(a)(2) (1976).

52. The value of the trust property is included in settlor's gross estate if settlor retained the "power . . . to alter, amend, revoke, or terminate [the trust], or where any such power [was] relinquished during the three-year period ending on the date of the [settlor's] death." *Id.* § 2038(a)(1).

53. Proposed Treas. Reg. 26.2613-4(d), 46 Fed. Reg. 120, 128 (1981).

54. I.R.C. § 2613(b)(1) (1976).

55. See *United States v. Byrum*, 408 U.S. 125 (1972), aff'g 440 F.2d 949 (6th Cir. 1971), aff'g 311 F. Supp. 892 (S.D. Ohio 1970) (broad management powers will not subject settlor to estate tax exposure); *Old Colony Trust v. United States*, 423 F.2d 601 (1st Cir. 1970), aff'g 300 F. Supp. 1032 (D. Mass. 1969) (purely administrative powers will not generate exposure); C. Lowndes, R. Kramer & J. McCord, *Federal Estate and Gift Taxes* § 8.9, at 158 & § 9.20, at 226 (3d ed. 1974) [hereinafter cited as Lowndes, Kramer & McCord]. See also Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1976*, H.R. Rep. No. 10612, 94th Cong., 2d Sess. 567; H.R. Rep. No. 1380, 94th Cong., 2d Sess. 49, reprinted in 1976 U.S. Code Cong. & Ad. News 3356, 3403, for the generation-skipping tax legislative history stating that the same general exception shall apply for purposes of section 2613(b)(1).

56. See, e.g., *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), aff'd per curiam, 450 F.2d 878 (2d Cir. 1971); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967).

57. See, e.g., *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *King v. Commissioner*,

exempt under sections 2036 and 2038 if limited by a "definite external standard," the theory being that such a limitation effectively denies discretion to the power holder and, therefore, the power ought to be ignored.⁵⁸ As compared to the "ascertainable standard" of sections 2041 and 2514 and the similarly titled "reasonably definite (external) standard" of sections 674 and 678, the "definite external standard" of sections 2036 and 2038 is the more liberal. Unlike other standards considered, cases have established such terms as "emergency,"⁵⁹ "welfare,"⁶⁰ "comfort" (standing alone)⁶¹ and "happiness"⁶² as qualifying under sections 2036 and 2038. Moreover, terms clearly qualified under other standards also qualify under sections 2036 and 2038, most notably including "education,"⁶³ "maintenance" or "support,"⁶⁴ and varying terms relative to health or medical care.⁶⁵

It seems safe to say that a standard that qualifies as an "ascertainable standard" will qualify for income tax purposes under sections 674 and 678 as well as for estate and generation-skipping tax purposes by effectively limiting a trustee's discretion as required to avoid exposure under sections 2036, 2038, 2041 and 2613. Thus, notwithstanding the disparate standards considered, the single "ascertainable standard" will protect against exposure under each relevant Code provision. Consequently, whenever the grantor or a beneficiary is, may become, or may be deemed to be or possess the powers of the trustee,⁶⁶ extensive protection from exposure to the income, estate, gift and generation-

37 T.C. 973 (1962), nonacq., 1963-1 C.B. 5; *Hall v. Commissioner*, 6 T.C. 933 (1946), acq., 1946-2 C.B. 3. The similar power to vote stock held in trust is not in all circumstances immune, due to provisions of Code section 2036(b). By it, retention of power to vote stock transferred to the trust by the settlor will result in inclusion under section 2036(a)(1), and the Service has ruled that this provision also includes a power to veto the vote of such stock by someone else. Rev. Rul. 80-346, 1980-2 C.B. 271. Whether this special rule, added as an afterthought to section 2036 for the express purpose of overruling the decision in *United States v. Byrum*, 408 U.S. 125 (1972), will be imported into the generation-skipping tax by virtue of the language of proposed Treasury Regulation section 26.2613-4(d) is a matter of speculation. However, because it is likely that it will be imported, wise estate planners will draft defensively in anticipation of such a ruling. In this regard, however, see text accompanying notes 115-17 *infra*.

58. See generally *Lowndes, Kramer & McCord*, *supra* note 55, § 8.9, at 156 & § 9.20, at 225.

59. See *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968) ("in the event of sickness, accident, misfortune or other emergency"); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), acq., 1973-2 C.B. 3 ("education, maintenance, medical expenses, or other needs occasioned by emergency").

60. See *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971).

61. See *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962).

62. See *id.*; *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971).

63. See *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), acq., 1973-2 C.B. 3; *Estate of Weir v. Commissioner*, 17 T.C. 409 (1951).

64. See *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971); *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), acq., 1973-2 C.B. 3; *Estate of Weir v. Commissioner*, 17 T.C. 409 (1951).

65. *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971); *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968); *Estate of Kasch v. Commissioner*, 30 T.C. 102 (1958), acq., 1958-2 C.B. 6.

66. See text accompanying notes 83-106 *infra*.

skipping taxes is available if the estate planner limits the trustee's discretion in all events with a strictly ascertainable standard as defined in the safe harbors of the regulations under sections 2041 and 2514.

D. Gifts of Income

When a trustee is also an income beneficiary of the trust, use of an ascertainable standard will offer another form of protection to the trustee. According to the Internal Revenue Service, if such a beneficiary, as trustee, distributes corpus to a third party pursuant to authority granted in the trust document, the distribution constitutes a taxable gift of the beneficiary's income interest in the assets distributed.⁶⁷ While there is authority rejecting the Service's position,⁶⁸ one estate planning approach to the problem bears the Service's imprimatur and may avoid the need to litigate the issue. Pursuant to the regulations,⁶⁹ if the trustee's powers over corpus are limited by an ascertainable standard, no gift of the trustee's income interest results from any distribution of corpus. While other approaches also might serve to avoid exposure to the gift tax,⁷⁰ reliance on guaranteed avoidance through use of the same ascertainable standard used to avoid other income, estate, gift and generation-skipping tax exposure⁷¹ is the most attractive alternative.

E. Discharge of Legal Obligations

In one notable situation the use of standards, ascertainable or otherwise, to limit a trustee's discretion will not prevent estate or gift tax exposure to an

67. Treas. Reg. § 25.2514-1(b)(2) (1958); Rev. Rul. 79-327, 1979-2 C.B. 342. Both involve a beneficiary with a nontaxable inter vivos power of appointment. This is basically what a beneficiary possesses as trustee if the trustee's powers are properly circumscribed so as not to constitute a general power of appointment. Probably the most common example would be a residuary or bypass trust in which a surviving spouse is both income beneficiary and trustee with power to distribute corpus to children during the spouse's overlife.

68. *Self v. United States*, 142 F. Supp. 939 (Ct. Cl. 1956) (holding that the beneficiary has made no gift of income for two reasons: (1) because corpus distributions necessarily carry all rights to the income therefrom, the distribution should be viewed as a single transfer of corpus and not as a gift of a separate income interest; and (2) the trustee's action should be treated as analogous to the situation when another trustee makes the distribution, in which case no gift would result). Cf. *Maryland Nat'l Bank v. United States*, 236 F. Supp. 532 (D. Md. 1964) (exercise of inter vivos special power of appointment divested donee of vested remainder interest; court held that no gift resulted from exercise).

69. Treas. Reg. § 25.2511-1(g)(2) (1958). Although this section makes no reference to section 25.2514-1(b)(2), it would appear that it should control by virtue of the language in the penultimate sentence of section 25.2514-1(b)(2), which states that the transfer of corpus "constitutes a taxable gift under section 2511(a), without regard to section 2514." *Id.* § 25.2514-1(b)(2).

70. Two alternatives might be to give all discretion over distributions of corpus to a trustee, with a prohibition on the beneficially interested trustee from participating therein, or give the beneficiary-trustee only a right to receive income in the trustee's discretion rather than an absolute entitlement to the trust income. Under this latter approach, if the beneficiary has no "right" to receive income, he or she presumably has no interest that may be the subject of a gift when the corpus is distributed. If, however, the beneficiary is the trustee who will determine whether to distribute any part or all of the income, a court might find this approach to be specious. A third approach to the issue presumably would be to rely on the annual exclusion under Code section 2503 and the gift tax unified credit entitlement under Code section 2505 to absorb any expected gift tax exposure.

71. See text accompanying notes 24-65 *supra*.

individual trustee. By the same theory found elsewhere in the income⁷² and estate⁷³ taxes, and proposed for application under the generation-skipping tax,⁷⁴ if trust property is, or may be, applied for the purpose, or with the effect, of discharging the trustee's legal obligation to support a beneficiary, the trustee is deemed to possess a general power of appointment.⁷⁵ Moreover, unlike other powers that may be "purified" through use of an ascertainable standard,⁷⁶ such a limitation is ineffective in this situation.

It is an oddity that, if the trustee were the beneficiary, use of an ascertainable standard would serve to protect the individual from section 2041 exposure, but when the trustee is only deemed to be benefited by virtue of the power to make distributions that would discharge a legal obligation of the trustee, existence of such a standard is irrelevant.⁷⁷ The protection afforded by an ascertainable standard exists only if the standard relates to distributions to the trustee as holder of the power.⁷⁸ Unfortunately, distributions to a depen-

72. See I.R.C. § 677(b) (1976) (to the extent income is distributed for the support or maintenance of a dependent of the grantor it is taxed to the grantor as if it had been distributed directly to the grantor); id. § 678(c) (same treatment applicable to a trustee vice the grantor). See also Treas. Reg. § 1.662(a)-4 (1960) (same treatment is said to obtain to whomever is obligated to support an income beneficiary who actually receives income distributions); the regulation has never been applied by either cases or rulings.

73. See Treas. Reg. § 20.2036-1(b)(2) (1958).

74. Proposed Treasury Regulation section 26.2613-4(c)(3) adopts the position that anyone whose legal obligation of support may be discharged by trust distributions is a beneficiary of the trust by virtue thereof, even if not acting as trustee. Proposed Treas. Reg. § 26.2613-4(c)(3), 46 Fed. Reg. 120, 127-28 (1981).

75. See Treas. Reg. §§ 20.2041-1(c)(1), 25.2514-1(c)(1) (1958).

76. See text accompanying notes 24-65 *supra*.

77. See Lowndes, Kramer & McCord, *supra* note 55, § 12.6. It may seem ludicrous to suggest that an individual's power to make distributions directly to himself or herself, if limited by the appropriate standard, is immune from the reach of section 2041(a)(2), while at the same time a power, limited by that same standard, to make distributions to a dependent is not immune even though it is only *deemed* to be a power to make distributions to himself or herself. Yet this is clearly the state of the regulations and is probably justified given the wording of section 2041(b)(1)(A).

A subcommittee of the Estate and Gift Tax Committee of the Tax Section of the American Bar Association is considering a legislative recommendation to deal with this inconsistency. The subcommittee may propose excepting all powers limited by an ascertainable standard relating to the beneficiary's health, education, support or maintenance. However, extension of the ascertainable standard exception to powers indirectly benefiting the donee may be improper. Under Code sections 677(b) and 678(c), the same treatment is dictated whenever a power holder may distribute trust income for the beneficiary's support or maintenance, regardless of whether the power holder is the grantor of the trust or a nonadverse third party. I.R.C. §§ 677(b), 678(c) (1976). Perhaps the estate tax consequences also should not differ as between the creator of a power, to whom sections 2036 and 2038 would apply, and a third party, as to whom section 2041(a)(2) applies.

If the legal obligation theory is the basis for estate tax inclusion, sections 2036(a)(1) and 2041(a)(2) are the analogous provisions, respectively, for grantor and for third-party includibility. Because section 2036(a)(1) contains no exception to its legal obligation inclusion rules for distributions made pursuant to an ascertainable standard, perhaps no such exception should apply under section 2041(a)(2) for distributions subject to inclusion under the same legal obligation theory. If analyzed in this light, then the absence of the ascertainable standard exception is correct, and the section 2041(b)(1)(A) exception currently existing for powers limited by standards relating to the decedent's own health, education, support and maintenance is the aberration. While no suggestion is advanced here to repeal section 2041(b)(1)(A), it is suggested that perhaps it should not be extended beyond its present scope.

78. Compare Treas. Reg. §§ 20.2041-1(c)(1) and 25.2514-1(c)(1) (1958) with id. §§ 20.2041-1(c)(2) and 25.2514-1(c)(2). The former regulations specify that the power to make distributions

dent are regarded as only indirectly for the benefit of the trustee. Thus, some other protection against application of the discharge theory is needed.⁷⁹

The most direct estate planning defense against application of the discharge of obligation theory, for all purposes throughout the Code, is to include an *Upjohn* limitation⁸⁰ prohibiting the trustee from making any distributions which would have the effect of discharging any person's legal obligation to support any beneficiary of the trust. Aside from a possible allegation that the trustee had breached the trust by making distributions discharging such an obligation, notwithstanding the prohibition, the Service would effectively be precluded by such a prohibition from asserting any tax exposure to any obligated person. In practical application, moreover, the prohibition should prove harmless in terms of trust flexibility for two reasons. First, many trust distributions provide funds over and above the legal obligation of support owed by any person to the beneficiary; as a factual matter most trust distributions are made after any legal obligations have been satisfied. More fundamentally, local law in the majority of states provides that trust distributions do not discharge a person's legal obligation to support the beneficiary unless the person is financially unable to provide that support or the trust was established for the express purpose of supplanting that legal obligation.⁸¹ Thus, other than in

discharging a legal obligation is deemed a power exercisable in favor of the decedent or possessor. The latter regulations consider only standards related directly to the decedent or possessor.

79. Moreover, even if an ascertainable standard would serve as a protection against sections 2041 and 2514 exposure, it would do nothing to eliminate the exposure of proposed Treasury Regulation section 26.2613-4(c)(3). See note 74 *supra*. Because the generation-skipping tax is inapplicable to the extent the estate or gift taxes apply, see I.R.C. §§ 2613(a)(4)(B), (b)(5)(B) (1976), elimination of exposure to only the estate and gift taxes simply would create exposure to the generation-skipping tax. Thus, a solution must be utilized to avoid all these provisions.

80. So named after the case of *Upjohn v. United States*, 72-2 U.S. Tax Cas. ¶ 12,888 (W.D. Mich. 1972), in which the question arose whether a prohibition against making distributions discharging a person's legal obligation to support the beneficiary constituted a "substantial restriction" for purposes of Treasury Regulation section 25.2503-4(b)(1). If it did, then no annual exclusion would be allowed for contributions made to the trust. Citing *Williams v. United States*, 378 F.2d 693 (Ct. Cl. 1967), the *Upjohn* court held that it did not constitute a disqualifying restriction. 72-2 U.S. Tax Cas. ¶ 12,888, at 86,078-79. Cf. Rev. Rul. 81-6, 1981-1 C.B. 385 (existence of prohibition allowed section 678(a) to apply to trust created by parent; see I.R.C. §§ 678(b), 677(c) (1976)).

81. Probably the most incredible aspect of the discharge-of-obligation theory is that it finds no support under state law in the vast majority of states and yet has not been realistically challenged by taxpayers. This may in part be attributable to the fact that "not only is there a lack of uniformity among the states, there is in many states uncertainty whether [a] parent's support obligation varies with [a] child's resources." Committee Report, Trust Income Taxation and the Obligation of Support, 1 Real Prop., Prob. & Tr. J. 327, 331 (1966). However, the following Internal Revenue Service pronouncements on this issue are accurate summations of the general rules:

The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" . . . to support [a] minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him.

Treas. Reg. § 1.662(a)-4 (1960). Moreover, "in most jurisdictions, a [parent], if of sufficient ability, must support, maintain, and educate . . . minor children without resorting to their separate estates or their income derived from property, trusts, or annuities." Rev. Rul. 56-484, 1956-1 C.B. 23, 23. See generally Annot., 39 A.L.R.3d 1292, 1295 (1971); 59 Am. Jur. 2d Parent and Child § 77 (1971). See also Pennell, *Custodians, Incompetents, Trustees and Others: Taxable Powers of Appointment?*, 15 U. Miami Inst. Est. Plan. ¶ 1602.3 (1981).

those exceptional cases when the person is destitute or when the fund was established for the purpose of relieving that person's legal obligation to support the beneficiary (or in a state which does not follow the majority rule), no distribution will in fact be prohibited by the *Upjohn* limitation because no distribution would have the prohibited effect. Because the proposed generation-skipping regulations will apply the discharge theory in all cases, regardless of the trustee's identity or relation to the beneficiaries,⁸² such a prohibition is likely to become a standard provision in well-drafted trusts in the future. To preempt application of the discharge of obligation theory, an *Upjohn* limitation should be included in any trust under which an individual trustee may make distributions to any of his or her dependents.

III. "DEEMED" TRUSTEES

In two particularly dangerous situations an individual may be deemed to be, or to possess all the powers of, the trustee. Just as naming an individual as trustee demands added thought, additional planning is dictated when either of these situations exists.

A. *Revolving Door Power*

If the settlor has designated a trustee whose track record, or the lack thereof, invites concern over future performance, it may be desirable to establish a method for removal and replacement of the trustee at will. If any individual has an unconditional power to remove and replace the trustee and is not prohibited from appointing himself or herself as successor, all the trustee's powers will be deemed to be held by that individual.⁸³ In a recent ruling the Internal Revenue Service extended this doctrine to cover such a "revolving door" power, retained by a settlor, to remove and replace trustees, even though the settlor was specifically prohibited from naming himself as successor trustee.⁸⁴ Notwithstanding this limitation, the Service opined that the mere power to remove and replace trustees, until one is found to the settlor's liking, is so powerful that the settlor should be deemed to possess all the trustee's powers. Although this ruling dealt only with the revolving door power in the hands of the settlor and involved application of sections 2036(a)(2) and 2038(a)(1), and notwithstanding strong criticism of the ruling itself, there is current speculation⁸⁵ that an analogous ruling will be issued to apply the same imputation of trustee powers for purposes of sections 2041, 2042⁸⁶ and the generation-skipping tax.⁸⁷ If this position is ultimately

82. See note 74 *supra*.

83. Treas. Reg. §§ 20.2036-1(b)(3), 20.2038-1(a)(3), 20.2041-1(b)(1) (1958).

84. Rev. Rul. 79-353, 1979-2 C.B. 325, as modified by Rev. Rul. 81-51, 1981-1 C.B. 458, limiting it to prospective application after October 29, 1979.

85. With respect to both the criticism of Revenue Ruling 79-353 and the speculation associated with it, see Pennell, *supra* note 81, ¶ 1603.1, and the authorities cited therein.

86. See text accompanying notes 107-10 *infra* for a discussion of the section 2042 exposure the revolving door power may present to a given power holder.

87. Intentionally excluded from the list of areas of potential application of the revolving door

adopted by the courts, possession of such a revolving door power would be tantamount to being the trustee, with all the exposures attendant therewith and the need to plan accordingly. For many purposes, the most effective planning will be to draft the trustee's powers so that, even if imputed to the holder of a revolving door power, they will generate no adverse tax consequences. This frequently entails little more than addition of an *Upjohn* limitation⁸⁸ and use of ascertainable standards⁸⁹ throughout the trust.

For those who are unwilling to shackle the trustee with such limitation and standards, the alternative is to create a power that does not constitute a revolving door power, while at the same time insuring the ultimate objective of not being locked in with an undesirable trustee. The most direct means of accomplishing this objective is bifurcation of the power, lodging the removal power in one individual and the replacement function in another.⁹⁰ Although it might be argued that the holder of merely the removal power alone is in a powerful position, being able to remove trustees until an acceptable replacement is finally appointed, the Internal Revenue Service has yet to regard such a solitary power as causing the same results as the complete power to both remove and replace. Thus, assuming the absence of any prearranged concerted action between the parties holding the bifurcation powers to remove and replace, this arrangement should fall short of the type of power that would cause either holder to be deemed to possess the trustee's powers.

Another alternative would be to create a conditional power, relying on the theory that, if the condition is not met at a particular time, the power holder would be regarded as not possessing the power. Among various conceivable conditions, one tied to an objective or comparative measure, such as failure to meet a designated level of investment performance, or a subjective determination by a disinterested individual or panel that the trustee's performance does not measure up to the quality the settlor would have expected, are the most promising.⁹¹ Other approaches, so long as not disguised attempts to create a revolving door power,⁹² might be equally acceptable.

power ruling is the income tax. Notwithstanding the decision in *Corning v. Commissioner*, 24 T.C. 907 (1955), *aff'd per curiam*, 239 F.2d 646 (9th Cir. 1957), which would support a revolving door ruling under section 674, such a ruling under the grantor trust provisions would appear to be foreclosed by Treasury Regulation section 1.674(d)-2(a), which states that "a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying" for the section 674(c) exception for powers held by an independent trustee. Treas. Reg. § 1.674(d)-2(a) (1958).

88. See text accompanying note 80 *supra*.

89. See text accompanying notes 24-48 *supra*.

90. Alternatively, the entire power might be given to a third party if he or she has no exposure under the trust by virtue of being deemed to possess all the trustee's powers. Particular attention, however, must be given to each of the estate, gift and generation-skipping tax consequences thereof.

91. Another alternative may not be safe. Under it the power would be exercisable only at intervals, such as on a given day of each month or once a year, with the thought that on any other day the power does not exist. The issue with such a power is whether the failure to exercise it on a given day when available, with a consequent expiration thereof, would constitute a taxable lapse for gift tax purposes and, if so, with what value. The absence of any reasonably discernible answer to either of these questions is reason enough to favor a less problematic alternative.

92. For example, the suggestion that the trustee tender a signed resignation, available for

B. Reciprocal Trust Doctrine

The reciprocal trust doctrine is the second method by which an individual may be deemed to be trustee of a trust that he or she is not otherwise serving. Though most commonly encountered under sections 2036 and 2038 of the estate tax, the breadth of the doctrine's applicability is illustrated by an occasional use for income⁹³ or gift⁹⁴ tax purposes. In its traditional application the doctrine would "uncross" a transaction such as the following: assume that *A* creates a trust with *B* as trustee for the benefit of *A*'s spouse and children; meanwhile, *B* creates a trust with *A* as trustee for the benefit of *B*'s spouse and children.⁹⁵ To the extent of mutual value in the trusts as of creation,⁹⁶ the doctrine would treat these trusts as if *B* had created the trust with *B* as trustee for *A*'s spouse and children, and as if *A* had created the trust with *A* as trustee for *B*'s spouse and children.⁹⁷ As so applied, the result is to treat the trustee as the settlor of the trust, raising issues of application of the grantor trust income tax provisions⁹⁸ and exposure under the estate tax⁹⁹ due to retained control over transferred property.

The sole test for application of the doctrine is whether the two trusts are "interrelated," meaning that they (1) are substantially identical in terms, (2) were created at approximately the same time and (3) to the extent of their mutual value, have approximately the same economic effect as if "crossing" had not occurred.¹⁰⁰ It is notable that "uncrossing" for estate tax purposes has

acceptance by the holder at any future time, is not unlike a power to remove. If coupled with a replacement power, the combination might appear sufficiently like a revolving door power to treat it identically.

93. See *Krause v. Commissioner*, 57 T.C. 890 (1972), aff'd, 497 F.2d 1109 (6th Cir. 1974).

94. See Rev. Rul. 69-505, 1969-2 C.B. 179. See also Priv. Ltr. Rul. 8029001, reprinted in 1980 IRS Letter Rul. Rep. (CCH), discussed more fully at text accompanying notes 102-04 infra.

95. See Priv. Ltr. Rul. 8019041, reprinted in 1980 IRS Letter Rul. Rep. (CCH), which involved facts that, viewed graphically, would be:

A ———> *B* as trustee for *A*'s spouse and children

B ———> *A* as trustee for *B*'s spouse and children.

96. For example, if *A*'s trust were \$50,000, and *B*'s were \$75,000, the mutual value would be all of *A*'s smaller trust and two-thirds (\$50,000/\$75,000) of *B*'s trust.

97. Again viewed graphically, the trusts would be deemed to be:

A B ———> *B* as trustee for *A*'s spouse and children.

B A ———> *A* as trustee for *B*'s spouse and children.

See Priv. Ltr. Rul. 8019041, reprinted in 1980 IRS Letter Rul. Rep. (CCH). See also *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977) (basically the same fact pattern except that the beneficiary of each trust was a third party; "uncrossing," however, occurred in the same fashion to treat *A* as settlor and trustee of the trust *B* actually created, and vice versa).

It is interesting that the Service did not assert section 2036(a)(1) exposure in Private Letter Ruling 8019041 without uncrossing the trusts, based on the fact that each settlor's spouse and children were beneficiaries and the trustee could have made distributions discharging each settlor's legal obligation of support. See *Commissioner v. Dwight's Estate*, 205 F.2d 298 (2d Cir. 1953), rev'g 17 T.C. 1317 (1952), cert. denied, 346 U.S. 371 (1953); *Estate of Prudowsky v. Commissioner*, 55 T.C. 890 (1971), aff'd per curiam, 465 F.2d 62 (7th Cir. 1972) (both cases regarding discharge of obligations as retained enjoyment of income for purposes of section 2036(a)(1)).

98. E.g., I.R.C. § 674 (1976).

99. E.g., id. §§ 2036(a)(2), 2038(a)(1). See *Exchange Bank & Trust Co. v. United States*, 82-1 U.S. Tax Cas. ¶ 13,444 (Ct. Cl. 1981) (involving uncrossing of Uniform Gifts to Minors Act accounts established by decedent and spouse with each other as custodian).

100. *United States v. Estate of Grace*, 395 U.S. 316 (1969), rev'g 393 F.2d 939 (Ct. Cl. 1968)

always occurred at the "settlor level"; in the example, *A* was deemed to be the settlor of the trust *B* actually created, rather than uncrossing at the "trustee level" by treating *A* as trustee of the trust *A* created for *A*'s spouse and children.¹⁰¹ This treatment, however, may be subject to change in the future.

In a recent ruling applying the reciprocal trust doctrine for gift tax purposes,¹⁰² a father (*F*) created two trusts, one for each of his children, *A* and *B*. In one, *B* was named as trustee for the benefit of *A*; in the other, *A* was named as trustee for the benefit of *B*.¹⁰³ Applying the traditional "interrelation" test, the Internal Revenue Service ruled that the reciprocal trust doctrine ought to apply but departed from the historical pattern in one significant respect. Because uncrossing at the settlor level would have produced no change, the father being settlor of both trusts, the Service uncrossed the trusts at the trustee level, treating *A* as trustee for *A* and *B* as trustee for *B*. Although the ruling was not issued for estate tax purposes,¹⁰⁴ and although there is to date no case or ruling applying the reciprocal trust doctrine for purposes of finding taxable general powers of appointment under Code sections 2041 or 2514, the clear import of the ruling is that the deemed trustees are different than the actual trustees. If this "trustee level" uncrossing is upheld by the courts, it would mean that crossing trustees to avoid exposure to any of the estate, gift or income taxes¹⁰⁵ could fail. To prevent exposure, it would be necessary to draft interrelated trusts as though the beneficiary were the trustee.¹⁰⁶ Consequently, crossing is probably not a wise estate planning alternative to careful drafting using standards and limitations to avoid tax exposure.

IV. ADDITIONAL CONSIDERATIONS

A number of less common issues ought to be considered when naming individuals as trustees. The first is relevant if the trust might contain life insurance policies on the life of a trustee. In such a case, the Internal Revenue Service has argued vehemently that incidents of ownership held by the trustee

(establishing the "interrelation" test as opposed to any subjective inquiry into the intent of the parties in creation of the trusts and rejecting any notion of consideration or a *quid pro quo* as essential to application of the doctrine).

101. Graphically, it is interesting to note that Private Letter Ruling 8019041 followed the common application of the doctrine and, thus, did *not* regard the trusts as if they were

A ———> *B* *A* as trustee for *A*'s spouse and children.

B ———> *A* *B* as trustee for *B*'s spouse and children.

102. Priv. Ltr. Rul. 8029001, reprinted in 1980 IRS Letter Rul. Rep. (CCH), in which the issue was whether child *A* could be treated as trustee of a trust actually administered by *B* as trustee. The Service's objective in "uncrossing" the trusts was to combine *A*'s voting control of stock held individually with stock held in the trust, thereby generating a control block premium for valuation purposes under the gift tax.

103. Presumably the settlor was concerned about exposure under sections 2041 and 2514 if a child was trustee of the child's own trust. Viewed graphically, the trusts were

F ———> *A* as trustee for *B*

F ———> *B* as trustee for *A*.

104. See note 102 *supra*.

105. See I.R.C. § 2041 (1976)(estate tax); *id.* § 2514 (gift tax); *id.* § 678 (income tax).

106. Similarly, if *A* were made trustee for *B*'s children and vice versa, exposure would again result from *A* being deemed trustee for *A*'s dependents.

in his or her fiduciary capacity are sufficient to require inclusion of the proceeds of that insurance in the insured-trustee's gross estate if he or she dies while acting as trustee.¹⁰⁷ Although the Service has prevailed in only the Court of Appeals for the Fifth Circuit¹⁰⁸ and has been defeated in whole¹⁰⁹ or in part¹¹⁰ in four other circuits, the issue remains undecided in the remaining circuits and the risk of litigation justifies defensive planning to foreclose the issue. Certainly the most expeditious approach is simply to deny to any trustee the power to exercise incidents of ownership over any policy of insurance on his or her life. If the inability thus to deal with a policy would be detrimental, the prohibition could be coupled with designation of a special insurance advisor to act only for the purpose of dealing with such insurance.

A second issue deserves mention, although there has been no decision involving it.¹¹¹ Assume that a beneficiary possesses discretion (limited by a properly drafted ascertainable standard) to make distributions of corpus to himself or herself. If the standard triggering the power to distribute is met, but the trustee chooses not to make the distribution (for example, the trustee "may" distribute for support rather than the trustee "shall" distribute), has the trustee been exposed to the gift tax¹¹² by virtue of having had a withdrawal right that lapsed? If so, should that portion of the trust subject to withdrawal be treated as if it had been withdrawn and then recontributed, with grantor trust income tax¹¹³ and estate tax¹¹⁴ exposure as well? Because there is no direct authority, the cautious approach might be simply to require distributions ("shall distribute") whenever the standard is triggered. However, if administration of the trust will be subject to the scrutiny of counsel, it may be appropriate to permit the exercise of discretion not to distribute unwanted sums ("may distribute") if a judgment can be made from time to time that exposure does not exist under statutory or case law authority as it may develop.

107. See Rev. Rul. 76-261, 1976-2 C.B. 277, seeking to apply Code section 2042(2), which provides that a decedent's estate shall include the proceeds of insurance on his or her life if payable other than to the insured's estate, "to the extent . . . the decedent possessed at his death any of the incidents of ownership" over the policy. I.R.C. § 2042(2) (1976).

108. *Terrberry v. United States*, 517 F.2d 286 (5th Cir. 1975), cert. denied, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975); *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092 (5th Cir. 1973), vacating and remanding 56 T.C. 815 (1971).

109. *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980), aff'g 474 F. Supp. 763 (W.D. Mo. 1979); *Connelly v. United States*, 551 F.2d 545 (3d Cir. 1977), aff'g 398 F. Supp. 815 (D.N.J. 1975), nonacq., Rev. Rul. 81-128, 1981-1 C.B. 469 (stating the Service's intent to continue to litigate the issue presented in all circuits other than the Third); *Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), aff'g 56 T.C. 1190 (1971).

110. In two decisions the courts have rejected the Service's "per se" or absolute rule of inclusion but have upheld the Service if the incidents held as fiduciary could be exercised for the fiduciary's own economic benefit as, for example, if the trustee was also income beneficiary and had the ability to surrender a policy for cash, thus increasing the fund producing future income. See *Gesner v. United States*, 600 F.2d 1349 (Ct. Cl. 1979); *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970), aff'g 50 T.C. 915 (1968).

111. See Horn, *Planning Flexible Trusts for Nonprofessional Trustees: Analysis of Choices for Draftsmen*, 4 Est. Plan. 172, 176-77 (1977), containing a discussion of the issue.

112. See I.R.C. § 2514(e) (1976).

113. See id. §§ 674, 677.

114. See id. § 2041(a)(2) (second clause).

A third consideration relates to a type of provision occasionally found in trust forms provided by corporate fiduciaries. Certain regulatory reporting provisions are triggered by the amount of stock a party may vote.¹¹⁵ Especially with corporate fiduciaries, but also applicable to individual trustees, the aggregate voting rights held in trusts under administration and otherwise may be sufficient to trigger reporting requirements. Because disclosure is commonly regarded as undesirable, a "boilerplate" trust provision may specify that voting control of subject stock shall be exercised by someone other than the trustee,¹¹⁶ thus removing the element requiring reporting. However, voting control may be sufficient to treat the holder thereof as a beneficiary of the trust for generation-skipping tax purposes.¹¹⁷ Consequently, care should be exercised to ensure that voting authority is not given to someone whose designation as a generation-skipping trust beneficiary would generate adverse generation-skipping tax consequences. Normally, the issue may be avoided if the vote simply passes to the income beneficiaries of the trust because they are already present interest beneficiaries for generation-skipping tax purposes. Otherwise, it would be wise to place the vote with an individual, either as a trustee or as a special adviser, who generates no added generation-skipping tax exposure and who is not affected by any regulatory reporting requirements.

A fourth concern relates to a boilerplate provision found in some trusts to avoid the need to maintain the trust after it has become uneconomically small. Such "small trust termination" provisions are commonly keyed to a specified dollar amount; if the trust falls below that amount, the trustee is either directed or authorized to terminate the trust by making final distribution to the then income beneficiaries.¹¹⁸ If the trustee is a beneficiary and if the power is triggered, a taxable power of withdrawal will exist.¹¹⁹ This taxation usually is acceptable because the trust is sufficiently small. However, some estate planners, fearing that inflation will make a figure chosen today unrealistic in the future, have begun to draft these provisions in a vague or flexible fashion to avoid using a dollar figure to trigger the provision. As an alternative, the provision may give the trustee discretion to terminate the trust whenever, in the trustee's discretion, it would be appropriate to do so. The danger with such a provision is that the Service may allege that it grants an absolute power of withdrawal to the trustee who, upon exercising the discretion to terminate the

115. See, e.g., 15 U.S.C. § 78m(d), (f) (1976 & Supp. IV 1980).

116. A typical boilerplate provision might read:

Any security as to which the trustee's possession of voting discretion would subject the issuing company or the trustee to any law, rule or regulation adversely affecting either the company or the trustee's ability to retain or vote company securities, shall be voted as directed by the beneficiaries then entitled to receive or have the benefit of the income from the trust.

117. See note 57 *supra*.

118. A typical provision might read:

If at any time a trust hereunder has a market value determined by the trustee of \$X or less, the trustee may in its discretion terminate the trust and distribute the trust property proportionately to the persons then entitled to receive or have the benefit of the income therefrom.

119. I.R.C. §§ 678, 2514 (1976).

trust, will receive a share of the distribution. Accordingly, when a beneficiary is acting as trustee, the provision ought to be set to a clearly specified dollar amount. In the alternative, the determination of when termination may occur should be given to some other party.

The final miscellaneous consideration is non-tax oriented. In designating individuals to act as trustee, attention ought to be given to possible conflicts of interest. For example, is the trustee a family member who is active in managing a family business, stock of which is held in the trust? To foreclose any threat of litigation focusing, for example, upon the trustee's ability to vote trusteed stock in his or her favor as part of corporate management, a broad provision might appropriately be included in the trust specifying that acting as trustee will not disqualify an individual from pursuing other activities, from accepting remuneration both from the trust and from those other activities, or from voting stock notwithstanding conflicts which might arise from such other involvements, and generally indicating the settlor's intent that the two forms of activity are not mutually exclusive and that a conflict of interest will not constitute a breach of trust.

V. EXCULPATORY AND SAVING CLAUSES

When individuals are selected to serve as trustees, especially individuals who are family members, close friends or advisors who may be perceived as making a personal sacrifice by agreeing to serve, it is common to find inclusion of exculpatory clauses designed to absolve the trustee of any fault in his or her actions. Also common are tax saving clauses which state in general terms that the trustee, in effect, shall have no powers generating any unexpected tax exposure. While both types of clauses have distinct limitations,¹²⁰ their use is probably salutary, provided certain cautions are observed. Exculpatory clauses should not be drafted so expansively that the fundamental obligation to act in a fiduciary capacity is removed; otherwise, certain protections applicable only if the power is exercised in a fiduciary capacity will be lost.¹²¹ Moreover, tax saving clauses cannot be relied upon. While they may prove useful in escaping exposure and almost always will be harmless, they are of questionable efficacy,¹²² meaning that they cannot be relied upon as a substitute for careful drafting to confront anticipated tax problems.

120. An exculpatory clause, for example, cannot insulate a trustee against liabilities flowing from bad faith, gross negligence or reckless indifference. See Prochnow, *Conflict of Interest and the Corporate Trustee*, 22 *Bus. Law.* 929 (1967). Tax saving clauses have been challenged consistently by the Internal Revenue Service, its only real concession to the effect of such clauses being *Rev. Rul.* 75-440, 1975-2 *C.B.* 372, stating that such a clause will be honored to the extent it reveals the settlor's intent when an ambiguity exists requiring the use of extrinsic evidence for resolution. See Johanson, *The Use of Tax Saving Clauses in Drafting Wills and Trusts*, 15 *U. Miami Inst. Est. Plan.* ¶ 2000 (1981).

121. Each of the exceptions for administrative and ministerial powers available under sections 2036(a)(2) and 2038(a)(1), as discussed at text accompanying notes 55-57 *supra*, and also available under Treasury Regulation sections 1.674(b)-1(b)(5)(i), 20.2041-1(b)(1), 25.2511-1(g)(2) and 25.2514-1(b)(1), would be lost.

122. See note 120 *supra*.

VI. CONCLUSION

It is a common belief among estate planners, often perpetuated by corporate fiduciaries, that employing individuals as trustees is fraught with tax dangers and that a trust beneficiary should never serve as trustee. It is not the intent here to suggest that corporate fiduciaries not be employed. Rather, the purpose is to illustrate that, by using proper precautions in planning, coupled with precise drafting, the estate planner may feel safe in employing whomever is best suited for a particular circumstance. Through expeditious use of ascertainable standards, as defined for power of appointment purposes, together with installation of an *Upjohn* prohibition, unnecessary tax exposure to individual trustees may be minimized. If effectively accomplished, employment of even beneficently interested individual trustees may be risk-free and may become increasingly common in the future.