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ESTATE PLANNING AND THE PARTIALLY IRREVOCABLE TRUST: ANOTHER VIEW OF *UNITED STATES V. BYRUM*

*Charles P. Sacher**

I. Introduction

The utility of the inter vivos trust has attained great stature as an estate planning vehicle. The inter vivos trust may be either revocable or irrevocable. The advantages of the revocable trust[1] are as follows: (1) the trust property may be distributed to the beneficiaries without becoming a part of the grantor's probate estate; (2) the grantor may divest himself of the administrative details of record keeping and collection of income; (3) the grantor may observe and evaluate the management capabilities of the trustee; (4) publicity will be minimized; (5) the grantor may select governing law; and (6) the grantor's property will be administered if he becomes incapacitated. The revocable trust will not result in income or estate tax savings to the grantor and it will not give rise to the imposition of gift taxes.[2]

An irrevocable trust[3] is not used as frequently in estate planning but it does have many advantages. The advantages of an irrevocable trust are, in addition to those enumerated for the revocable trust, the following: (1) The income and corpus of the trust may be made available to the beneficiaries without permitting the beneficiaries to dissipate the corpus of the trust; (2) trust assets may be immunized from the claims of creditors of the beneficiaries; and (3) a trust for the grantor's benefit may be used to protect a grantor who might otherwise be susceptible to undue influence. The tax consequences of the creation of an irrevocable trust are complex. Such complexity arises from the extent of the grantor's retained rights or other beneficial interest in the irrevocable trust and the capacity of any person who may make discretionary determinations in favor of the grantor.

If the grantor retains absolutely no right or interest in an irrevocable trust the income will be taxable to the beneficiaries or to the trust.[4] On the other hand if the grantor retains direct or substantial beneficial interests in an irrevocable trust the income and estate tax consequences of an irrevocable trust may be the same as a revocable trust without the attendant advantage of revocability or amendability. There will be no income or estate tax savings to the grantor or his estate if the income of an irrevocable trust is required to be paid to the grantor or his spouse. If the grantor relinquished all rights to the income and

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1 As used herein, the term "revocable trust" means a trust in which the grantor retains the income interest for his lifetime and retains the power, at any time or from time to time, to revoke, alter or amend the trust in any particular.

2 All references to taxes in this article will be limited to federal taxes. No attempt has been made to consider the tax consequences under the tax laws of any state.

3 As used herein, the term "irrevocable trust" means a trust in which the grantor has specifically renounced his right or power to terminate, alter or amend the trust. It will be assumed that such irrevocable trust has been established in good faith and is not illusory.

4 INT. REV. CODE OF 1954, §§ 641-669.

delegated to the trustee the discretionary right to pay income to him, or to his spouse, the grantor would still be taxable on all the trust income unless the trustee (or a majority in number thereof) is an "adverse party" as defined in the Internal Revenue Code.[5] In that event, the grantor would only be taxable on the income actually distributed to him or to his spouse and the trust would be taxable on the remaining income. If the trustee were given the discretion to distribute income to the grantor, and if the grantor retained no right to designate the persons who will possess or enjoy the property or the income therefrom, the value of the property placed into the irrevocable trust would not be includable in the grantor's estate for estate tax purposes. Gift taxes may be imposed depending upon the grantor's power to distribute the trust corpus. The effect of the grantor's retention of some lesser rights or other beneficial interests presents a myriad of problems with respect to the income and estate taxation of irrevocable trusts which will be discussed subsequently.

Estate planners may in appropriate situations recommend the making of inter vivos gifts in order to reduce income taxes or minimize estate taxes. In order to be effective, such gifts must be irrevocable and complete when made. Such a gift will remove the income earned on the gift property from the donor's taxable income. The value of the gift property will not be included in the donor's taxable estate (assuming that gift is not made in contemplation of death). In order to attain these two tax savings, the donor must give up both the property and its income. Accordingly, recommendations for inter vivos gifts should only be made when the donor's personalty and property are such that there will be no mental or financial detriment to the donor. Additionally, such recommendations should consider the donee's capability of handling the gift property or the income therefrom.

Having determined that an inter vivos gift is appropriate under the criteria set out above, the estate planner may encounter problems with respect to selecting the appropriate property and the manner of making the gift. Gifts are generally made to reduce estate taxes rather than income taxes. Accordingly, property which has a potential for further and significant appreciation in value between the date of the gift and the date of the donor's death is the most suitable type of gift property. Two kinds of property which fall within this general category are stock in closely held corporations (hereinafter referred to as "closely held stock") and land.

An outright gift of either closely held stock or land presents unusual problems. A gift of closely held stock may adversely affect the donor's voting control over that corporation, the right of the donor's estate to consummate a nondividend redemption,[6] and the right of the donor's estate to pay estate taxes in installments.[7] An outright gift of land may subject the property to the donee's spouse's dower interest or may involve the creation of multiple ownerships which could adversely affect the marketability of the land.

The advantages attendant upon inter vivos gifts of closely held stock or land

5 *Id.* § 672(a).
6 *Id.* § 303.
7 *Id.* § 6166.

can be obtained, and the disadvantages of making such gifts can be minimized, through the utilization of a "partially irrevocable trust."[8] It is contemplated that the grantor would utilize this trust vehicle as a typical revocable inter vivos trust in which substantially all of his property would be transferred to obtain the advantages listed above for a revocable inter vivos trust. The trust instrument would provide, however, a mechanism whereby the grantor could relinquish his income interest and right to revoke, alter and amend some portion of the entire trust and thereby establish a partially irrevocable trust. In doing so, the grantor would give up entirely and completely his right to revoke, alter or amend a specified portion of the trust together with such irrevocable portion so that an undivided interest in the trust income and assets would be set aside solely for the benefit of other named beneficiaries.

The advantages of this type of trust arrangement are numerous. If substantially all of the grantor's property is transferred to this trust, the irrevocable setting aside of an undivided interest avoids the problem of selection of assets which will appreciate in value. The grantor will, if the conditions described below are met, effectively remove the value of such undivided interest in all of his property from his taxable estate and thereby remove the same percentile of appreciation in all the assets. This minimizes the problems of attempting to select assets which will appreciate in value between the date of the gift and the date of the grantor's death. With respect to the closely held stock, as will be discussed subsequently, the grantor can retain the right to vote the stock if exercisable only in a fiduciary capacity or, with appropriate restrictions, can serve as trustee of the trust so as to retain voting control over the closely held corporations. Additionally, so long as certain percentage requirements are met with regard to the value of closely held stock included in the grantor's taxable estate, the advantages of the nondividend redemption of closely held stock and the right to pay estate taxes in installments will still be available to the grantor's estate. The inclusion of land in the trust will avoid the attachment of a trust beneficiary's spouse's dower or curtesy interest to the land[9] and will avoid a multiplicity of legal ownerships.

This article will consider in detail the use of a mechanism whereby a grantor can, from time to time, make an irrevocable gift of an undivided interest in an otherwise revocable trust through the relinquishment of all of his retained interests in such trust. This analysis will consider in detail (1) the legality of the periodic relinquishments of such right of revocability and the other retained interest in the trust, (2) the tax consequences attendant upon the use of such

8 As used herein, the term "partially irrevocable trust" means a trust in which the grantor originally retained the full income interest and retained the right to revoke, alter or amend the trust in its entirety and subsequently irrevocably relinquished his income in and right to revoke, alter or amend some percentile interest therein and thereby cause such interest to be irrevocably set aside for the benefit of other named beneficiaries.

9 With respect to the gift of land, the utilization of a trust rather than an outright gift will exempt the trust interest from the dower claims of the beneficiary's spouse. The rule at common law and, accordingly, the rule which should apply in any state which has adopted the common law and has not enacted contrary legislation is that wives are not entitled to dower in equitable estates. Some states have enacted legislation which grants spouses dower in their husbands' equitable estates. The states following the common law rule and the states which have enacted legislation giving wives dower in equitable interests are listed in 2 A. SCOTT, THE LAW OF TRUSTS § 144 (3d ed. 1967).

partially irrevocable trust, and (3) the type of language which may be employed to create such a partially irrevocable trust.

II. Analysis

A. *Trust Law*

An individual otherwise competent to make a contract can establish a revocable trust and can include therein such terms, conditions, rights and other provisions as he desires so long as they are not violative of public policy.[10] Included among the terms, conditions, rights and provisions which may be included in a revocable inter vivos trust is the grantor's right to relinquish, wholly or partially, any and all rights which he may have in such trust, including the right of revocation.[11] An undivided interest can be held in trust for the use and benefit of named beneficiaries.[12] Similarly, one trustee may hold separate trusts under one instrument without physical separation or segregation of the trust assets where the trust instrument authorizes such act and separate books and records are maintained.[13]

The terms of the original revocable inter vivos trust must provide for the disposition of the interests which the grantor may, from time to time, relinquish. Assuming that such provision has been made, the partial relinquishment of the right of revocation and the other retained rights which the grantor had over the original trust will result in the substitution of new trust beneficiaries. Such new trust beneficiaries will possess equitable interests in the irrevocable portion of the trust. For the purposes of this article, it will be assumed that the original inter vivos trust was drafted with provisions for the grantor's partial relinquishment of his right of revocation and other retained interests. In the event of the relinquishment of such rights, beneficiaries other than the grantor will be entitled to a specified percentage of all the assets comprising the corpus of the trust, including the income from and appreciation thereon.

B. *Income Tax Consequences*

1. General

Before undertaking a detailed analysis of the income tax consequences of the utilization of a partially irrevocable trust, some general observations with regard to tax law must be made. The creation of the partially irrevocable trust will constitute a gift for gift tax purposes.[14] The value of this gift will be the proportionate value of all of the underlying assets of the trust as of the date on which the partially irrevocable trust is established. The requirement of filing a gift tax return and the amount, if any, of gift taxes due thereon will depend

10 1 A. SCOTT, THE LAW OF TRUSTS § 59 (3d ed. 1967).
11 RESTATEMENT (SECOND) OF TRUSTS § 330, comment *n* at 142 (1959).
12 A. SCOTT, *supra* note 10, at § 77.
13 *Id.*
14 INT. REV. CODE OF 1954, § 2511.

on a number of factors: (1) the grantor-donor's other gifts for that year and for prior years; (2) what portion of the grantor-donor's $30,000.00 lifetime exemption[15] remains; (3) whether or not the grantor-donor's spouse consents to having a part of the gift deemed made by her;[16] and (4) the number of beneficiaries and the relative values of their income interests for purposes of the $3,000.00 annual per donee exclusion.[17]

Two basic objectives of establishing the partially irrevocable trust are to reduce the income taxes of the grantor-donor (hereinafter referred to as "grantor") and to reduce the estate tax liability of the grantor's estate. The means of achieving these objectives and problems attendant thereon will be considered in detail.

Detailed consideration will not be given to the tax consequences to the beneficiary. Assuming that only ordinary income will be payable to the beneficiaries, they will be taxable on their prorata share of such income earned by the trust[18] and the trust will be taxable on realized capital gains.[19] The trust instrument could authorize distribution of the prorata portion of any realized capital gains and, in that event, the beneficiaries would be taxable on their prorata share of such capital gains.[20] If the beneficiary dies prior to the termination of the trust, his prorata interest in the trust may or may not be includable in his taxable estate. If the trust instrument gives the beneficiary a general power of appointment such interest will be includable in the beneficiary's taxable estate.[21] Unless the beneficiary's interest was established to obtain the benefits of the $3,000.00 annual gift tax exclusion for a gift in trust to a minor,[22] the trust instrument could provide that the beneficiary would have no interest in the trust should he die before ultimate distribution. Alternatively, the beneficiary could be given a limited or special power of appointment.[23] In either of these events, the beneficiary's taxable estate would include only the value of those items to which the beneficiary had an absolute right at the time of his death. For example, the beneficiary's taxable estate may include the prorata share of income earned between the last regular payment date and the date of death and any rights to demand corpus which the beneficiary may have possessed.

Consideration will be given to the feasibility of the grantor's serving as

15 *Id.* § 2521.
16 *Id.* § 2513.
17 *Id.* § 2503(b). The 3,000.00 per year exclusion for each donee is limited to the present value of each beneficiary's income interest plus the amount, if any, subject to the beneficiary's unrestricted right of withdrawal. Treas. Reg. § 25.2503-3.
18 INT. REV. CODE OF 1954, § 652.
19 190 BNA TAX MGT. PORTFOLIO, Subchapter J—Computation of Tax, pp. A-22 *et seq.*
20 INT. REV. CODE OF 1954, §§ 662, 643(a)(3).
21 *Id.* § 2041. A general power of appointment means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate excluding 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. *Id.* § 2041(b).
22 *Id.* § 2503(c) requires, in part, that any income which has been accumulated for the benefit of a minor must be payable to his estate or must be subject to a general power of appointment in order to qualify the income interest for the $3,000.00 annual per donee exclusion for gift tax purposes.
23 A power of disposition which is not exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Treas. Reg. § 20.2041-1(c).

trustee of the partially irrevocable trust. The tax consequences stemming from the selection of particular beneficiaries will also be analyzed. It should be noted, however, that the grantor will be taxable on any income which may be held or accumulated for, or distributed to, his spouse, if such payment may be made without the approval or consent of any adverse party.[24] Accordingly, it will be assumed for all purposes herein that the grantor's spouse is not a beneficiary of any interest in the partially irrevocable trust.

Many of the tax consequences in the income tax area depend upon the interest, if any, in the trust possessed by an individual who may control the payment or distribution of income or corpus. Such individual may be classified as an "adverse party" or as a "related or subordinate party." The 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.[25]

The term "nonadverse party" means: any person who is not an adverse party.[26] The term "related or subordinate party" means:

> 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.
>
> For purposes of sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.[27]

It should be noted in this context that the grantor's spouse or any of the relatives named above will only be considered a "related or subordinate party" if he is not an "adverse party."

The Internal Revenue Code and the Regulations promulgated thereunder recognize the possibility that a grantor may only retain a partial interest in a trust which would subject him, or his estate, to taxation. The Code provision dealing with the attribution of trust income and deductions to the grantor provides that such tax treatment may be proportional:

> Where it is specified in this subpart that the grantor or another person

24 INT. REV. CODE OF 1954, § 677(a).
25 *Id.* § 672(a).
26 *Id.* § 672(b).
27 *Id.* § 672(c).

> shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of any individual. Any remaining portion of the trust shall be subject to subparts A through D. . . .[28]

The Treasury Regulations interpreting this provision are even more explicit in providing as follows:

> When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example. . . .
>
> . . . .
>
> (3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D.[29]

Similarly, the Code provisions describing the type of interests which will cause the income from a trust to be attributable to the grantor all specifically note that such interests may extend only to a "portion of a trust."[30]

The provisions dealing with the inclusion of a trust in the grantor's taxable estate recognize that there may be a prorata rather than a complete inclusion through the use of the phrase "to the extent of any interest therein."[31] Judicial construction of these Code sections has resulted in the inclusion of only a prorata portion of the value of a trust in the grantor's taxable estate where the grantor's retained beneficial interest or enjoyment extended to only a portion of such trust.[32]

2. Retained Interests

The retention by the grantor of substantial beneficial or economic interests in a trust will generally result in the trust income being attributed to the grantor.

28 *Id.* § 671.
29 Treas. Reg. § 1.671-3(a)(3).
30 INT. REV. CODE OF 1954, §§ 673(a), 674(a), 675(a), 676(a), 677(a), 678(a).
31 *Id.* §§ 2036, 2037, 2038.
32 Joy v. United States, 404 F.2d 419 (6th Cir. 1968); Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947); Estate of Fannie Bomash, 50 T.C. 667 (1968); Estate of Mary Fownes Tomec, 40 T.C. 134 (1963).

Reversionary interests, revocability and utilization of trust income to discharge the grantor's legal obligations constitute such economic interests as to require that the trust income be attributed to the grantor. Thus, trust income will be attributed to a grantor who has, at least ostensibly, sought to have the income from the trust payable to some third party but who has retained a substantial beneficial or economic interest.

A grantor who reserves a reversionary interest in the trust corpus will have the income therefrom attributed to him.[33] The attribution of income to the grantor because of such reversionary interest is subject to two exceptions. The first exception relates to a reversionary interest which is postponed until the death of the income beneficiary.[34] The second exception relates to the postponement of the reversionary interest for at least a ten-year period commencing on the date the property is placed in trust.[35] The postponement period may either be specified as a term of years or may be dependent upon the occurrence of an event which, at the time of transfer to the trust, may not reasonably be expected to occur within ten years of the date of transfer.[36] These periods constituting exceptions to the attribution of income to the grantor because of the retention of a reversionary interest will be referred to herein as "permitted reversionary periods."

A grantor who retains, or who has delegated to a nonadverse party, a power exercisable alone or with a nonadverse party to revoke the trust and return any portion of the trust corpus to the grantor will have the income therefrom attributed to him.[37] Such attribution of trust income based on the existence of a power of revocation is subject to the same exception which applies to the reversionary interest. That is, trust income will not be attributable to the grantor on account of the possibility that any portion of the trust corpus will be returned to him if such power is not exercisable until after the expiration of the permitted reversionary periods.[38] Trust income will be attributable to the grantor after the expiration of such periods if the power is not relinquished prior to that time. A power to revoke, terminate, alter or amend, or to appoint the trust corpus in favor of the grantor will be deemed to be a power to return the trust corpus to the grantor for purposes of the attribution of trust income rules.[39] However, broad management powers exercisable in a fiduciary capacity do not constitute a power to return trust corpus to the grantor.[40] Similarly, the power to direct investments[41] or to substitute assets[42] or to borrow trust funds where fiduciary standards must be observed[43] is not a power to return the trust corpus to the grantor. However, such powers must not constitute prohibited "adminis-

33 INT. REV. CODE OF 1954 § 673(a).
34 *Id.* § 673(c).
35 *Id.* § 673(d).
36 Treas. Reg. § 1.673(a)-1(c).
37 INT. REV. CODE OF 1954, § 676(a).
38 *Id.* § 676(b).
39 Treas. Reg. § 1.676(a)-1.
40 United States v. Morss, 159 F.2d 142 (1st Cir. 1947).
41 William P. Anderson, 8 T.C. 921 (1947); Emma B. Maloy, 45 B.T.A. 1104 (1941).
42 Frick v. Driscoll, 29 Am. Fed. Tax R. 1298 (W.D. Pa. 1941).
43 Philip Meyers, 13 P-H TAX CT. REP. & MEM. DEC. ¶ 44,167 (1944).

trative powers." The definition and description of such "administrative powers" will be considered subsequently.

Trust income which, without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse, or applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse will be attributed to the grantor.[44] This rule, as with the rule for the attribution of income on account of the reversionary interest or a right to return trust corpus, is subject to an exception where the power to so use the trust income is only exercisable after the expiration of the permitted reversionary periods.[45] Trust income will be attributable to the grantor upon the expiration of this period. Trust income will be attributed to the grantor based merely on the existence of a power to pay trust income to or for the benefit of the grantor or his spouse.

Trust income will not be attributed to the grantor merely because such income may, in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee, be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse). However, trust income will be attributed to the grantor to the extent that such income is, in fact, applied or distributed for the support and maintenance of a beneficiary whom the grantor is legally obligated to support.[46] Problems arise as to what constitutes a "legal obligation of support" and when the trust income is, in fact, used to satisfy such obligations. The determination of whether or not the grantor is legally obligated for support and maintenance is determined under applicable state law.[47]

This exception for the attribution of trust income to the grantor relating to the actual application or payment of trust income applies only if: 1) such distribution of trust income is discretionary,[48] 2) is not within the discretion of the grantor unless he is a trustee,[49] and 3) is restricted to the satisfaction of the grantor's obligation of support or maintenance, and not to payment of the grantor's debts.[50]

The attribution of trust income to the grantor because of a reversionary interest, right of revocation or use of trust income in satisfaction of the grantor's legal obligations can be easily avoided with respect to the establishment of a partially irrevocable trust. The grantor in making this partial relinquishment of his right of revocation should specifically and irrevocably: (1) give up any reversionary interest he may have in such portion of the trust, (2) give up his right to alter, amend, terminate or revoke such portion of the trust and (3) direct that the income from such portion may not be applied or distributed in satisfaction of the grantor's or the grantor's spouse's legal obligations.

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44 INT. REV. CODE OF 1954, § 677(a).
45 *Id.*
46 INT. REV. CODE OF 1954, § 677(b).
47 Brooke v. United States, 300 F. Supp. 465 (D. Mont. 1969).
48 Treas. Reg. § 1.677(b)-1(f).
49 *Id.* § 1.677(b)-1(e).
50 *Id.* § 1.677(b)-1(d).

Thus, the trust instrument can immunize the grantor from the attribution of income problems with respect to a reversionary interest, revocability, and the utilization of income for the satisfaction of legal obligations. However, because one of the objectives of establishing the partially irrevocable trust is to permit the grantor to control the trust corpus which will include closely held stock, there are two additional indicia of the retention of a substantial and beneficial interest which may result in the attribution of trust income to the grantor. The retention of a substantial and beneficial interest in the trust may result from the power to control beneficial enjoyment or the retention of administrative powers which are exercisable primarily for the benefit of the grantor.

3. Power to Control Beneficial Enjoyment

Trust income will be attributed to the grantor from any portion of a trust over which the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, has any power of disposition affecting the beneficial enjoyment of the corpus or the income therefrom.[51] This rule is subject to a number of exceptions, the extent and scope of which are dependent upon the categorization of the person holding the power. The following powers affecting the beneficial enjoyment of a trust will not result in the attribution of trust income to the grantor regardless of the categorization of the holder or in what capacity they are held:

> 1. a power to accumulate trust income for the support or maintenance of a beneficiary, other than the grantor's spouse, whom the grantor is legally obligated to support provided no distribution is actually made for such purposes;
>
> 2. a power to affect beneficial enjoyment which commences only after the expiration of the permitted reversionary periods, but trust income will be attributed to the grantor thereafter unless the power has been relinquished prior to that time;
>
> 3. a testamentary power over the trust corpus other than a power in the grantor to appoint income which may be accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party;
>
> 4. a power to determine the charitable recipients and the time of receipt of income or corpus which has been irrevocably set aside for charitable purposes;
>
> 5. a power to distribute corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries)

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51 INT. REV. CODE OF 1954, § 674(a).

provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument, if no other person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children;

6. a power to distribute corpus to or for any income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust, if no person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except to provide for after-born or after-adopted children;

7. a power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable;

(A) to the beneficiary from whom it was withheld, to his estate or to his appointees (or persons named as takers in default) if such beneficiary possesses a general power of appointment over such portion of the trust, or

(B) to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument on termination of the trust, or in conjunction with the distribution of corpus which is augmented by such accumulated income, if no person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except to provide for after-born or after-adopted children;

8. a power to distribute or apply income to a beneficiary or to accumulate and add such income to corpus during the existence of a legal disability of such current income beneficiary or during the period during which any income beneficiary shall be under the age of twenty-one (21) years, if no person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except to provide for after-born or after-adopted children;

9. a power to allocate receipts and disbursements between corpus and income, even though the power is expressed in broad language.[52]

The existence of even broader powers will not result in the attribution of trust income to the grantor if such powers are held by "independent trustees." "Independent trustees" are defined to be trustees who will act without the ap-

52 *Id.* § 674(b).

proval or consent of any other person if the grantor is not included in such class and if no more than half of such trustees are "related or subordinate parties" who are subservient to the wishes of the grantor. These broader powers include:

> 1. a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; and
>
> 2. a power to pay out corpus to or for a beneficiary beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).
>
> In order to constitute such excepted powers, no person may have a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except to provide for after-born or after-adopted children.[53]

Additionally, trust income will not be attributed to the grantor if a trustee or trustees, none of whom is the grantor or the grantor's spouse if living with the grantor, has the power to distribute, appoint, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries whether or not such accumulated income will ultimately be payable to the beneficiary or whether or not it is during a period of legal disability or prior to age twenty-one (21), so long as such power is limited by a reasonably definite external standard which is set forth in the trust instrument. This exception does not apply if any other person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except to provide for after-born or after-adopted children.[54]

Except if a power affecting the beneficial enjoyment of the trust exercisable without the consent or approval of an adverse party falls into one of the three broad exceptions discussed above, the trust income will be attributable to the grantor. Powers affecting the beneficial enjoyment of trust income or trust corpus include powers exercisable in a fiduciary power, powers of appointment, or any other power affecting the beneficial enjoyment of trust income.[55]

The exception that trust income will not be attributed to the grantor even though he has a power to distribute trust corpus is an extremely useful one and warrants further consideration. This exception relates to any power held by the grantor or a nonadverse party which permits the invasion or distribution of corpus if such power is limited by a reasonably definite standard which is set forth in the trust instrument. This power may only be exercisable in favor of designated beneficiaries of the trust (either income beneficiaries or remaindermen) who have an interest in the trust other than one arising through the exercise of such power. The reasonably definite standard need not consist of the needs and circumstances of the beneficiary; however, it must be a clearly measurable standard under

53 *Id.* § 674(c).
54 *Id.* § 674(d).
55 Treas. Reg. § 1.674(a)-1(a).

which the holder thereof is legally accountable. Thus, the power to distribute corpus for the pleasure, desire or happiness of the beneficiary is not limited by a reasonably definite standard. A power which is exercisable solely and conclusively in the discretion of the trustee will not qualify as a power subject to a reasonably definite standard. However, the power may be within the discretion of the trustee so long as this is not tantamount to conclusive and nonrecourse discretion and still be subject to a reasonably definite standard.[56] If the distribution of trust corpus is not limited by a reasonably definite standard, trust income will not be attributed to the grantor only if the distributions of corpus may be made solely in favor of current income beneficiaries and only if such corpus distribution must be charged against the proportionate part of corpus held in trust for payment of income to such beneficiary as if it constituted a separate trust (whether or not physically segregated).[57]

Certain of the powers described above may not be exercisable by the grantor or the grantor's spouse. Other powers must be exercisable by "independent trustees." In either event, the retention by the grantor of the power to remove, substitute or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year) may prevent such exceptions from applying. Powers exercisable by an independent trustee will not prevent the attribution of trust income to the grantor if he has an unrestricted power to remove such independent trustee and substitute any person, including himself, as trustee. However, the existence of a power of removal which is limited so that its exercise could not alter the trust in a manner which would defeat any exception, will not result in the attribution of trust income to the grantor. For example, the power to remove one independent trustee so long as another independent trustee must be substituted.[58]

4. Retained Administrative Powers in General

Because of the intended utilization of the partially irrevocable trust, the rule that trust income will be attributable to the grantor who holds certain administrative powers must also be considered. The law provides that income from a trust, or any portion thereof, will be attributed to the grantor if the grantor, or any nonadverse party, or both, has a power which is exercisable without the approval or consent of any adverse party, which permits: (1) the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth, or (2) the grantor to borrow the trust corpus or income, directly or indirectly, without adequate interest or without adequate security. A general lending power given to a trustee (other than the grantor) to make loans to any person without regard to interest or security will not be deemed to be a prohibited power. However, trust income will be attributed to the grantor if he has borrowed the trust corpus or income and has not completely repaid the loan, in-

56 *Id.* § 1.674(b)-1(b)(5)(i) Examples (1) and (2); and § 1.674(b)-1(b)(5)(iii).
57 *Id.* § 1.674(b)-1(b)(5)(ii).
58 *Id.* § 1.674(d)-2.

cluding any interest, before the beginning of the next taxable year. The trust income will not be attributed to the grantor on account of any unrepaid loans, if the loan provides for adequate interest and adequate security, and if the loan was made by a trustee other than the grantor and other than a related or subordinate person subservient to the grantor.[59]

In addition to the foregoing instances of self-dealing on the part of the grantor, there will be attributed to the grantor income from any portion of a trust in respect of which a "power of administration" is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" is defined as follows:

> (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;
>
> (B) a power to control the investment of the trust funds either by directing investment or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or
>
> (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.[60]

The power of administration provisions attribute trust income to a grantor if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than for the beneficiaries of the trust. If the grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be taxed on income from the trust, he will be so taxed from the inception of the trust.[61] As indicated above, the defined power of administration provisions are only those which are exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The fact that the holder of the power is a trustee raises a presumption that the power is exercisable in a fiduciary capacity primarily in the interest of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interest of the beneficiaries.[62]

5. Retained Right to Vote Closely Held Stock and to Direct Trust Investments

The problem of the possible attribution of the proportionate share of income of a partially irrevocable trust to the grantor because such trust owns closely held

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59 INT. REV. CODE OF 1954, § 675(1)-(3).
60 *Id.* § 675(4).
61 Treas. Reg. § 1.675-1(a).
62 *Id.* § 1.675-1(b)(4).

stock must be considered. If attribution of trust income were possible solely under the power of administration provisions, no problem would be encountered if the grantor served as a trustee under enforceable fiduciary obligations. However, the Internal Revenue Service may attempt to extend the statutory provisions dealing with the attribution of trust income to a grantor because of his power to dispose of the beneficial enjoyment of the trust if closely held stock is included as a trust asset. It is submitted that such an extension of the attribution of trust income to the grantor is unwarranted.

The law dealing with the attribution of trust income on account of retention by the grantor of substantial beneficial and economic interest in a trust had its origin in two decisions of the United States Supreme Court: *Helvering v. Clifford*[63] and *Helvering v. Horst*.[64] Both decisions were based on a finding that the grantor had retained such a degree of control over the income of the trust that it was properly taxable to him under the definition of gross income contained in the 1939 Internal Revenue Code:

> "Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .[65]

As the Supreme Court stated in *Helvering v. Horst:*

> The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure that payment of income to another is the enjoyment and hence, the realization of the income by him who exercises it.[66]

The *Horst* and *Clifford* decisions and the later landmark decision, *Harrison v. Schaffner*[67] considered all the facts and circumstances of the trust in determining whether or not the grantor retained a sufficient degree of beneficial enjoyment over the trust as to cause the income therefrom to be attributed to him. These decisions, as well as the myriad of other decisions involving the application of the definition of gross income under the Internal Revenue Code of 1939, did not rely on one or more factors as indicating the necessary retention of control but considered the entire "bundle of rights" which the grantor retained in determining whether or not the trust income should be attributed to the grantor. After the *Clifford* decision, the Internal Revenue Service promulgated Treasury Regulations under the gross income section of the Internal Revenue Code of 1939.

63 309 U.S. 331 (1940).
64 311 U.S. 112 (1940).
65 INT. REV. CODE OF 1939, § 22(a).
66 311 U.S. at 79.
67 312 U.S. 579 (1941).

These Treasury Regulations are commonly referred to as the "Clifford Regulations."[68] The rationale for these Regulations is set forth in the following language:

> The income of a trust is taxable to the grantor under Section 22(a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligation if he has retained a control of the trust so complete that he is still in practical effect the owner of its income. (Citation omitted.) In the absence of precise guides supplied by an appropriate regulation, the application of this principle to varying and diversified factual situations has led to considerable uncertainty and confusion. The provisions of this section accordingly resolve the present difficulties of the application by defining and specifying those factors which demonstrate the retention by the grantor of such complete control of the trust that he is taxable on the income therefrom under Section 22(a).[69]

The Clifford Regulations then listed the various factors which the Internal Revenue Service indicated would require the attribution of trust income to the grantor.

Congress subsequently enacted specific statutory language dealing with the attribution of trust income to the grantor.[70] These provisions incorporated, in great part, the factors set forth in the Clifford Regulations. Thus, the cases interpreting the Clifford Regulations are basically of historical interest only. That is, insofar as the case may arise for a taxable year beginning after December 31, 1953.[71] Precedents antedating the enactment of the present statutory provisions have been specifically rejected.[72] However, a consideration of the cases interpreting the Clifford Regulations is helpful in seeking guidelines for the application of the present statutory law where it codified the prior Regulations.

Such an analysis is particularly helpful in considering whether or not the income of a partially irrevocable trust can be attributed to the grantor solely because the grantor retains the right to exercise all control over the management of the trust assets, including closely held stock. If the grantor is precluded from exercising the prohibited acts of self-dealing and inadequately secured borrowing, and repays, if necessary, any existing loans before the end of the year, and is subject to fiduciary responsibility toward the beneficiaries, no trust income may be attributable to the grantor under the power of administration statutory provision.[73] However, the fact that the trust income may not be attributable to the grantor under one section does not preclude attribution under another section.

The Internal Revenue Service may contend that the retention by a grantor of a right to vote closely held stock, and the protection of such voting right by retaining the right to veto the sale of such closely held stock, constitutes a power to dispose of the beneficial enjoyment of the portion of the trust corpus, or income therefrom, consisting of such stock. Such contention, if accepted, will result in

68 Treas. Reg. 111, § 29.22(a)-21 (1939).
69 *Id.* § 29.22(a)-21(a) (1939).
70 INT. REV. CODE OF 1954, §§ 671-677.
71 *Id.* § 683.
72 Gurich v. Commissioner, 295 F.2d 845 (1st Cir. 1961).
73 INT. REV. CODE OF 1954, § 675.

the attribution of the trust income from such portion of the trust to the grantor.[74] The Internal Revenue Service has asserted that the retention of similar voting and veto rights constituted the retention of the "possession or enjoyment of . . . the property" and "the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom" in an effort to include the value of such closely held stock in the grantor's taxable estate.[75]

The attribution of trust income to the grantor necessitates a finding that the grantor had a "power of disposition" and that such power was not within one of the exceptions set forth in the statute. The Treasury Department interprets a "power of disposition" affecting beneficial enjoyment to be:

> A power, beyond specified limits, to dispose of the income or corpus, whether the power is a fiduciary power, a power of appointment or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a non-adverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsection (b), (c), and (d) of Section 674.[76]

This Treasury Regulation prescribed that the grantor's capability to "affect" in any particular, the beneficial enjoyment of any portion of the trust constitutes a "power of disposition." Among some of the definitions of the word "affect" are the following:

> To act upon; influence; change; enlarge or abridge; to act or produce an effect upon; implies an indirect relation.[77]

The Clifford Regulation which was the forerunner of the present statute attributing trust income to a grantor based on his power to affect beneficial enjoyment was not as broad as the current Treasury Regulation. The pertinent portion of the Clifford Regulations provided as follows:

> Income of a trust is taxable to the grantor where, whatever the duration of the trust, the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition except as provided in Section 167(c) and as hereafter provided in Subparagrarphs (1)-(4), inclusive, whether by revocation, alteration or otherwise, exercisable (in any capacity and regardless of whether such exercise is subject to a precedent giving of notice or is limited to some future date) by the grantor, or any other person not having a substantial interest in the beneficial enjoyment of the corpus or income, whichever is subject to the power or both.[78]

The Internal Revenue Service could contend that the ability to elect corporate directors and thereby control the dividend payment policy of a closely held corporation constitutes a power to affect the beneficial enjoyment of the trust income. Similarly, it could be contended that the power to determine when,

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74 *Id.* § 674.
75 United States v. Byrum, 408 U.S. 125 (1972). This decision will be discussed.
76 Treas. Reg. § 1.674(a)-1(a).
77 BLACK'S LAW DICTIONARY 79 (4th ed. 1951).
78 Treas. Reg. 111, § 29.22(a)-21(d) (1939).

and in what amount, trust assets are to be sold and the extent to which the trust assets are to be invested in property which does not produce current income, but has substantial capital appreciation, or assets which have substantial current income, but may be subject to substantial depreciation, constitutes a power to affect beneficial enjoyment. In either event, success in sustaining such contentions will result in the attribution of the trust income to the grantor.

Although as indicated above, the capacity in which such powers may be held is immaterial,[79] it is submitted that no one or all of the foregoing factors will be sufficient to cause the trust income to be attributed to the grantor. The statute specifically provides that either the grantor or a nonadverse party, or both, can have the following power regardless of the capacity in which it is held without causing trust income to be attributable to the grantor:

> A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income may ultimately be payable—
>
> > (A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate; or
> >
> > (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.
>
> Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.[80]

Thus, a grantor can establish a partially irrevocable trust in which he retains, in a fiduciary capacity, the right to vote closely held stock and to direct the investments (including the veto of investments) of the trust and not have the income from that portion attributable to him. He must, however, irrevocably give up any reversionary interest, any right of revocation, alteration, amendment or termination with respect to such portion and must insure that the income from such portion is not used to satisfy his legal obligations. The form of language

79 Treas. Reg. § 1.674(a)-1(a).
80 INT. REV. CODE OF 1954, § 674(b)(6).

which may be used to accomplish this result is set forth subsequently in this article.

C. *Estate Tax Consequences*

1. General

As in the income tax area, the recognition of a trust as an entity, separate and apart from its grantor for estate tax purposes, requires that the grantor divest himself of all substantial beneficial and economic interests in such trust. There are three statutory provisions which, to some extent, overlap in including in the grantor's taxable estate property which has been transferred to a trust. These sections are in addition to a provision whereby property irrevocably transferred to a trust within three (3) years of the grantor's death may be includable for estate tax purposes as a transfer "in contemplation of death."[81] It will be assumed for the purpose of this article that the transfer was made either outside of the three (3) year period prior to the grantor's death or the estate's personal representative can rebut the presumption that a transfer made within such period was made in contemplation of death. Similarly, it will be assumed that the grantor did not retain any express reversionary interest in the partially irrevocable trust.

One statutory provision under which such partially irrevocable trust may be included in the grantor's taxable estate is as follows:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[82]

The Treasury Department's interpretation of this language extends its application considerably. For example, the Treasury Regulations extend the section to include "use or other enjoyment of the transferred property" which is claimed to have been retained by or reserved to the grantor "to the extent that the use, possession, right to the income, or other enjoyment is to be applied towards the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit."[83] Property may be included in a grantor's taxable estate if he has the requisite "right to designate" regardless of whether the power was exercisable alone or only in conjunction with another person or persons, and without regard for

81 *Id.* § 2035.
82 *Id.* § 2036.
83 Treas. Reg. § 20.2036-1(a)(i) and (b)(2).

the existence of any adverse interest, the capacity in which the power is exercisable, and whether or not the exercise of the power was subject to the contingency beyond the grantor's control which did not occur before his death.[84]

A grantor's interest in a trust may also be included in his taxable estate to the extent that it is deemed to be revocable. The applicable statutory provision states:

> The value of the gross estate shall include the value of all property—
>
> > (1) Transfers After June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of death.[85]

This statutory language has been amplified by the Treasury Department's interpretation. For example, any power affecting the time or manner or enjoyment of property or its income, even though the identity of the beneficiary is not affected, will require inclusion in the grantor's taxable estate. The following example is included in the regulations: "A power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate," will constitute a taxable power of revocation. It is noted, however, that only the value of an interest in property subject to this power is included in the decedent's gross estate.[86] The grantor's right to accumulate income and to allocate gains from sales of trust stock to either income or corpus justified inclusion of the trust property in the grantor trustee's taxable estate even though he had no power to defeat the interest of the remaindermen.[87] However, the right to control the investment and reinvestment of trust assets which could indirectly affect the beneficial enjoyment of the income or corpus of a trust does not constitute a power of revocation.[88]

Property may also be includable in a grantor's taxable estate if the transfer in trust is deemed to take effect at death. The applicable statutory provision states:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after December 7, 1916, made a transfer (except in case of a bona fide sale for an adequate and full consideraton in money or money's worth), by trust or otherwise if—

84 *Id.* § 20.2036-1(b)(3).
85 INT. REV. CODE OF 1954, § 2038.
86 Treas. Reg. § 20.2038-1(a)(3).
87 Commissioner of Internal Revenue v. Hager's Estate, 173 F.2d 613 (3d Cir. 1949).
88 Estate of Willard V. King, 37 T.C. 973 (1962).

> (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and
>
> (2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.[89]

The inclusion of any portion of a trust in the grantor's taxable estate under the reversionary interest section requires both (1) a transfer by the grantor of an interest in the trust in which the transferee could obtain the possession or enjoyment of the property only by surviving the grantor and (2) the retention by the grantor of some possibility that the transferred property, other than the income alone, would return to the grantor or his estate or would be subject to a power of disposition by him.[90]

The three statutory provisions under which the value of property transferred in trust may be includable in the grantor's taxable estate will reach a partial or undivided interest in such property. Accordingly, if the grantor has irrevocably: (1) relinquished his right to revoke a portion of the trust, (2) divested himself of any reversionary interest in such portion, and (3) irrevocably relinquished any right to use or enjoy the income from such portion or the right to designate the persons who shall possess or enjoy the property or the income therefrom, only the portion of the trust still subject to the grantor's right of revocation and other retained interest is includable in his taxable estate.[91] The case of *Joy v. United States*[92] illustrates the application of the retained interest section to a partial interest trust. This trust instrument required that the grantor-cotrustee set aside twenty per cent (20%) of the trust income to be added to principal and granted the grantor-cotrustee discretionary authority to pay out, or withhold, the remaining eighty per cent (80%) of the trust income. The Court held that eighty per cent (80%) of the value of the trust corpus and all of the undistributed income were includable in the grantor's taxable estate based on the retained power to accumulate trust income. The Court's rationale was that the grantor, as cotrustee, retained and possessed at her death the completely discretionary power to distribute part or all of eighty per cent (80%) of the trust income, or to accumulate it, and thereby denying the beneficiaries immediate enjoyment. Under these same retained powers, the grantor, as cotrustee, could have withheld from the primary beneficiaries the right to immediate enjoyment of the income and, indeed, possibly the right ever to enjoy the income that might be accumulated if the beneficiary died prior to the termination of the trust. The Court held that such a discretionary power was a "significant power and of sufficient

89 INT. REV. CODE of 1954, § 2037.
90 Treas. Reg. § 20.2037-1(a).
91 *See* cases cited note 32, *supra;* C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES § 8.20 (2d ed. 1962); 3 J. MERTENS, FEDERAL GIFT AND ESTATE TAXATION § 24.24 (1959).
92 404 F.2d 419 (6th Cir. 1968).

substance to be deemed the power to designate" within the meaning of the retained income section.

Assuming that the grantor has irrevocably relinquished his reversionary interest or any other right specifically described in the statutes or the Treasury Regulations promulgated thereunder which would require the inclusion of the partially irrevocable trust in his taxable estate, the question arises as to whether or not the right to control investments and the inclusion of closely held stock will require the inclusion of the value of such portion of the trust in the grantor's taxable estate. The mere retention of broad administrative or investment powers does not require inclusion in the grantor's taxable estate (under either the retained interest provision or the revocability provision) so long as such powers are exercisable in a fiduciary capacity.[93] The case of *Old Colony Trust Company v. United States*[94] illustrates the current judicial approach to this question. The Court held that although the grantor-trustee was authorized to do all things in relation to the trust fund which the grantor could do if living, the trust was not includable in the grantor's taxable interest because the grantor, as trustee, was bound to act in the best interests of the trust and its beneficiaries as a whole. As the Court stated:

> With all respect to the majority of the then Court, we find it difficult to see how a power can be subject to control by the probate court, and exercisable only in what the trustee fairly concludes is in the interest of the trust and its beneficiaries as a whole, and at the same time be an ownership power.
>
> The government's position, to be sound, must be that the trustee's powers are beyond the court's control. Under Massachusetts law, however, no amount of administrative discretion prevents judicial supervision of the Trustee.[95]

Accordingly, it appears that no aggregation of purely administrative powers can meet the Government's amorphous test of "sufficient dominion and control" so as to be equated with ownership if there is or may be some judicial restraint on such administrative and managerial powers.

Similarly, the Court in *United States v. Powell*[96] considered the applicability of the statute which requires the inclusion in the taxable estate of trust property which is subject to a power of revocation as it related to broadly worded administrative and managerial powers. The Court concluded that such administrative and managerial powers did not give the grantor-trustee any direct power to alter or amend the trust corpus or the trust instrument itself. To the extent that such administrative or managerial powers could affect the beneficial interest in the trust, they did so indirectly and as a secondary consequence of the exercise of such administrative and managerial powers. This Court noted that there was no

93 *See* Reinecke v. Northern Trust Co., 278 U.S. 339 (1929); Old Colony Trust Company v. United States, 423 F.2d 601 (1st Cir. 1970); United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Fifth Avenue Bank of New York v. Nunan, 59 F. Supp. 753 (E.D.N.Y. 1945); Estate of Marvin L. Pardee, 49 T.C. 140 (1967); Estate of Willard V. King, 37 T.C. 973 (1962); Estate of James H. Graham, 47 T.C. 415 (1966).

94 423 F.2d 601 (1st Cir. 1970).

95 *Id.* at 603.

96 307 F.2d 821 (10th Cir. 1962).

exculpatory language with respect to the exercise of these powers and that a court of equity could review their exercise and correct any abuses of discretion. The Court concluded that the trustees were obligated, in the exercise of their discretion, to invest the corpus for the benefit of the trust estate and in such manner as to preserve a fair balance between the income beneficiaries and the remaindermen. The *Powell* Court held that such a duty constituted an ascertainable, external and judicially established standard, enforceable by a court of equity in the exercise of its power to review the action of trustees in administrating trusts. Thus, the powers did not result in the inclusion of the trust in the grantor's taxable estate. Comparable results obtain if such administrative and managerial powers could not be exercised in a "reckless or willful manner" or if the grantor-trustee was subject to obligations of "fidelity and diligence."[97] Where the grantor-trustee must act in good faith in accordance with his fiduciary responsibilities and must act to safeguard and conserve the trust property, the value of the trust will not be includable in his taxable estate.[98]

If, in addition to the broad administrative and managerial rights which the grantor-trustee has retained, the trust assets include closely held stock which the grantor controls through the trust stock and other stock outside the trust, a further problem arises. The Internal Revenue Service has taken the position that the value of such stock must be included in the grantor-trustee's taxable estate:

> The value of non-voting corporate common stock transferred in trust is includable in the grantor's gross estate for Federal Estate Tax purposes, where the grantor retained for the remainder of his life the controlling interest in the corporate voting stock, and where (1) the grantor was himself a trustee of the trust at his death, or (2) the trustee was restricted in any way in his power to dispose of the non-voting stock, and the trustee held the non-voting stock at the grantor's death. Since the grantor retained the power to regulate the income from the transferred property, he retained for his life or for a period which did not in fact end before his death, the right to designate the persons who shall possess or enjoy the property or the income therefrom. The value of the non-voting shares included in the gross estate should reflect the additional value inherent in the closely held voting shares by reason of control of the company policies.[99]

Since publishing this Ruling, the Internal Revenue Service has lost every reported case in which it has sought to include the value of closely held stock in similar situations.[100] The first such case is *Yeazel v. Coyle*.[101] In this case, the

97 37 T.C. at 980.

98 *See* Estate of James H. Graham, 47 T.C. 415 (1966).

99 Rev. Rul. 67-54, 1967-1 Cum. Bull. 269.

100 Yeazel v. Coyle, 21 Am. Fed. Tax R.2d 1681 (N.D. Ill. 1968); Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970), *aff'd* 440 F.2d 949 (6th Cir. 971), *aff'd* 408 U.S. 125 (1972).

But see Harry H. Beckwith, 55 T.C. 242 (1971) (A) in which the Tax Court has, in dicta, indicated that it may apply the rationale of Revenue Ruling 67-54. This statement was dicta because (1) the individual trustees, other than the grantor, had a power of sale over all of the trust assets and (2) the government did not prove that there was any plan, arrangement or other scheme which gave the grantor the right to vote the stock in trust so as to retain control. With respect to the first item, the Tax Court noted that the right to control the dividend policy grantor established an irrevocable trust naming herself as trustee. The grantor transferred to this trust approximately sixty per cent (60%) of the stock in her wholly owned corporation and retained the remaining stock in her individual name. The Court recognized that the retention of voting control permitted the grantor to control the election of the directors and thereby effect some control over the dividend policy of the corporation, and thus, the distribution of income to the trust beneficiaries. Although the grantor could have elected directors who would not declare any dividends, such action would not have deprived the beneficiaries of the possession or enjoyment of either the property or income therefrom because the retained earnings of the corporation would increase, thus making the beneficiaries' stock more valuable. Even without the direct payment of dividends, the beneficiaries were in a position to receive the economic benefit of the stock since they could use it as security for a loan which would provide them with cash until the termination of the trust. Based upon the foregoing analysis, the Court concluded that the retention of the voting control was not one of the retained powers which required inclusion in the grantor's taxable estate. As the Court noted:

> If the Government's argument were carried to its logical conclusion, the donor of the stock in a closely held corporation would be required to divorce himself of all remaining interest in the corporation in order to make his gift effective for tax purposes. The sweep of section 2036(a) is not that broad.[102]

2. United States v. Byrum

The United States Supreme Court has given certainty in estate planning where closely held stock is transferred to a trust in which the grantor retained administrative and managerial powers. The Court, in *United States v. Byrum*,[103] held that this combination of retained administrative and managerial powers, exercisable in a fiduciary capacity, and closely held stock does not require that the value of such stock be included in the grantor's taxable estate as a retained power affecting beneficial enjoyment. In 1958 Milliken C. Byrum established an irrevocable inter vivos trust to which he transferred shares of stock in three closely held corporations. Prior to this transfer, the grantor owned at least seventy-one per cent (71%) of the outstanding stock of each corporation. The beneficiaries of this irrevocable trust were the grantor's children or, in the event of their death before the termination of the trust, their surviving children. Although the trust instrument provided for the appointment of an independent corporate trustee, it reserved to the grantor the following rights:

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of a corporation can be a right to designate the income recipient of a trust holding its stock only if the corporation is, of necessity, a source of trust income. With respect to the second item, the Court stated:

> Even if retention of the right to vote a fraction of the stock of a corporation can be said to be a retention of its possession or enjoyment, the evidence does not show that the decedent here retained any such right within the meaning of Section 2036(a)(1). 55 T.C. at 251.

101 21 Am. Fed. Tax R.2d 1681 (N.D. Ill. 1968).

102 *Id.* at 1685.

103 408 U.S. 125 (1972).

(1) to vote the shares of unlisted stock held in the trust estate;
(2) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust;
(3) to approve investments and reinvestments; and
(4) to remove the trustee and designate another corporate trustee to serve as successor.

The Government contended that the value of the closely held stocks (and only the value of these stocks) was taxable in the grantor's estate on the theory that the grantor had retained for his lifetime either (1) "the possession or enjoyment of, or the right to the income from, the property" transferred or (2) "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The essence of the Government's contention was that the grantor, by retaining voting control over the corporations whose stock was transferred, was in a position to select the corporate directors. The grantor could retain this controlling position by not selling the shares he owned individually and by vetoing any sale of the transferred shares by the trustee. The Government reasoned that based upon these rights, the grantor retained control over corporate dividend policy. Thus, while in control of the corporate dividend policy, the grantor could "regulate the flow of income to the trust" by increasing, decreasing or stopping dividends completely and thereby shift or defer the beneficial enjoyment of trust income between current income beneficiaries and remaindermen. The Government argued that the totality of these retained powers was tantamount to a grantor's power to accumulate trust income and thereby made the transfer includable in the grantor's taxable estate. The Government was unsuccessful in the District Court,[104] the Sixth Circuit Court of Appeals,[105] and ultimately in the Supreme Court.

The grantor's retained powers, including the power to preserve his controlling position by refusing to approve sales of the stock, does not result in the retention of the type of beneficial interest warranting taxation. There were two specific theories advanced for this holding. The Sixth Circuit equated such power with the retention of broad administrative or managerial control which does not result in the inclusion of such trusts in the grantor's taxable estate. As the Sixth Circuit stated:

> The government contends that since the grantor remained in voting control of the corporation he could, by electing the Board of Directors, determine dividend policies and thus the grantor could indirectly regulate or control who enjoyed the income from the property. However, the grantor by retaining the voting right of the stock only controlled who could serve as directors of the corporation. These individual directors would then be under a fiduciary obligation to exercise sound business judgment in declaring dividends and could not act in bad faith to the injury of the beneficial owners of the stock. This obligation is governed by an ascertainable standard

104 Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970).
105 Byrum v. United States, 440 F.2d 949 (6th Cir. 1971).

> and is analogous to the situation which exists in cases where the grantor retains broad managerial control of the trust, see Reinecke v. Northern Trust Company, supra; and does not result in making these assets includable in the grantor's estate.[106]

The Sixth Circuit specifically rejected the applicability of Revenue Ruling 67-54 in the following language:

> While Revenue Ruling 67-54, 1967-1 Cum. Bull. 269, strictly construed is distinguishable from the facts in this case, it does tend to support the position advanced by the Government on this appeal. Rulings, however, do not have the force of law and are at most merely persuasive. (Citations omitted.) Insofar as such Ruling might be applied to the facts of this case, it is in conflict with the law as interpreted by the Courts and should be disregarded. (Citations omitted.)[107]

The Supreme Court affirmed the decision of the Sixth Circuit and held that the retention of broad managerial powers over closely held stock does not require the inclusion of such stock in the grantor's taxable estate. The Supreme Court went further, however, and analyzed the question of whether or not the grantor reserved any "right" in the trust instrument or otherwise. The Court stated that the term "right" connotes an ascertainable and legally enforceable power which is not present in the instant case. The Court then dwelled at length upon general propositions of corporate law involving the fiduciary obligations of the directors (whom the controlling stockholder may elect) with regard to both the corporation, its creditors, and the stockholders in determining whether or not dividends would be paid. The Court also considered the fiduciary obligations of a majority shareholder not to misuse his power by promoting his personal interests at the expense of corporate interests. Finally, the Court stated that the power to control the dividend policy, even if it could be exercised, could not exist unless the controlled corporations were able to pay dividends. Ability to pay dividends is dependent on business and economic variables which are beyond the control of the grantor. Even assuming the availability of earnings, the legal power to declare dividends is vested solely in the corporate board of directors. This Board must balance the expectation of stockholders to reasonable dividends against the multiple and varied corporate needs for the retention of earnings.

The Government advanced an alternative ground for including the trust's closely held stock in the grantor's taxable estate. It contended that by retaining control, the grantor guaranteed himself continued employment and remuneration, as well as the right to determine whether and when the corporations would be liquidated or merged. Thus, the Government argued that the grantor retained "the enjoyment of . . . the property" making it includable in his taxable estate. In rejecting this contention, the Court noted that the statutory language plainly contemplates retention of an attribute of the property transferred; for example, a right to income, use of the property itself, or a power of appointment with respect either to income or principal. The Court held that the examples posited

106 *Id.* at 952.
107 *Id.* at 952-53.

by the Government were too speculative and contingent to constitute enjoyment. Additionally, the Court noted that such benefits related to emoluments flowing from the controlling vote, they do not apply to the "property" transferred which was the stock.

In concluding that the value of the closely held stock was not includable in the grantor's taxable estate, the Supreme Court, by way of footnote, ratified the efficaciousness of the use of closely held stock as gifts to irrevocable trusts in the following language:

> The interpretation given § 2036(a) by the Government and by Mr. Justice White's dissenting opinion, would seriously disadvantage settlors in a control posture. If the settlor remained a controlling stockholder, any transfer of stock would be taxable to his estate. See N.4, supra. The typical closely held corporation is small, has a checkered earning record, and has no market for its share. Yet its shares often have substantial asset value. To prevent the crippling liquidity problem that would result from the imposition of estate taxes on such shares, the controlling shareholder's estate planning often includes an irrevocable trust. The Government and the dissenting opinion would deny to controlling shareholders the privilege of using this generally acceptable method of estate planning without adverse tax consequences. Yet a settlor whose wealth consisted of listed securities of corporations he did not control would be permitted the tax advantage of the irrevocable trust even though his more marketable assets present a far less serious liquidity problem. The language of the statute does not support such a result and we cannot believe Congress intended it to have such discriminatory and far-reaching impact.[108]

Although the Court did not specifically consider whether the closely held stock should be included in the grantor's taxable estate because of the retention of a power of revocation over the trust, it is submitted that the *Byrum* decision would be controlling in holding that the retention and protection of voting control of closely held stock is not a taxable power of revocation. The portion of the Supreme Court's decision which involved the equating of voting control with the retention of administrative and managerial powers should be determinative. Broad managerial powers coupled with a right to veto sales had previously been held by the Court not to require the inclusion of the trust assets in the grantor's taxable estate.[109] The Supreme Court cited with approval the Tax Court decision of *Estate of Willard V. King*[110] which held, in part, that broad management powers retained by the grantor to invest and reinvest the corpus and income did not constitute a taxable power of revocation. Although these decisions did not consider the transfer of closely held stock which the grantor controlled, they are in accord with the Supreme Court's rationale that a controlling stockholder does not have either actual or legal control over whether a corporation has earnings or whether the Board of Directors will declare a dividend. Additionally, the Supreme Court's disposition to permit stockholders of closely held corporations to enjoy the same estate planning possibilities as owners of widely held securities is

108 United States v. Byrum, 408 U.S. 125, 149 n. 34 (1972).
109 McCormick v. Burnet, 283 U.S. 784 (1931).
110 Estate of Willard V. King, 37 T.C. 973 (1962).

indicative of how the Supreme Court would have treated the Government's attempt to require inclusion of the closely held stock in the grantor's taxable estate through the assertion that the retention of voting control gave the grantor a power to alter, amend, revoke or terminate the trust.

D. *Other Tax Considerations of the Use of a Partially Irrevocable Trust*

Two factors which must be considered in connection with the inter vivos transfer of closely held stock is whether or not such transfer will preclude the stockholder's estate from (1) effectuating a nondividend redemption of the stock in order to pay inheritance taxes and administrative expenses, and (2) electing to pay the inheritance taxes attributable to the closely held stock in installments extending for as much as ten (10) years while paying four per cent (4%) interest. The nondividend redemption provisions are as follows:

> A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of—
>
> (1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and
>
> (2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States)
>
> shall be treated as a distribution in full payment in exchange for the stock so redeemed.[111]

This nondividend redemption treatment is only available if the stock to be redeemed constitutes a substantial asset in the decedent's estate. Specifically, this nondividend redemption procedure is available only if the value (for federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either more than thirty-five per cent (35%) of the value of the gross estate of such decedent or more than fifty per cent (50%) of the taxable estate of such decedent. If the decedent owns stock in two or more corporations, such stock may be treated as the stock of a single corporation for the purposes of satisfying either the thirty-five per cent (35%) or the fifty per cent (50%) requirements if more than seventy-five per cent (75%) in value of the outstanding stock of each separate corporation is included in determining the value of the decedent's gross estate for federal estate tax purposes.[112]

This nondividend redemption procedure will be available, if the percentile limitations are met, with respect to the value of the undivided interest in closely

111 INT. REV. CODE OF 1954, § 303(a).
112 *Id.* § 303(b)(2).

held stocks included in the portion of the inter vivos trust over which the decedent retained a right of revocation at the time of his death. The regulations interpreting the nondividend redemption statutory language specifically provide:

> While section 303 will most frequently have application in the case where stock is redeemed from the executor or the administrator of an estate, the section is also applicable to distributions in redemption of stock included in the decedent's gross estate and held at the time of the redemption by any person who acquired the stock by any of the means comprehended by part III, subchapter A, chapter 11 of the Code, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent.[113]

The applicability of this provision to a redemption by a trustee with respect to stock included in the decedent's gross taxable estate was illustrated by the Internal Revenue Service position set forth in Revenue Ruling 69-616.[114] In this Revenue Ruling, the Internal Revenue Service stated that the number of shares of stock which be includable in the decedent's gross taxable estate because of a general power of appointment which the decedent held over a trust could be added to the number of shares of stock which the decedent owned to determine whether or not the percentile requirements were met. This aggregation was permitted even though the distribution had not been made to the trust where the number of shares to be distributed was established by a binding agreement with the Internal Revenue Service and the value of the stock to be distributed was includable in the decedent's gross taxable estate for federal estate tax purposes.

If the gross taxable estate of a decedent includes a substantial interest in a closely held business, the estate will be entitled to secure an extension of time in which to pay the estate taxes attributable to such stock of up to ten (10) years. This authority is contained in the following language:

> If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds either—
> (1) 35 percent of the value of the gross estate of such decedent, or
> (2) 50 percent of the taxable estate of such decedent,
> the executor may elect to pay part or all of the tax imposed by section 2001 in two or more (but not exceeding ten) equal installments.[115]

For purposes of this installment payment privilege, the term "interest" in a closely held business means, among other things, stock in a corporation carrying on a trade or business if the corporation has no more than ten (10) stockholders and if at least twenty per cent (20%) of the value of the voting stock in such corporation is included in determining the gross taxable estate of the decedent.[116] If the requisite percentage of qualifying shares of closely held stock is met, the

113 Treas. Reg. § 1.303-2(f).
114 1969-2 CUM. BULL. 45.
115 INT. REV. CODE OF 1954, § 6166(a).
116 *Id.* § 6166(c)(3).

privilege of installment payments will only apply to that portion of the estate taxes which bears the same ratio to the total net estate taxes as the value of the interest in the closely held business bears to the value gross estate.[117] In determining whether or not the thirty-five per cent (35%) and the fifty per cent (50%) requirements are met, the stock in two (2) closely held corporations can be combined and treated as the stock in a single closely held corporation if at least fifty per cent (50%) of the total value of each such corporation is included in determining the value of the decedent's gross estate.[118] The due date of any installment may be accelerated if money is withdrawn from the closely held business or if the interest in that business which was included in the taxable estate is sold.[119] So long as the privilege of paying installments exists, interest on the unpaid balance of the taxes will only be four per cent (4%) per year.[120]

III. Drafting Suggestions

The following provisions are included solely as illustrations of the type of provisions which may be included in a revocable inter vivos trust instrument in which the grantor will serve as cotrustee if the use of a partially irrevocable trust is contemplated. These provisions permit the partial relinquishment of a power of revocation together with all other retained rights.

Income is to be distributed to the beneficiaries, none of whom is the grantor's spouse or individuals whom the grantor is legally obligated to support. Far greater latitude would be available without causing the trust income to be attributed to the grantor if it were not contemplated that the grantor serve as cotrustee. The illustrative provisions are as follows:

A. Grantor intends, from time to time, to establish Irrevocable Separate Trusts consisting of specified percentile interests in the principal and income of the Trust Estate by irrevocably relinquishing all his rights over such percentile interest in the principal and income of the Trust Estate, including any right of revocation, alteration, amendment or termination. Grantor intends that the establishment of such Irrevocable Separate Trusts shall constitute completed gifts for Federal Income, Estate and Gift Tax purposes and that percentages thus held for each beneficiary shall constitute separate and distinct Trusts to be legally separated from the Trusts held for each other beneficiary hereunder, from the Trust being held for the Settlor, and from Trusts established in accordance with the provisions of Paragraph — hereof. (Trusts to be established on the Grantor's death.)

B. Irrevocable Separate Trusts are to be established by Grantor in accordance with the provisions of this Paragraph in the following manner:

(1) Grantor shall deliver, by registered or certified mail, to the beneficiary of any Irrevocable Separate Trust to be established a statement specifying the percentage in Grantor's Trust estate which is irrevocably established and set aside

117 *Id.* § 6166(b).
118 *Id.* § 6166(d).
119 *Id.* § 6166(h).
120 *Id.* § 6601(b).

as an Irrevocable Separate Trust for such beneficiary and indicating the effective date of such establishment.

(2) Grantor shall, upon the effective date of the establishment of each such Irrevocable Separate Trust, endorse the name and specified percentage on Exhibit [ ] attached hereto.

(3) Grantor shall, within [ ] days of the establishment of each such Irrevocable Separate Trust, deliver to the newly named beneficiary a copy of Grantor's Federal Gift Tax Return (Form 709), if any, reporting such establishment and a copy of the inventory of the Trust Estate indicating Settlor's cost basis and the fair market value of each asset listed thereon as of the date of the establishment of the Irrevocable Separate Trust.

(4) The provisions outlined above shall apply equally to an increase in the percentage of an existing beneficiary as well as the establishment of an Irrevocable Separate Trust for a new beneficiary.

C. Trustee shall continue to hold, invest and reinvest the assets of the Trust Estate as a commingled fund from and after the establishment of each Irrevocable Separate Trust in accordance with the provisions of Subparagraph B of this Paragraph. Trustee shall, however, maintain separate records reflecting that each beneficiary so designated is entitled both to receive the specified percentage of the income of the Trust Estate and to receive the specified percentage of the Trust Estate upon termination, which may be satisfied by a distribution in kind of the specified percentile interest in the assets constituting the principal of the Trust Estate, or by the distribution of an amount of money equal to the value of the specified percentage of the Trust Estate, as of the date of distribution or partially in kind and in cash. Trustee shall identify each such Irrevocable Separate Trust as the (Beneficiary's Name) Irrevocable Separate Trust and shall make periodic reports in accordance with Paragraph [ ] hereof to each such beneficiary and shall file separate income tax returns for each such Irrevocable Separate Trust.

D. Upon the establishment of any Irrevocable Separate Trust in accordance with the provisions of Subparagraph B of this Paragraph, each beneficiary so named shall be irrevocably entitled to receive the specified percentile amount of the income (a provision may be included defining "income" to include or exclude capital gains) earned from the Trust Estate and such income shall be paid annually. Each such beneficiary so named shall be irrevocably entitled to receive a distribution from the principal of the Trust Estate in an amount equal to the total percentage so designated by the Grantor to be distributed by the Trustee, outright and free from Trust, to each so-named beneficiary, per stirpes, nine (9) months after Grantor's death. Such beneficiary shall have, with respect to the requisite percentage interest in and to such income and assets, all of the rights and interest of a beneficiary in and to any Trust established and administered pursuant to the laws of the State of [ ], containing similar provisions for the payment of distribution of principal and income, subject to the spendthrift provisions contained in Subparagraph H of this Paragraph.

E. If, after the establishment of any Irrevocable Separate Trust as herein provided, Grantor makes additions to the Trust Estate, Grantor shall elect one of the following alternative procedures:

(1) Grantor may treat such addition as a completed gift to the extent of the total percentages theretofore declared to be irrevocable and shall notify the beneficiaries of the Irrevocable Separate Trusts of such addition by complying with the provisions of Subparagraph B(3) of this Paragraph with respect to such addition; or

(2) Grantor may exclude such addition from gift treatment by decreasing the specified percentile interest so that the net fair market values of the Irrevocable Separate Trusts shall be unchanged after such addition. The decrease in the specified percentile interests shall be determined by (a) computing the net fair market value of the Irrevocable Separate Trusts prior to the proposed addition and (b) the net fair market value of the proposed addition. Grantor shall then reduce the specified percentile interests constituting the Irrevocable Separate Trusts so that the reduced percentages of the augmented Trust Estate will equal the net fair market values prior to the addition determined pursuant to (a) above. Grantor shall follow the provisions of Subparagraphs B(1) and (2) of this Paragraph with respect to notification and endorsement of such reduced percentage.

F. If, after the establishment of any Irrevocable Separate Trust as herein provided, Grantor desires to withdraw assets from the Trust Estate, Grantor shall elect one of the following alternative procedures:

(1) Grantor shall substitute an asset of equal net fair market value for the asset to be withdrawn; or

(2) Grantor may affect such withdrawal without altering, revoking or otherwise changing the Irrevocable Separate Trusts heretofore established by increasing the specified percentile interests so that the net fair market value of the Irrevocable Separate Trusts shall be unchanged after such withdrawal. The increase in the specified percentile interests shall be determined by (a) computing the net fair market values of the Irrevocable Separate Trusts prior to the proposed withdrawal and (b) the net fair market value of the assets proposed to be withdrawn. Grantor shall then increase the specified percentile interests constituting the Irrevocable Separate Trusts so that the increased percentages of the depleted Trust Estate will equal the values prior to the withdrawal. Grantor shall follow the provisions of Subparagraphs B(1) and (2) of this Paragraph with respect to notification and endorsement of such increased percentage.[121]

G. Grantor intends to establish Irrevocable Separate Trusts, and upon the compliance with the provisions of Subparagraph B of this Paragraph, Settlor does hereby irrevocably give up any right in and to the income from such Irrevocable Separate Trusts, the right to designate the beneficial enjoyment or possession of the percentile interests constituting such Irrevocable Separate Trust Estates, the right to alter, amend, revoke or terminate such Irrevocable Separate Trusts and the right to secure any economic benefit from the income or percentile interests in the assets comprising the principal of such Irrevocable Separate Trust Estates.

121 Caution must be exercised with respect to permitting the grantor to withdraw assets from the partially irrevocable trust. § 675(4) provides that such a power in the grantor constitutes an "administrative power" resulting in the attribution of trust income to him if the power is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

To this end, Grantor hereby declares that, with respect to each such Irrevocable Separate Trust, he will administer this Trust in a fiduciary capacity as one of the Co-Trustees. Furthermore, notwithstanding anything to the contrary contained elsewhere in this Indenture:

(1) Trustee shall not lend any portion of such Irrevocable Separate Trust Estates to the Grantor or any corporation or any other entity or organization in which the Grantor has a substantial interest, except on adequate security and at an adequate rate of interest;

(2) Trustee shall not otherwise deal with the Grantor or any corporation or other entity or organization in which the Grantor has a substantial interest, with respect to any portion of the Irrevocable Separate Trust Estates, except for adequate consideration in money or money's worth; and

(3) Trustee shall not arbitrarily take any action which would favor one beneficiary or group of beneficiaries over any other beneficiary or group of beneficiaries.[122]

H. Notwithstanding the provisions of Paragraph [ ] hereof, each beneficiary of such Irrevocable Separate Trust shall have the personal authority to borrow on the value of such Irrevocable Separate Trust and to anticipate the ultimate distribution of such Irrevocable Separate Trust. Provided, however, such borrowing must be solely for the personal needs of each such beneficiary and provided further that any such creditor who lends on the security of such Irrevocable Separate Trust and forecloses such security shall have only the right to income from such security during the term of the Irrevocable Separate Trust specified in Subparagraph D hereof and shall have the right to receive the distribution of the principal in accordance with the provisions of Subparagraph D hereof.[123]

IV. Conclusion

Utilization of the partially irrevocable trust affords an unequaled opportunity for effective estate planning. A specified undivided percentile interest in the income and appreciation (or depreciation) in value of all of the trust assets can be removed from the grantor's taxable income and estate. Meticulous attention to the statutory provisions is essential to obtain the desired tax consequences. Closely held stock, especially after the decision of the United States Supreme Court in *Byrum*, makes a very attractive gift property to be included in such partially irrevocable trust.

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122 Adopted from 50-2nd T.M., Lifetime Transfers with Retained Powers, p. B-21.

123 This provision was included because of the decision in *Yeazel v. Coyle*, 21 Am. Fed. Tax R. 2d 1681 (N.D. Ill. 1968), excluding the value of the trust corpus from the grantor's taxable estate, in part, because the retention of dividends would increase the value of the stock which could be immediately enjoyed by the beneficiaries because of the loan provisions.