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Estate Planning

Proposed Testamentary Charitable Trust of Close Corporate Stock

Introduction

A problem area of growing importance in the field of estate planning concerns the testate disposition of stock holdings in close corporations. The solution to any particular problem in this area is necessarily dependent upon the factual situation presented and the wishes of the testator. Perhaps the most important of the many factors to be considered in drawing up an estate plan for a stockholder of a close corporation are: his duty to the other stockholders to see that his shares do not fall into unfriendly hands; his relationship to the surviving stockholders and their ability to carry on the business after his death; and the value and composition of his estate and its ability to absorb expenses and taxes without necessitating a sale of the stock.[1]

A frequently occurring situation, and the one with which this article will be concerned, may be generally described: The testator owns a substantial percentage of the shares of a close corporation, the other shareholders of which are members of his immediate family and perhaps a non-family managing associate. He is an active member of the corporation and has considerable influence in the management of its affairs. He wishes to dispose of his shares after his death in such a way that their control will remain within the family. However, he also wishes to make a gift to charity, fulfilling any charitable obligation he may have, and to lower his estate taxes by means of the charitable deduction.[2]

If the testator has a large estate other than his holdings in the corporation, he may will the shares to his family, make a charitable gift, paying the taxes and expenses of the estate out of the other assets. However, even under these circumstancs, such a plan may prove unsatisfactory because should the corporation fail to survive the loss of his managerial services, his family may be left holding worthless stock which probably had poor marketable

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1 See *Estate Planning, Interests in Close Corporations,* 1 CCH FED. EST. & GIFT TAX REP. ¶¶ 7401-7427 (1955) for a detailed discussion of estate planning problems in this field and proposed solutions.

2 INT. REV. CODE of 1954, § 2055.

qualities originally. On the other hand, should he make an outright charitable gift of such stock and the corporation continues to prosper, the benefit of the stock and its control would no longer be in the family and conceivably could fall into hostile hands. The purpose of this article is to set forth an estate plan which would overcome the difficulties met in these situations.

The plan may be described as a charitable trust of close corporate stock subject to an option given to the shareholders of the corporation to purchase such stock.[3] The stock would be the *res* of a testamentary trust under the terms of which a named charitable institution would be the beneficiary and the surviving shareholders, or any of them, or the corporation itself, would be the trustees. This trust would be made subject to an option given the surviving shareholders, or any of them, or the corporation[4] to purchase the stock within a short period of time, perhaps ten or fifteen years, at a price established by the terms of the trust. At the expiration of the option period, or at the time of exercise of the option, the trust would terminate and the *res* (the purchase price if option is exercised or the stock) would go absolutely to the charity. The benefit of the option to the family is in the right to choose to purchase if the corporation prospers.

The Trust

I. *Validity of the Trust and its Provisions*

In determining the advisability of utilizing the plan as set out above, the planner should first examine the laws of his state to determine whether or not the proposed trust or any of its provisions may be invalid.

An apparent objection to the trust is that the trustees, the surviving stockholders or the corporation which they control, are given the option to purchase the trust *res*. It is a fundamental principle of trust law that the trustee is a fiduciary and as such is under a duty to the beneficiaries of the trust to administer it

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3 For cases involving similar plans, but where the beneficiaries were not charitable, see Kitts v. Hanna, 29 F.2d 1010 (E.D. Pa.), *aff'd*, 29 F.2d 1013 (3d Cir. 1928); Rosencrans v. Fry, 12 N.J. 88, 95 A.2d 905 (1953); Robertson v. Hert's Adm'rs, 312 Ky. 405, 227 S.W.2d 899 (1950).

4 Before selecting the corporation as optionee, the planner should examine his state statutes to determine whether the corporation is prohibited from purchasing its own stock. For a state by state listing of such statutes, see 1 CCH FED. EST. & GIFT REP. ¶ 7412 (1955).

solely in their interest.[5] He will not be permitted to enter into any engagements in which he has, or can have, a personal interest conflicting with those of the beneficiary.[6] This duty precludes the trustee from selling, directly or indirectly, property of the trust to himself or to a corporation in which he has an interest.[7] He is not permitted to assume the opposing positions of seller and buyer,[8] and any such sale is voidable by the beneficiary.[9] However, in the absence of a statute or expressions of public policy to the contrary, it has been held that this prohibition is not applicable where by the terms of the trust the trustee is given the right to purchase the trust property.[10] This right need not be express but may be implied.[11] But the trustee must pay a fair price and not be guilty of bad faith.[12] This exception to the general rule prohibiting self-dealing has been recognized by the courts of Arizona, Illinois, Kentucky, Maryland, Massachusetts, Michigan, New Jersey, New York, Oklahoma, Pennsylvania and Wisconsin,[13] and by statute in Washington.[14] It is reasoned that since

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5 Chandler v. Commissioner, 119 F.2d 623 (3d Cir. 1941); Societa Operaia Di Mutuo Soccorso Villalba v. Di Maria, 40 N. J. Super. 344, 122 A.2d 897 (Ch. 1956); Manchester v. Cleveland Trust Co., 95 Ohio App. 201, 114 N.E.2d 242 (1953); RESTATEMENT, TRUSTS § 170 (1) (1935); 2 SCOTT, TRUSTS § 170 (2d ed. 1956).

6 Fidelity & Deposit Co. v. Freud, 115 Md. 29, 80 Atl. 603 (1911).

7 Daniel v. Henderson, 183 S.W.2d 242, *aff'd sub nom.*, Southern Trust & Mortgage Co. v. Daniel, 143 Tex 321, 184 S.W.2d 465 (1944); Hamrick v. Bryan, 21 F. Supp. 392 (N. D. Okla. 1937), *modified*, 106 F.2d 245 (10th Cir.), *cert. denied*, 308 U.S. 615 (1939) (dictum); 2 SCOTT, TRUSTS §§ 170.1, 170.10 (2d ed. 1956).

8 Michoud v. Girod, 45 U.S. (4 How.) 502, 555 (1846).

9 Michoud v. Girod, *supra* note 8; 2 SCOTT, TRUSTS § 170.1 (2d ed. 1956). It makes no difference whether or not the trustee acted in good faith and paid a fair price.

10 Robertson v. Hert's Adm'rs, 312 Ky. 405, 227 S.W.2d 899 (1950); *In re* Balfe's Will, 245 App. Div. 22, 280 N.Y. Supp. 128 (Sup. Ct. 1935); RESTATEMENT, TRUSTS § 170 (1), comment *s* (1935); 2 SCOTT, TRUSTS § 170.9 (2d ed. 1956).

11 Rosencrans v. Fry, 12 N.J. 88, 95 A.2d 905 (1953); *In re* Flagg's Estate, 365 Pa. 82, 73 A.2d 411 (1950); *In re* Schuster's Estate, 35 Ariz. 457, 281 Pac. 38 (1929). *But see, In re* Durston's Will, 297 N.Y. 64, 74 N.E.2d 310, 313 (1947), where it was held that the words "with all the authority, and powers in connection with the same, I would possess, if living" were not sufficient to authorize self-dealing.

12 See note 10 *supra*.

13 Arizona: *In re* Schuster's Estate, 35 Ariz. 457, 281 Pac. 38 (1929). Illinois: Morris v. The Broadview, Inc., 328 Ill. App. 267, 65 N.E.2d 605 (1946). Kinney v. Lindgren, 373 Ill. 415, 26 N.E.2d 471, 474 (1940) (dictum). Kentucky: Robertson v. Hert's Adm'rs, 312 Ky. 405, 227 S.W.2d 899 (1950). Maryland: Turk v. Grossman, 176 Md. 644, 6 A.2d 639 (1939); Harlan v. Lee, 174 Md.

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the settlor has the power to dispose of his property in any manner and under any conditions he may choose, provided he violates no principle of public policy, he may, incident to the administration of his property, place the trustee in a position of conflicting interest.[15] The beneficiary should not be heard to complain for he receives all that was intended to be given him.

Also, if the conditions of the sale and the purchase price are set by the trust instrument, it cannot be said that the trustee occupies the conflicting roles of seller and buyer, for in fact, the settlor is the seller. Therefore, where the trust instrument had set the price as the value of the property for federal estate tax purposes[16] or geared it to the inventory value of the business,[17] the sale has been upheld. Even where the trustee himself was authorized to determine the price, the sale has been held valid provided the price was fair.[18]

The rule prohibiting self-dealing is stated to be based upon strong public policy. From this it may be argued that any provision in the trust permitting such is void as contrary to this policy. However, even those courts which describe the rule as uncompromisingly rigid,[19] absolute,[20] stubborn and inflexible,[21]

579, 199 Atl. 862 (1938). Massachusetts: Boston Safe Deposit & Trust Co. v. Lewis, 317 Mass. 137, 57 N.E.2d 638 (1944); *See* MASS. ANN. LAWS c. 203, § 16 (1955). Michigan: Waddell v. Waddell, 335 Mich. 498, 56 N.W.2d 257 (1953). *But see,* MICH. COMP. LAWS § 709.27 (1948). New Jersey: Rosencrans v. Fry, 12 N.J. 88, 95 A.2d 905 (1953). New York: *In re* Durston's Will, 297 N.Y. 64, 74 N.E.2d 310 (1947); Heyman v. Heyman, 33 N.Y.S.2d 235 (Sup. Ct. 1942). Oklahoma: Finley v. Exchange Trust Co., 183 Okla. 167, 80 P.2d 296 (1938). *But see,* OKLA. STAT. ANN. tit. 60, §§ 175.11, 175.21, 175.22 (1949) which prohibits a corporate trustee from purchasing trust property even when authorized to do so by the terms of the trust. Pennsylvania: *In re* Flagg's Estate, 365 Pa. 82, 73 A.2d 411 (1950); PA. STAT. ANN. tit. 20, § 320.966 (Purdon 1950). Wisconsin: Welch v. Welch, 235 Wis. 282, 290 N.W. 758, *mandate modified,* 235 Wis. 282, 293 N.W. 150 (1940).

14 WASH. REV. CODE § 30.24.090 (1955). Statutes of Florida and Connecticut indicate that the exception may be recognized there. FLA. STAT. ANN. § 733.22 (1944); CONN. GEN. STAT. §§ 7021, 7028 (1949).

15 *In re* Flagg's Estate, 365 Pa. 82, 73 A.2d 411 (1950).

16 Robertson v. Hert's Adm'rs, 312 Ky. 405, 227 S.W.2d 899 (1950).

17 Waddell v. Waddell, 335 Mich. 498, 56 N.W.2d 257 (1953).

18 Boston Safe Deposit & Trust Co. v. Lewis, 317 Mass. 137, 57 N.E.2d 638 (1944).

19 Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 546 (1928).

20 Dufford v. Nowakoski, 125 N. J. Eq. 262, 4 A.2d 314, 317 (Ct. Err. & App. 1939).

21 Lawndale Nat'l Bank v. Kaspar American State Bank, 288 Ill. App. 555, 6 N.E.2d 670, 672 (1937).

recognize the above exception.[22] Also, it may be contended that the policy that a fiduciary shall not be permitted to purchase is expressed in the statutory provision in force in many states that "an executor or administrator shall not . . . purchase any property of the estate he represents. . . ."[23] But, the terms "administrator" and "executor" are technical and should not be held to include trustees. The Arizona Supreme Court did not apply their statute to a trustee's purchase,[24] and the courts of Michigan and Pennsylvania have indicated that such prohibition, though stated in mandatory terms, does not apply to an executor's purchase which was authorized by the terms of the will.[25] However, it should be noted that several state statutes use the word "fiduciary" and it may be that under these statutes the option would be held void.[26] At any rate, the argument would be stronger.

It is clear that in some states the option provision of the trust is expressly outlawed by statute. The UNIFORM TRUSTS ACT,[27] which has been adopted verbatim or with minor changes and omissions in Louisiana, Nevada, New Mexico, North Carolina, Oklahoma, South Dakota and Texas,[28] provides in section 5:

> No trustee shall directly or indirectly buy or sell any property for the trust from or to itself or an affiliate; or from or to a director,

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22 See cases listed under note 13 *supra.*

23 ALASKA COMP. LAWS ANN. § 61-14-26 (1949); ARIZ. REV. STAT. ANN. § 14-604 (West 1956); IDAHO CODE ANN. 742 § 15-742 (1948); MONT. REV. CODES ANN. § 91-3039 (1947); N. D. REV. CODE § 30-1927 (1943); TEX. PROB. CODE § 352 (1956); UTAH CODE ANN. § 75-10-6 (1953). This provision is said to be but a declaration of the fundamental principle of trusteeship which prohibits trustees from dealing with the subject matter of their trusts in any way which may inure to their personal benefit. Bruun v. Hanson, 103 F.2d 685 (9th Cir.), *cert. denied,* 308 U.S. 571 (1939); Haight v. Pearson, 11 Utah 51, 39 Pac. 479 (1895).

24 *In re* Schuster's Estate, 35 Ariz. 457, 281 Pac. 38 (1929).

25 Curtis v. Brewer, 140 Mich. 139, 103 N.W. 579 (1905); *In re* Wallace's Estate, 299 Pa. 333, 149 Atl. 473, 475 (1930) (dictum).

26 KAN. GEN. STAT. ANN. § 59-1703 (1949); MICH. COMP. LAWS § 709.27 (1948); MISS. CODE ANN. § 619 (1942). The Michigan statute states that such sales shall be void but the courts permit the trustee to purchase when authorized to do so by the terms of the trust. Waddell v. Waddell, 335 Mich. 498, 56 N.W.2d 257 (1953).

27 One of the purposes of this act is to clarify and tighten the rules regarding loyalty by a trustee to the interests of his beneficiary. Commissioners' Prefatory Note, 9A UNIFORM LAWS ANN. 333 (1951).

28 LA. REV. STAT. ANN. §§ 9:1791-9:2212 (West 1950); NEV. COMP. LAWS §§ 7718.30-7718.52 (Supp. 1941); N. M. STAT. ANN. §§ 33-3-1 — 33-3-22 (1953); N. C. GEN. STAT. §§ 36-24 — 36-46 (1950); OKLA. STAT. ANN. tit. 60, §§ 175.1 — 175.53 (1949); S. D. CODE §§ 59.0501 — 59.0924 (Supp. 1952); TEX. REV. CIV. STAT. ANN. art. 7425b-1 — 7425b-47 (1951).

> officer, or employee of such trustee or of an affiliate; or from or to a relative, employer, partner, or other business associate.

This language clearly includes corporate as well as individual trustees. By virtue of sections 17 and 18, the settlor and the beneficiaries are expressly denied the power to relieve the trustee of this restriction.[29] In Texas and Oklahoma this power is denied only where the trustee is a corporation.[30] Under an Ohio statute[31] a corporate trustee may never purchase, and an individual trustee only when permission is granted by the probate court. In California and North Dakota it appears that a purchase under the option would be valid only if all the beneficiaries having capacity to contract are fully informed of the facts and consent and the proper court grants permission in behalf of those lacking such capacity.[32] Presumably, a testator could safely use the proposed plan in these two states if he notifies his chosen charitable beneficiary of his intentions, fully informs it of the trust provisions and all other pertinent facts and then contracts with it that should he name it beneficiary it will consent to the trustee's purchase of the stock.

In those states where the option would be held invalid because of the conflict of interests, substantially the same result as that of the trust plan may be obtained by bequeathing the stock to the charitable institution subject to an option given the surviving shareholders, or any of them, or to the corporation to purchase within a period and at a price set by the will. The major difference under this plan is that the charity will have the right to vote the stock until the option is exercised. Unless this could upset the family's control of the corporation, it should not prove objectionable. The only possible legal objection to such a gift is that the option constitutes a restraint upon alienation. However, if it is a restraint at all,[33] it would merely be an indirect

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29 Section 17. ". . . but no act of the settlor shall relieve a trustee from the duties, restrictions, and liabilities imposed upon him by Sections 3, 4 and 5 of this Act."
Section 18. "Any beneficiary . . . may . . . relieve the trustee . . . from any or all of the duties, restrictions, and liabilities . . . imposed on the trustee . . . except as to [those] imposed by Sections 3, 4 and 5 of this Act."

30 OKLA. STAT. ANN. tit. 60, §§ 175.21, 175.22 (1949); TEX. REV. CIV. STAT. ANN. art. 7425b-22, 7425b-23 (1951). ". . . no act . . . shall relieve a *corporate trustee. . . .*" (Emphasis added.)

31 OHIO REV. CODE ANN. § 2109.44 (Page 1954).

32 CAL. CIV. CODE ANN. § 2230 (West 1954); N. D. REV. CODE § 59-0111 (1943).

33 See *In re* Remensnyder's Estate, 267 Pa. 348, 110 Atl. 244 (1920), where
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and partial one.[34] Such restraints are upheld where reasonable.[35] In view of the nature of the corporation and the duration of the option provision, the restraint in this situation clearly appears to be reasonable. The UNIFORM STOCK TRANSFER ACT, which has been adopted by all the states, provides that no restriction upon the transfer of the shares shall be enforceable unless the restriction is stated upon the certificate.[36] Therefore, if this plan is adopted, it would be advisable to have the provisions of the option printed upon the stock certificates.

It may appear that another way to circumvent the prohibition against the trustee purchasing the trust property is to make the corporation the trustee and the shareholders the optionees, or vice versa. But, the trustee's duty of loyalty also precludes him from selling to a corporation in which he has a substantial interest,[37] and in the case of a corporate trustee, from selling to one who exercises control over its operations.[38] Even though this arrangement may not fall under the specific prohibition of the state statute, the courts would probably disregard the corporate entity and hold that the trustee and optionee were the same persons.[39]

II. Selecting The Trustee

Because the trustee under the proposed plan will have the power to exercise the voting rights of the stock placed in trust, the testator should select as trustee one whose interest or ideas of management will least conflict with those of the surviving

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in a bequest of corporate stock in trust, a proviso was upheld which stated that before the stock was sold, it should first be offered to a named person at book value. The lower court stated: "There is a marked distinction between a restraint against alienation and a gift with a condition annexed, one implies a violation of, and the other a compliance with, the policy of the law. . . ." 110 Atl. at 244.

34 In our case the stock could always be sold by the charity, but subject to the option.

35 4 THOMPSON, REAL PROPERTY § 2083 (1940).

36 UNIFORM STOCK TRANSFER ACT § 15. For a listing of the state statutes, see 6 UNIFORM LAWS ANN. 6 (Supp. 1956).

37 See note 7 *supra.*

38 Purchase v. Atlantic Safe Deposit & Trust Co., 81 N. J. Eq. 344, 87 Atl. 444 (Ch. 1912), *aff'd mem.,* 81 N. J. Eq. 353, 91 Atl. 1070 (Ct. Err. & App. 1914); H. B. Cartwright & Bros. v. United States Bank & Trust Co., 23 N. M. 82, 167 Pac. 436 (1917). 2 SCOTT, TRUSTS § 170.11 (2d ed. 1956).

39 Mosher v. Lee, 32 Ariz. 560, 261 Pac. 35 (1927); Horowitz, *Disregarding the Entity of Private Corporations,* 15 WASH. L. REV. 1 (1940).

stockholders. The greater the voting powers of the trust shares, the more important this factor becomes. Therefore, if the laws of the state and the policy against self-dealing permit, in order to avoid any such conflict it is advisable that the surviving stockholders or the corporation which they control be named trustee.

The testator should be careful to select a person whom he knows has capacity to take title to the property by will, to retain such title, and to administer the trust. This is important because although the trust will not fail if the named trustee lacks one of the above capacities,[40] the testator has no assurance that the court will select a replacement who would not create friction within the family corporation. In most cases a natural person who is of age and capable of manging his own property can safely be named as trustee. In most states a private corporation cannot take property by will unless expressly authorized to do so by its charter or statute.[41] A corporation cannot engage in administering a trust unless it is similarly authorized or if the purposes of such trust are germane to the purpose for which it was created.[42] However, in the majority of cases, it would seem that the purposes of a charitable trust would not be germane to those of a private close corporation.

The rule stated above that a trust will not fail for the want of a trustee is not applicable where the testator manifests an intention that the existence of the trust be dependent upon its administration by the particular person named by him as trustee. Here the entire trust will fall if the named individual dies or is incapable of administering the trust.[43] Under the facts of the proposed plan, a court could conceivably find either way. Therefore, the testator should provide in his will whether or not he wishes the trust to fall should the named trustee fail to qualify. His de-

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40 Equity will not permit a trust to fail for want of a trustee, as the court will appoint one if necessary. *In re* Barter's Estate, 30 Cal.2d 549, 184 P.2d 305 (1947); Hoeffer v. Clogan, 171 Ill. 462, 49 N.E. 527 (1898).

41 See, *e.g.*, CAL. PROB. CODE ANN. § 27 (West 1956); N. D. REV. CODE § 56-0205 (1943); OKLA. STAT. ANN. tit. 84, § 45 (1951); S. D. CODE § 56.0205 (1939). In California, a corporation ineligible under the statute to take a testamentary bequest for its own benefit may nevertheless receive, as trustee, a bequest for a charitable purpose. See *In re* Tarrant's Estate, 38 Cal.2d 42 237 P.2d 505 (1951).

42 Hossack v. Ottawa Development Ass'n, 244 Ill. 274, 91 N.E. 439 (1910); Thomas v. General Bd. of Church of Nazarene, 76 R.I. 197, 68 A.2d 66 (1949); Latshaw v. Western Townsite Co., 91 Wash. 575, 158 Pac. 248 (1916).

43 South End Bank & Trust Co. v. Hurwitz, 128 Conn. 204, 21 A.2d 407 (1941); Hentschell v. Fidelity & Deposit Co., 87 F.2d 833 (8th Cir. 1937) (dictum).

cision will necessarily depend upon the relative importance he places upon who will possess the voting power of the stock as against the other advantages of the plan.

III. Selecting the Charitable Beneficiary

The testator in drawing up his estate plan may either designate a specific charitable institution as beneficiary or direct the trustees to make the selection. If he plans to designate a specific institution, he should first check to see if it would be recognized under federal tax law[44] as being charitable. If it would not, no charitable deduction from his gross estate would obtain for estate tax purposes. Secondly, since the gift will not be made until he dies, he should contact the intended beneficiary to determine whether or not it would accept the gift, for if after his death it should refuse to accept, the trust would fail for lack of a beneficiary and the corpus (the stock) would revert back to his estate. His entire plan would fail. In order to avoid such a result, the testator, if at all possible, should also contract with the intended beneficiary to the effect that should he name it beneficiary, it would accept the gift.

Although there seems to be no case concerning such a contract, it should be specifically enforceable on general equity principles. In effect it is an option contract; if the testator chooses to exercise the option and make a gift, the charitable institution is bound to accept. Option contracts, though lacking in mutuality, have been held to be specifically enforceable where the remedy at law is inadequate.[45] Certainly in this case there is no adequate legal remedy. Money damages would be practically impossible to determine. On one hand the testator's estate taxes would be increased but on the other, his estate would have the stock. Another factor to be considered is that by the gift the testator also wished to fulfill his charitable obligations. Since he is now dead, he cannot make another gift. It may be argued that this is purely a matter of sentiment, but such are recognized in equity. An heirloom may be of a common class and a duplicate easily obtainable but, due to the sentimental value attached, equity will grant relief in proper cases.[46] The contract should be for a separate

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[44] INT. REV. CODE of 1954 § 2055.

[45] FRY, SPECIFIC PERFORMANCE OF CONTRACTS § 291 (2d Am. ed. 1871); POMEROY, SPECIFIC PERFORMANCE OF CONTRACTS § 169 (3d ed. 1926); CLARK, EQUITY § 178 (1954); 2 BEVERIDGE, LAW OF FEDERAL ESTATE TAXATION § 19.17 (1956).

[46] Marthinson v. King, 150 Fed. 48, 52 (5th Cir. 1906) (dictum); Carolee v. Handelis, 103 Ga. 299, 29 S.E. 935, 937 (1898) (dictum); Adams v. Messenger, 147 Mass. 185, 17 N.E. 491, 495 (1888) (dictum).

consideration to make it binding, and in writing, to avoid any difficulty with the statute of frauds. The terms and conditions of the intended gift should be incorporated in the contract to make it certain and complete, for the court may have to decide just what the defendant must do.[47]

Even should the testator enter the contract as outlined, many events may occur between the time of its making and the death of the testator which would make it impossible or highly inequitable to enforce it. Since the testator cannot foresee such events, he should in addition to naming the beneficiary, provide that should the gift fail, the trustees are to select a beneficiary recognized as charitable under the estate tax law. This way the trust would not fail for want of a beneficiary.

Estate Tax Consequences

Because death may involve the payment of substantial federal estate taxes, the tax consequences of any estate plan must be considered. The estate tax problem which the proposed estate plan presents is the realization of the maximum deduction for the gift to charity.[48]

I. Requirements for Deductibility of Charitable Gifts

In seeking a charitable deduction under the federal estate tax for any gift by testamentary disposition, several general principles must be considered. The charitable deduction is to be allowed only for a gift to a qualified charity.[49] The gift must be clearly

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[47] Colson v. Thompson, 15 U.S. (2 Wheat.) 336 (1817); Ginsburg v. White, 139 N. J. Eq. 271, 50 A.2d 644 (Ct. Err. & App. 1947); FRY, SPECIFIC PERFORMANCE OF CONTRACTS § 229 (2d Am. ed. 1871).

[48] INT. REV. CODE OF 1954, § 2055 provides:

"(a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises or transfers . . .

". . . .

"(2) to or for the use of any corporation organized exclusively for . . . charitable . . . purposes . . .

"(3) to a trustee or trustees . . ., but only if such contributions or gifts are to be used by such trustee or trustees, . . . exclusively for . . . charitable . . . purposes. . . ."

[49] The purposes which will qualify a corporation, association, or trust under § 2055 as charitable is a problem not within the scope of this note. See LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 351-52 (1956).

ascertainable at the time of the testator's death with the possibility of the gift being diverted to someone other than a charity being "negligible" or "highly improbable."[50] The value of a gift of property to charity cannot depend upon any subsequently occurring events which are speculative in nature.[51]

Under the proposed plan the value of the gift to charity is definite at the testator's death as the value can never be more than the option price. This is the necessary result for if the value of the stock were to go higher than the option price it is assumed the optionee will purchase; the proceeds will then be given to charity and the trust terminated.

If the gift to the charitable trust is void under the law of the jurisdiction in which the estate is to be probated, a charitable deduction will not be allowed even though the heirs convey the intended bequest to the charity named in the will.[52] However, if the bequest is held to be voidable and the persons having the right to avoid the gift fail to do so, and the gift goes to charity, a deduction for a charitable gift will be allowed the estate.[53]

If the testator has a particular charity or charities in mind at the time the will is executed, they should be explicitly mentioned in the will in order to prevent lawsuits.[54] Should the testator provide for a selection of the beneficiary by the trustee, the trust instrument must bind the trustee to choose a qualified charity and to use the proceeds of the trust exclusively for charitable purposes.[55] If the trustee is granted the discretionary

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50 Commissioner v. Sternberger's Estate, 348 U.S. 187 (1955); Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595 (1949). See Cohen, *Means and Methods of Making Charitable Contributions Under the Internal Revenue Code of 1954,* 3 St. Louis U.L.J. 117, 130 (1954).

51 Merchants Nat'l Bank v. Commissioner, 320 U.S. 256 (1943); Humes v. United States, 276 U.S. 487 (1928); Industrial Trust Co. v. Commissioner, 151 F.2d 592 (1st Cir. 1945), *cert. denied,* 327 U.S. 788 (1946); St. Louis Union Trust Co. v. Burnet, 59 F.2d 922 (8th Cir. 1932).

52 William A. Carey, 9 T.C. 1047 (1947), *aff'd per curiam sub nom.,* Marine Nat'l Bank of Erie v. Commissioner, 168 F.2d 400 (3d Cir. 1948); Valentine Janson, 3 B.T.A. 296 (1926).

53 Nicholas Murray Butler, 18 T.C. 914 (1952); Melusina H. Varick, 10 T.C. 318 (1948).

54 Turk, *Estate Planning Suggestions — Deductions,* 94 Trusts and Estates 225 (1955).

55 Int. Rev. Code of 1954 § 2055 (a) (3). There is a conflict as to whether the charitable deduction will be allowed only when the terms of the will clearly indicate that the proceeds of the *res* shall go to a charitable beneficiary, or whether upon the finding of a constructive trust, the court will allow the charitable deduction. *Compare* Delaney v. Gardner, 204 F.2d 855 (1st Cir. 1953), *with* Marine Midland Trust Co. v. McGowan, 223 F.2d 408 (2d Cir. 1955).

power to give the bequest either to a charitable or a non-charitable beneficiary, a deduction will be refused because it is not certain the charity will receive the bequest when the testator dies.[56] If the gift is made in this way it is considered the act of the trustee or administrator and not of the testator.[57]

The amount of any charitable deduction for any gift of property is limited to the valuation of the same property when included in the testator's gross estate.[58] The proposed estate plan presumes that it is the testator's intent that the person buying the stock from the charitable trust will pay a fair value for it and that the testator has no intention of making a disguised bequest to the party purchasing the stock or of obtaining an unduly low valuation to minimize his estate tax.[59] The solution to the problem depends on a determination of a method whereby the value of the stock when included in the gross estate is the same as that which the charity is assured of receiving. It is therefore submitted that the proposed stock purchase agreement will be the best method, as restrictive stock option agreements have been held to be determinative of the value of the stock to be included in the gross estate.[60]

II. Restrictive Stock Option as Limiting the Value of the Stock

The use of this type of agreement to establish the value of the stock normally results in a lower valuation of the stock than if the value were left to be determined by the valuation experts

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56 In Norris v. Commissioner, 134 F.2d 796 (7th Cir.), *cert. denied,* 320 U.S. 756 (1943), under the state law, the will created a "precatory" trust —thus the trustee was under no obligation to make the gift to charity. See Delbridge v. United States, 89 F. Supp. 845 (E.D. Mich. 1950).

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

58 "This carries out the very reasonable purpose not to permit deductions for items which are not included in the gross estate." 2 BEVERIDGE, LAW OF FEDERAL ESTATE TAXATION § 15.01 (1956).

59 One author points out that this might be the crux of the decision should the question come before any of the circuit courts except that of the Second Circuit. Pavenstedt, *The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation,* 51 MICH. L. REV. 1, 28 (1952).

60 May v. McGowan, 194 F.2d 396 (2d Cir. 1952). That case reaffirms in general the earlier authorities of Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932) and Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936). Only the stock covered by the agreement will be free from outside valuation. Friedman, *Buy and Sell Agreements: A Review and a New Look,* N.Y.U. 15TH INST. ON FED. TAX. 1053, 1071 (1957).

of the Internal Revenue Service.[61]

Whether or not the stock option agreement establishes the value of the testator's stock for estate tax purposes depends on the facts of each case and whether or not the agreement is merely a disguised bequest.[62]

The restrictive stock agreement must meet certain requirements in order to effectively limit valuation.[63] The option to purchase stock must be more than an offer; at least, it must be a binding agreement as determined by the laws of the particular state.[64] In order to make it binding, the first requisite is that there be sufficient consideration for the agreement.[65] It is the binding nature of the option which permits use of the restrictive stock agreement for valuation purposes. The courts consider these agreements valid in establishing the stock's value because they provide for the maximum value of the stock at the testator's death.[66] Without consideration, the estate would not be bound

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61 In a recent survey of cases involving the valuation of stock of a close corporation for federal estate taxation, it was found that out of 148 cases the executor's valuation of the stock was sustained in only 20. Although this result is tempered by the fact that some of the differences were not excessive, there were enough large tax deficiencies to make this an important problem when formulating a plan for an estate which will include close corporation stock. The possibility that the executor's valuation of the stock will be upheld has become much less probable in recent years as the courts have sustained the executor's valuation in only four cases since 1945. Pavenstedt, *supra* note 59, at 4-6.

62 Rev. Rul. 54-77, 1954-1 CUM. BULL. 187, at 193-94.

> ". . . [W]hile a bona fide contract, based upon adequate consideration, to sell property for less than its value may fix the value of the property for the purposes of the estate tax, a mere gratuitous promise to permit some favored individual, particularly the natural object of the bounty of the promissor, to purchase it at a grossly inadequate price can have no such effect." Claire Giannini Hoffman, 2 T.C. 1160, 1179 (1943), *aff'd sub nom.*, Giannini v. Commissioner, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945).

63 If this type of agreement is drawn up, the importance of complying with the established requirements cannot be over-emphasized because of the danger of paying tax for more than the stock is worth to the estate. BOWE, TAX PLANNING FOR ESTATES 90-91 (1955 Revision).

64 Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); see LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 539-40 (1956).

65 Armstrong's Estate v. Commissioner, 146 F.2d 457 (7th Cir. 1944); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Claire Giannini Hoffman, 2 T.C. 1160 (1943), *aff'd sub nom.*, Giannini v. Commissioner, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945).

66 Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Lionel Weil, 22 T.C. 1267 (1954); Albert L. Salt, 17 T.C. 92 (1951); Dupee, *Some Tax Problems in Connection With Buy and Sell Agreements Involving Corporate Stock*, 44 ILL. BAR J. 800 (1956).

and it could sell for a higher price than that called for by the option agreement.[67] Under the proposed plan, an agreement in which all the individual stockholders would have the same rights to purchase from each other in case any one of them should die might well be sufficient to show consideration.[68]

Secondly, the agreement must be bona fide and made at arm's-length.[69] This problem usually comes up where the parties are of the same family. In these situations the agreement is scrutinized to ascertain the presence or absence of arm's-length dealing.[70] Where a father and his son were on unfriendly terms and the father employed a stock option agreement with his son as a means of inducing him to remain in the family business, it was held that the agreement was a bona fide business transaction.[71]

The facts of the situation under discussion do not present a serious problem with regard to good faith and arm's-length dealing. This is because the valuation for inclusion purposes is the same valuation to be used for the purposes of a charitable deduction. Also the rights of a third party (the charity), not a member of the testator's family, are involved. These facts alone should dispel any suspicion of fictitious dealing.

A third requirement of the testator's stock option plan is that, not only must his estate be bound to sell the stock at the option price but, the testator, while living, must also be bound to sell, if at all, at such price.[72] This appears to be a sound principle in that any agreement binding only on the event of death clearly

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67 See Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Michigan Trust Co., 27 B.T.A. 556 (1933).

68 In Brodrick v. Gore, *supra* note 67, a state court had decided that the agreement was binding on the executor; see John Q. Strange, P-H 1942 T.C. Mem. Dec. ¶42247.

"Generally, the mutual promises of the parties in an 'arm's length' cross-purchase transaction provide the required consideration, since the parties do not know who will die first." Friedman, *Buy and Sell Agreements: A Review and a New Look,* N.Y.U. 15TH INST. ON FED. TAX. 1053, 1072 (1957).

69 Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); Edwin R. Armstrong, P-H 1944 T.C. Mem. Dec. ¶44023, *aff'd,* 146 F.2d 457 (7th Cir. 1944); McKinney, *Some Income Tax Problems of Partners and Death Problems of Partners and Owners of Close Corporation Stock,* 4 AM. U. TAX. INST. LECTURES 109, 137 (1952).

70 Commissioner v. Bensel, *supra* note 69; John Q. Strange, P-H 1942 T.C. Mem. Dec. ¶42247; Prop. Est. Tax Reg. § 20.2031-2 (h), 21 FED. REG. 7867 (1956).

71 Commissioner v. Bensel, *supra* note 69.

72 Baltimore Nat'l Bank v. United States, 136 F. Supp. 642 (D. Md. 1955); Harry W. Hammond, P-H 1954 T.C. Mem. Dec. ¶54271; Prop. Est. Tax Reg. § 20.2031-2 (h), 21 FED. REG. 7867 (1956).

does not measure the extent of the value of the property held by the testator at time of death.[73] This requirement may be satisfied if the testator and the optionee under the trust agree that if either should desire to sell his stock while living, he must sell to the other at the option price and that the other will be bound to purchase at such price when the stock is offered. The option must also be made available to the optionee for a period of time after the testator's death and the trustee must be bound under the trust instrument to sell to the optionee at the option price should the optionee wish to exercise his option. It is submitted that, under this type of agreement, the option price would limit the stock valuation for inclusion in the gross estate and would also limit the amount of the charitable deduction.

The restrictive option plans must stipulate the price at which the stock is to be sold or provide some method of determining the price.[74] Although the price is given in the agreement, the determination of whether it is a fair price and not merely a vehicle for a disguised bequest is to be made as of the date of the agreement, not the date of valuation for purposes of inclusion in the gross estate.[75]

Conclusion

The discussion of the trust and estate tax principles in this note was necessarily limited to the factual situation presented in the introduction. However, the basic pattern of an estate plan which features a gift subject to an option may be successfully employed in many diverse close corporate situations. Through the use of the plan set forth, the testator maximizes the probability of realizing his interests. Control of the stock remains in the family, the charitable obligation is fulfilled, and the estate taxes are lowered; should the corporation continue to prosper, the family can obtain outright ownership of the shares of stock; if the corporation is not successful, the family may step out of the picture by merely declining to exercise the option.

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73 Claire Giannini Hoffman, 2 T.C. 1160 (1943), *aff'd sub nom.*, Giannini v. Commissioner, 148 F.2d 285 (9th Cir.), *cert. denied,* 326 U.S. 730 (1945). The restrictions, if imposed only upon the death of the owner, do not limit the value of the stock because it "did not become effective until the decedent's death and did not affect its value until after his death." James H. Matthews, 3 T.C. 525 at 528 (1944).

74 2 BEVERIDGE, LAW OF FEDERAL ESTATE TAXATION § 19.17 (1956).

75 George Saxe McDonald, P-H 1951 T.C. Mem. Dec. ¶51326; LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 535 (1956).

The always-present spectre of possible litigation, with its attendant expenses and delays, should be enough to put the planner on guard in his draftmanship. However, the use of the charitable trust and stock option plan particularly calls for care on two key points: (1) the plan should be drawn so that it is not self-invalidating under trust law because it fails to avoid divided loyalty; (2) the option contract must be entered into, for sufficient consideration, during the life of the testator, in order that the option price be acceptable as the value of the gift for purposes of federal estate tax valuation. The United States Supreme Court has not ruled on the effect of the restrictive stock option agreement on estate tax valuation,[76] but the validity of the price limitation for tax purposes has been upheld in the lower courts. It is in the use of this limitation that the conditions, discussed above, have been imposed.

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[76] Pavenstedt, *The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation*, 51 MICH. L. REV. 1, 18 (1952).