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Article 8-A of the Personal Property Law--Its Utility in View of Recent Developments

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LEGISLATION

Article 8-A of the Personal Property Law—Its Utility in View of Recent Developments

General Background

Any evaluation of Article 8-A [1] of the Personal Property Law must consider the statute in relation to its purpose—to provide a simple and effective means of making gifts of securities to minors.[2] Prior to the passage of Article 8-A, which was derived from a Model Act sponsored by the New York Stock Exchange Firms,[3] a donor who neglected to set up a trust or a legal guardianship to manage the securities transferred, but instead managed them without such legal sanction, was subject to liability for losses incurred.[4] In addition, third parties, *e.g.*, purchasers and transfer agents, dealing in stocks owned by a minor, could also be held liable if the minor exercised his right to disaffirm.[5] Moreover, resort to either a legal guardianship [6]

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[1] N.Y. Pers. Prop. Law §§ 265-70.

[2] See *In re* Bushing's Custodian, 167 N.Y.S.2d 132, 134 (Surr. Ct. 1957), where the court said: "The Model Act was intended to provide a simple and inexpensive method for making gifts of securities to minors without the necessity of resorting to trusts and formal guardianships."

[3] Association of Stock Exchange Firms, Gifts of Securities or Money to Minor Children 3 (1956).

[4] As a general rule, a legally appointed guardian, bonded and qualified, can safely handle most of the minor's property. If one assumes to act as a guardian without authority, the infant can elect to regard him as a wrongdoer. Sherman v. Ballou, 8 Cow. 304 (N.Y. 1828). For the New York statutory provisions on guardians, see N.Y. Dom. Rel. Law §§ 980-85; N.Y. Surr. Ct. Act §§ 172-94. See Beveridge, Federal Gift Taxation § 13.01, at 237 (1958); Rogers, *Some Practical Considerations in Gifts to Minors*, 20 Fordham L. Rev. 233, 240 (1951).

[5] See Matter of Goodchild, 160 Misc. 738 (Surr. Ct. 1936), where a third party who purchased stock in good faith for value, from one purporting to act for an infant, was held liable for the value of the securities in a suit by the infant. See also Casey v. Kastel, 237 N.Y. 305, 142 N.E. 671 (1924), where an infant plaintiff was permitted to recover on a theory of conversion against a transferee to whom she indorsed the certificates in blank and later disaffirmed. A broker was also held liable for ". . . meddling with and selling the property of another . . . depriving her permanently of all rights therein." *Id.* at 312, 142 N.E. at 675.

[6] The disadvantages of a guardianship include the expense of a surety bond to the extent of the minor's property managed by him. N.Y. Surr. Ct. Act § 180. There is also the requirement of an annual accounting. N.Y. Surr. Ct. Act § 190. However, under both sections a simple procedure may be followed in the discretion of the surrogate if the value of the property does not exceed $10,000. For a discussion of other expenses and disadvantages, see Browning, *Gifts to Minors*, 27 Conn. B.J. 407 (1953). See also N.Y. Surr. Ct. Act §§ 172-94.

or a trust device[7] was expensive and cumbersome, and hence not a feasible way of making small gifts. The trust had the added difficulty of determining if the transfer was eligible for a gift tax exclusion[8] as a gift of a present interest.[9] The factors creating eligibility for the gift tax exclusion could render the trust income taxable to the donor.[10]

A gift of securities pursuant to Article 8-A is deemed irrevocable and vests indefeasible legal title to the securities in the minor; no guardian has any powers over them unless he is also the custodian.[11] The custodian has complete discretion over the application of the income or principal of the custodial property for the support, maintenance, education and benefit of the minor.[12] The undistributed income or principal is payable to the minor when he reaches twenty-one, or to his estate if he sooner dies.[13]

In dealing with the custodian, a person is not required to inquire into his authority unless actual knowledge that the designated custodian is breaching an obligation in making the transfer exists or unless he has in his possession facts which would render his actions tantamount to bad faith.[14] The rules applicable to permissible investments by fiduciaries are not applicable to the custodian,[15] who is given broad powers in the management of the property. A non-compensated custodian can only be liable for losses resulting from

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[7] A trust has the disadvantage that it usually requires the expense of attorney fees. Moreover, even where the powers given to the trustee by the trust agreement are broad, he is subject to state laws on permissible investments by fiduciaries and hence will often seek the advice of a court before acting. BEVERIDGE, FEDERAL GIFT TAXATION § 13.02, at 245 (1958). In addition, care must be taken in framing the trust agreement so as not to render income from the gift taxable to the donor under Sections 671-78 of the Internal Revenue Code of 1954, providing for taxing the donor on the income where certain powers over the property transferred are retained. See SURREY AND WARREN, FEDERAL INCOME TAXATION 829-43 (1955 ed.).

[8] See Fondren v. Commissioner, 324 U.S. 18 (1945). Some cases have held that if a trust is terminable on the request of the infant or his guardian, the donor could get a gift tax exclusion. Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951). See also Cannon v. Robertson, 98 F. Supp. 331 (W.D.N.C. 1951). The Second Circuit reached a different result where the legal guardian could terminate the trust and a legal guardian had not been appointed. Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952).

[9] INT. REV. CODE OF 1954, § 2503(c), provides that a gift to a minor is not a gift of a future interest if the property given and the income from it 1) may be expended by or for the benefit of the donee before his attaining the age of twenty-one years *and* 2) will to the extent not so expended pass to the donee on his attaining the age of twenty-one years and in the event that he dies before majority, be payable to the estate of the donee or as he may appoint under a general power of appointment.

[10] INT. REV. CODE OF 1954, §§ 671-78.

[11] N.Y. PERS. PROP. LAW § 265(2).

[12] *Id.* § 266(2)(a).

[13] *Ibid.*

[14] *Id.* § 266(2)(e).

[15] *Id.* § 266(2)(b). It should be noted, however, that the trust instrument may give the trustee broader investment powers. *Id.* § 21.

bad faith, intentional wrongdoing,[16] or through investments made without the discretion and intelligence of a prudent investor seeking a reasonable income from his property and preservation of corpus.[17]

More important for the purpose of determining how well the statute provides a simple means of making gifts to minors are the succession and resignation provisions.[18] These provisions require that the custodian petition the court for permission to resign and to have a successor appointed.[19] The same procedure is necessary when the removal of the custodian is desired [20] and when the appointment of a successor is made necessary by the death of the custodian before the minor reaches twenty-one.[21]

As a review of the Article reveals, the custodian's powers are considerable, including among others the power to accumulate income or to use it for the support of the minor. In fact, since the custodianship can result in the shifting of income to a lower bracket taxpayer [22] and since a high degree of control is given to a donor-custodian over the property transferred, the custodianship offered apparent advantages from the standpoint of the taxpayer.[23] Such a device seemed to offer all the advantages of a trust without the disadvantages of the necessity of compliance with statutory provisions regulating the powers that can be conferred upon a trustee without subjecting the donor to income tax liability.[24] That these advantages were not what they seemed to be will be discussed more fully later.

Procedural Difficulties Under the New York Statute

The resignation and succession provisions have become more important to the evaluation of the utility of Article 8-A in view of the recent case of *Matter of Strauss* [25] in which a donor-custodian petitioned the court for permission to resign as custodian and to have his wife appointed as his successor. The reason for the desired change was an Internal Revenue Service Ruling [26] which held that if a donor-custodian died before the majority of the minor, the value of the property transferred to the custodian would be taxable to the donor's estate.[27] The court held that since under Article 8-A, the custodian

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[16] *Id.* § 266(4).
[17] *Id.* §§ 266(2)(b), 266(4).
[18] *Id.* § 267.
[19] *Id.* § 267(2).
[20] *Id.* § 267(3).
[21] *Id.* § 267(4).
[22] Fleming, *The North Carolina Gift of Securities to Minors Law—Its Federal Tax Implications,* 34 N.C.L. REV. 207, 218 (1956).
[23] *Ibid.*
[24] INT. REV. CODE OF 1954, §§ 671-78.
[25] 138 N.Y.L.J. No. 94, p. 7, col. 1 (Sup. Ct. Nov. 13, 1957).
[26] Rev. Rul. 57-366, INT. REV. BULL. No. 32, at 20 (1957).
[27] See note 25 *supra.*

possesses a "power in trust," [28] the infant was entitled to be represented for purposes of an accounting proceeding arising from the petition to resign.[29]

Because of the fact that the New York statute requires a court petition to change a custodian, the procedure is at present expensive, but when the expense of having a representative appointed for the purposes of accounting is added, the cost might render the custodianship as disadvantageous in the case of a small gift as the trust or a guardianship, which were avoided expressly because of their cost.[30] In fact, such procedural requirements would seem to frustrate the very purpose of the act because they do not make the custodianship a simple and inexpensive way of giving securities to minors. Hence, a problem arises as to whether the additional protection afforded the infant by the requisite of a court petition is sufficient to override the advantages to be derived from a simpler and more inexpensive procedure.

First of all, it should be noted that of the states which have enacted statutes predicated upon the Model Act, only North Carolina and Virginia [31] have statutory succession provisions procedurally similar to those of New York. The other states have adopted the simpler procedures provided for in the Model Act.[32] No cases have arisen in these latter states, however, so that any detrimental effects upon the infant cannot be definitely ascertained. At best, all that can be said is that there have been no apparent ill effects up to the present.

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[28] N.Y. PERS. PROP. LAW § 266(1). This phraseology is peculiar to the New York statute.

[29] The court has the power to require an accounting by the custodian whenever a custodian seeks to resign or when petition is made to remove him or when petition is brought for the appointment of a successor upon the death of a custodian. N.Y. PERS. PROP. LAW § 268.

[30] See Shattuck, *A Practical Consideration Of Some Of The Legal And Tax Problems Inherent In Gifts To Minors*, 31 B.U.L. REV. 451 (1951).

[31] N.C. GEN. STAT. § 33-72 (Supp. 1957); VA. CODE ANN. § 31-23 (Supp. 1956).

[32] Other states have resignation provisions which provide that a custodian may resign and designate an adult member of the minor's family or a guardian as successor. In the alternative he can petition the court for permission to resign and for the appointment of a successor. See, *e.g.*, COLO. REV. STAT. ANN. § 125-5-6 (Supp. 1955). In case of death or incapacity the general guardian of the minor succeeds as custodian or if there be none, a child over fourteen years can designate a guardian or adult relative as custodian. If the child is under fourteen, an adult member of the donor's family may be designated by the last acting custodian or his legal representative. In the alternative petition may be had to the court. COLO. REV. STAT. ANN. §§ 125-5-7, 125-5-8 (Supp. 1955). For similar provisions, see GA. CODE ANN. §§ 48-306 to 308 (Supp. 1955); N.J. STAT. ANN. §§ 46-38-6 to 8 (Supp. 1957); OHIO REV. CODE ANN. §§ 1339.23 to .25 (Baldwin Supp. 1957); R.I. GEN. LAWS ANN. §§ 18-7-13 to 15 (1956); S.C. CODE §§ 62-515 to 517 (Supp. 1957).

However, it cannot be denied that the "prudent investor" standard[33] of the New York statute furnishes the custodian with much leeway in managing securities in his custody. This freedom from statutory rules regarding fiduciaries appears to negate whatever protection the infant might be afforded by procedural protections. However, the fact that the custodian is usually a relative of the minor should in itself furnish some measure of protection for the infant.[34] The New York statute seems to confer protection by requiring a petition to court for a change of custodian, and then to withdraw it through the extremely broad powers it confers upon the custodian. If there is concern for the welfare of the minor, it might be better to follow the Colorado statute,[35] namely, subject the custodian to the standards of other fiduciaries in managing and investing the property. However, whatever the value of the requisite of petition to court as far as protecting the infant is concerned, it does definitely render Article 8-A less useful in the making of a small gift.

The Tax Aspect in View of Recent Revenue Rulings

Added to the increased complexities in the procedure involving resignation and succession two recent rulings of the Internal Revenue Service[36] have rendered the custodianship less attractive to the small donor, from the standpoint of tax advantages. In both the estate tax and the income tax area these rulings have applied the same rules to the custodianship as have in the past been applied to trusts. As a result, those who had hoped for a more preferential treatment for the custodianship have not seen the realization of their expectations. Although it is true that *Rev. Rul.* 56-484 is broader in scope than Sections 677(b) and 678(c) of the Internal Revenue Code, this discussion will be limited to the income tax liability of the donor-custodian.

Internal Revenue agents do not, in fact, act contrary[37] to published rulings but the taxpayer may contest the position they take in the courts. In view of the importance of these rulings it is essential to analyze carefully their content, and the correctness of the view which they take.

The first of these rulings, *Rev. Rul.* 56-484, held that regardless of the relationship of the donor or the custodian to the donee, income derived from property given to a donee, which is used to discharge in whole or in part, the legal obligation of any person to support or maintain a minor, is to the extent so used, taxable to such person

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33 N.Y. PERS. PROP. LAW § 266(2)(b).

34 See Legis. Note, 31 ST. JOHN'S L. REV. 155 (1956).

35 COLO. REV. STAT. ANN. § 125-5-3(2) (Supp. 1955).

36 Rev. Rul. 56-484, INT. REV. BULL. No. 40, at 8 (1956); Rev. Rul. 57-366, INT. REV. BULL. No. 32, at 20 (1957).

37 See BLOUGH, THE FEDERAL TAXING PROCESS 161 (1952 ed.).

whose legal obligation is discharged, under Section 61(a) of the Internal Revenue Code of 1954. In view of this ruling, the provision of the Code relating to income from trusts, which is used to discharge a legal obligation,[38] has now been extended so as to apply to the custodianship via Section 61(a) of the Code.[39] Hence, taxation cannot be escaped on the theory that the custodian is not a trustee.[40]

The second ruling, *Rev. Rul.* 57-366, states that the value of property transferred by a donor to himself as custodian for a minor donee is includable in the donor's gross estate for federal estate tax purposes if the donor-custodian dies before the donee reaches twenty-one years of age. This ruling, while it perhaps may primarily affect the donor with a large estate,[41] does diminish the tax advantages of the custodian to a group that is most likely to be seeking tax savings. Undoubtedly the fact that the ruling only applies where the donor is also a custodian will cause many who are presently donor-custodians to petition the court for permission to resign as the *Matter of Strauss* case indicates.[42]

Rev. Rul. 56-484

The key problem in evaluating the soundness of this ruling is concerned with whether or not it was correct to apply the principle expressed in Section 677(b) [43] to the non-trust area when that statute applies only to trusts. In other words, was the Commissioner correct in ruling that Section 677(b) did not preclude taxing a donor-custodian under the gross income section, Section 61(a)?

Those who oppose the ruling base their argument on the distinction between a formal trust and a situation where property is managed without any trust agreement, a distinction that has been

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38 INT. REV. CODE OF 1954, § 677(b).

39 INT. REV. CODE OF 1954, § 61(a), provides: ". . . gross income means all income from whatever source derived. . . ."

40 There had been some question as to whether the Commissioner would tax income of custodial property used to support a minor in view of the fact that Section 677(b) applied only to trusts. See Fleming, *The North Carolina Gift of Securities to Minors Law—Its Federal Tax Implications,* 34 N.C.L. REV. 207 (1956). It would seem that the Internal Revenue Service in Rev. Rul. 56-484 has decided to treat the provisions of Section 677 as not excluding taxation of the income from custodial property used to discharge a legal obligation under Section 61.

41 INT. REV. CODE OF 1954, § 2052, provides for an exemption of $60,000 from the value of the gross estate in determining the taxable estate.

42 138 N.Y.L.J. No. 94, p. 7, col. 1 (Sup. Ct. Nov. 13, 1957).

43 INT. REV. CODE OF 1954, § 677(b), provides: "Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person . . . may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. . . ."

recognized by the Internal Revenue Service.[44] It is further argued that a donor-custodian should not be taxed like a grantor-trustee, because his powers are conferred by statute and not by the trust agreement [45] and in this respect he is similar to a guardian. A guardian apparently is not taxed on income from property donated and managed by him, even if it is used to maintain a minor.[46] The rationale behind this argument is that the powers of the custodian, like those of a guardian, are subject to being narrowed or broadened by the legislature,[47] so that the power to appropriate income for support could be taken away. Hence, it is argued the donor-custodian should not be taxed on the mere possession of this power. However, it would seem that these arguments rest upon the assumption that if a custodianship is unlike a trust, it should not be taxed like one. But if Section 677(b) does not exclude the use of Section 61(a) to impose a tax on the basis of use to discharge a legal obligation outside the trust area, then the fact that the donor-custodian is unlike a trustee in some aspects would not necessarily prevent taxing him.

The landmark case in the area of taxing income used to discharge the legal obligation of a grantor is *Douglas v. Willcuts*.[48] In this case, the Supreme Court held the settlor of a trust taxable on its income because the income was used to provide payments to his wife in lieu of alimony. This case did not rely principally on any statutory provision, but instead relied on the general intent of Section 61(a). The Court, referring to income used to discharge a legal obligation, said:

> We think that the definitions of gross income are broad enough to cover income of that description. . . . In the present case, the net income of the trust fund . . . stands substantially on the same footing as though he had received the income personally. . . . We do not regard . . . the statutes as to the taxation of trusts . . . as intended to apply to cases where the income of the trust would otherwise remain . . . taxable to him. . . . [W]e find no warrant for a construction which would preclude the laying of the tax against the one who . . . enjoys the benefit of the income as though he had personally received it.[49]

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[44] See Rev. Rul. 55-469, INT. REV. BULL. No. 30, at 34 (1955); Prudence Miller Trust, 7 T.C. 1245 (1946). A trust is a taxable entity under the code whereas a custodianship is not.

[45] Fleming, *The North Carolina Gift of Securities to Minors Law—Its Federal Tax Implications*, 34 N.C.L. REV. 207, 217-18 (1956).

[46] Freuler v. Helvering, 291 U.S. 35, 44 (1934) (dictum). "The whole of a minor's income received by his guardian is taxable to the minor irrespective of its accumulation in the guardian's hands, distribution to the minor or payment for his support or education." See Van Wart v. Commissioner, 295 U.S. 112 (1935); H. C. Priester v. Commissioner, 33 B.T.A. 230 (1935); R. E. Martin, P-H 1944 T.C. Mem. Dec. ¶ 44013, which follow the rule laid down in the *Freuler* case.

[47] Fleming, *supra* note 45, at 217.

[48] 296 U.S. 1 (1935).

[49] *Id.* at 9-10. The Court was referring to the predecessors of Sections 651-663 of the Internal Revenue Code relating to taxation of trusts, fiduciaries, and beneficiaries and the predecessor of Section 677(a) defining cases where

In view of the *Willcuts* case, the courts could find a basis for taxing the donor-custodian, and the courts are not likely to narrow the construction of Section 61(a); in fact the tendency of judicial decisions is strongly in favor of a liberal construction of Section 61(a),[50] based on the theory that Congress intended to use the full measure of its taxing power.[51] Taking into consideration the fact that *Rev. Rul.* 56-484 does not predicate taxation on the *mere ability* to use income to discharge a legal obligation, but instead requires, as Section 677(b) does, that the grantor-trustee actually use funds for this purpose to be taxable,[52] it cannot be said that the ruling is incorrect. As a practical matter, the loss of revenue that would result from not taxing a donor-custodian like a grantor-trustee, where income is used to discharge a legal obligation, suffices to warrant the acceptance of the analogy to the trustee.[53] The whole tenor of court decisions has been in the direction of overlooking legally justified distinctions where the effect of recognizing such distinctions would be to restrict the congressional intent to tax expressed in Section 61(a).[54]

Rev. Rul. 57-366

The ruling on the estate tax aspect might seem more difficult to justify at first glance. Indeed one writer has said there would be no basis for an estate tax on property transferred to a custodian.[55] A closer examination does reveal, however, a statutory basis for the government's position, but before a thorough analysis can be made of *Rev. Rul.* 57-366, it is essential that the general provisions relating to estate taxation of inter vivos transfers be briefly discussed.

Primarily, there are two principal grounds upon which an inter vivos transfer can be held taxable as part of a donor-decedent's estate:

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the grantor remains taxable where, for example, trust income is used to pay premiums for insurance on the life of the grantor. The existence of these specific provisions was held not to exclude taxing trust income on the basis of discharge of a legal obligation under the gross income section.

[50] See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); General Investors Co. v. Commissioner, 348 U.S. 434 (1955). In these cases the Supreme Court found a windfall recovery of triple damages and an "insider profits" recovery under the Securities Exchange Act of 1934 respectively as included within the broad scope of § 22[61(a)] of the Internal Revenue Code of 1939.

[51] Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955); Helvering v. Clifford, 309 U.S. 331, 334 (1940); Douglas v. Willcuts, 296 U.S. 1 (1935).

[52] It should also be noted that the powers of a custodian are fixed at least for the particular year in which income is used to discharge a legal obligation. See Fleming, *The North Carolina Gift of Securities to Minors Law—Its Federal Tax Implications*, 34 N.C.L. Rev. 207, 217 (1956).

[53] The guardian device appears to be less frequently used as the great majority of cases that have arisen have involved trust agreements.

[54] Harrison v. Schaeffner, 312 U.S. 579, 582-83 (1941); Helvering v. Clifford, 309 U.S. 331, 334 (1940); Lucas v. Earl, 281 U.S. 111, 114-15 (1930).

[55] See Fleming, *supra* note 52, at 210.

1) if it is made in contemplation of death;[56] or 2) if it falls under the statutory provisions relating to powers of control retained by the grantor and the time when full enjoyment of the gift will be attained by the donee.[57] The first ground is not directly pertinent to the statutory custodian, but the latter will be of much greater concern for purposes of evaluating *Rev. Rul.* 57-366.

Section 2036 provides for including in the taxable estate the value of the property transferred inter vivos where the donor retains at the time of the transfer until his death, or for a period not ascertainable without reference to his death, or for a period not in fact ending before his death, a) possession and enjoyment or b) a power to designate who shall enjoy the property or its income.[58] Section 2037, on the other hand, provides for an estate tax on the donor's estate where the donee acquires full possession and enjoyment by surviving the decedent, and where the donor retains a reversionary interest worth more than five per cent of the value of the property transferred measured immediately before the donor's death. Section 2038 provides for taxing as part of the decedent's estate, any interest transferred subject to change through a power, possessed by the donor at the time of his death, to alter, amend, revoke, or terminate.

Much confusion results in the estate tax area due to the fact that the provisions of the statutes overlap and, hence, may frequently apply to the same transaction with different tax results.[59] For example, if Section 2038 applies, only the interest affected by the power will be includable in the decedent's estate but under Section 2036(a)(2) the whole value of the property transferred will be includable.[60] The two sections seem to cover the same area, giving rise to one of the most difficult questions in the estate tax area, *i.e.*, when does Section 2038 act independently of 2036(a)(2)?[61] The Commissioner, however, will usually seek inclusion under both sections, hoping to include as much property in the taxable estate as the statute permits.[62] A similar difficulty arises in determining when

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56 INT. REV. CODE OF 1954, § 2035.

57 INT. REV. CODE OF 1954, §§ 2036-38.

58 The statute provides that the power may be exercised alone or in conjunction with another. However, unlike the situation in the income tax area, though the other party be adverse, this will not make a difference under § 2036(a)(2). SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 262-63 (1956 ed.).

59 *Id.* at 259-60, 267.

60 *Id.* at 266.

61 *Id.* at 263.

62 It would seem that Section 2038 acts independently of 2036(a)(2) where the power that renders the estate taxable is not retained at the time of the transfer as required by 2036(a) but instead is acquired later by the donor. However, Section 2038 still applies as it covers the power to "alter, amend, revoke, or terminate" whenever acquired. This is an unusual case; if it were

Section 2037 acts independently of Section 2036(a)(1).[63]

The ruling relied on the cases of *Commissioner v. Estate of Holmes*,[64] and *Lober v. United States*.[65] The *Holmes* case involved a pre-1936 trust in which the grantor retained the power as trustee [66] to terminate the trust and distribute the principal and income to the children. He could not vest enjoyment of the property in himself, but he did have the power to accumulate income for the welfare and happiness of each beneficiary. The estate of the donor was held taxable on the property transferred to the trust. This case also involved the problem of contingent remainders other than the beneficiaries and their heirs, in so far as the other beneficiaries would inherit the interest of any other beneficiary who died without issue. Hence, the Court was much concerned with the fact that the donor could deprive these contingent remaindermen of their rights by the exercise of his express right to terminate. The Court also considered the problem of whether or not a change in the wording of what is now Section 2038, adding the word "terminate" to "alter, amend, and revoke" was declaratory of existing law.[67] The Court decided that it was.

The *Lober* case, however, turned more on the concept of enjoyment. In this case, there was no provision for a remainder other than the income beneficiary and his heirs and it was argued that in law a person and his heirs are identical. However, the Supreme Court found that this latter argument "lacked reality" [68] for tax purposes, and held that the power to accelerate enjoyment was sufficient to warrant an estate tax. Under the holding in this case, even where the power to terminate is not given expressly but can be exercised through a power to pay to beneficiaries the whole corpus and income,

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planned that the grantor acquire the power later so as to avoid 2036(a)(2) such a scheme would probably not succeed. See U.S. Treas. Reg. 105, § 81.19(e) (1954).

[63] Section 2037 would seem to operate independently of Section 2036(a)(1) where no power over the property is retained except the reversionary interest necessary to bring the transfer within Section 2037. See SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 270 (1956 ed.).

[64] 326 U.S. 480 (1946).

[65] 346 U.S. 335 (1953), *affirming* 108 F. Supp. 731 (Ct. Cl. 1952).

[66] In Industrial Trust Co. v. Commissioner, 165 F.2d 142, 146 (1st Cir. 1947), the fact that a power was given as a trustee was held to make no difference.

[67] It must be kept in mind that these sections, while all applicable after August 16, 1954, are limited in their application to transfers made prior to certain dates before 1954. For example, Section 2036 doesn't apply to transfers made before March 4, 1931. Section 2037 applies to all transfers whenever made, but for those made before Oct. 8, 1949, the reversionary requisite can be satisfied only by an express reversion clause, whereas after 1949, a reversion arising solely by operation of law would be sufficient. The Revenue Act was amended to include the word "terminate" effective June 22, 1936 but the *Holmes* case held this to be declaratory of existing law. 49 STAT. 1744 (1936). 326 U.S. 480 (1946). See SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 270 (1956 ed.).

[68] 346 U.S. 335 (1953).

this will be enough to bring the transfer within either Section 2036(a)(2) or Section 2038. The same result follows even where the income beneficiary and remainderman are the same.

However, both the *Lober* case and the *Holmes* case concerned trusts. But what is their effect on the custodian? It has been observed that the donor-custodian has both the power to accumulate income and to distribute it in his discretion, and the power to terminate, in effect, his custodianship by paying to the minor (before the minor reaches twenty-one) the whole of the principal and income of the securities in his custody.[69] Moreover, a power to accumulate income has been held to constitute a power to designate enjoyment under Section 2036(a)(2) [70] whereas the power to invade corpus to pay out to a beneficiary has been regarded as a power to "alter, amend, revoke or terminate" under Section 2038.[71] It would seem that the custodian could be reached by both sections, as these sections, unlike Sections 671-78 in the income tax area, are not limited to trusts.[72] The entire value of the property would be includable under either section,[73] and if the donor-custodian dies before the minor's majority, the power was possessed for a period which did not, in fact, end before the donor's death.[74]

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[69] N.Y. PERS. PROP. LAW § 266(2)(a).

[70] See Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947).

[71] See Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), which involved both the right to terminate by invading corpus and the right to accumulate income so that uncertainty resulted as to whether the power to invade corpus is enough to render the estate taxable under Sections 2036 or 2038. SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 323 (1956 ed.). The dicta in the case of Du Charme's Estate v. Commissioner, 164 F.2d 959 (6th Cir. 1947), hinted that where only a power to invade corpus exists, only the remainder interest should be includable and any outstanding income interest would be excluded. The custodian has both powers, so that the question is not vital in evaluating the correctness of Rev. Rul. 57-366.

[72] INT. REV. CODE OF 1954, § 2036, provides: "The . . . gross estate shall include the value of all property . . . of which the decedent has . . . made a transfer . . . by trust or otherwise. . . ." Section 2037 and Section 2038 also contain clauses making the statute applicable to transfers made "by trust or otherwise."

[73] See SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION §§ 266-67 (1956 ed.).

[74] The power possessed under Section 2038 cannot be a contingent power. If it is subject to a contingency that has not occurred before the decedent's death, then the estate is not taxed on the value of the property subject to that power. See SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 314 (1956 ed.). Surrey and Warren refer to the fact that a power to "alter, amend, revoke or terminate" cannot be contingent, but the case of Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), applies the same concept to a power to accumulate income, which is a power that does fall under Section 2036. Unlike the income tax-trust sections (§§ 671-78) the fact that a donor possesses a power with an adverse party does not exclude the property transferred from estate taxation. This different treatment in the estate tax area would appear to be illogical. See SURREY AND WARREN, FEDERAL ESTATE AND INCOME TAXATION 262-63 (1956 ed.). If it is solely in a third party then the property transferred is not includable as part of the taxable estate. *Ibid.* See also

If the powers of the custodian do fall within the purview of Sections 2036 [75] and 2038, then *Rev. Rul.* 57-366 is correct. The fact that there is no reversion of greater than five per cent or that the donee need not survive the donor to get full enjoyment, while rendering Section 2037 inapplicable, does not defeat the estate tax because there is a basis for taxation if any of the provisions are applicable.[76] However, if the powers of the custodian can be distinguished from those possessed in the *Holmes* and *Lober* cases, and Sections 2036 and 2038 do not apply as a consequence of this distinction, the ruling is incorrect.

It has been held that if there is an external standard limiting either the power to accumulate or distribute income, or the power to invade the corpus and terminate the trust before the affixed termination date of the trust, then Section 2036, or Section 2038, as the case may be, does not apply.[77] In such cases it has been reasoned that the discretion of the trustee being not untrammeled, the power is such that a court of equity could compel the trustee to exercise it as dic-

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Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935); Estate of Sherman v. Commissioner, 9 T.C. 594 (1947); Kneeland v. Commissioner, 34 B.T.A. 816 (1936).

[75] This paper has not considered the possibility of the application of Section 2036(a)(1) of the Code of 1954. However, it could be argued that the donor has reserved a right to possession or enjoyment of the property if the income of the property can be used to relieve the donor of a duty of support. It has been said that the right of the transferror to have income used to discharge a legal obligation is equivalent to a right to the income. See ALI FED. INCOME, ESTATE, AND GIFT TAX STAT. § X2012(g), at 198 (April 1955 draft). Therefore, it could be argued that since the donor can have a legal obligation discharged by the payment of income to the minor, his estate should be taxable even where he (donor) is not the custodian. Rev. Rul. 57-366 has not gone this far and the cases in the analogous area of non-trustee grantor are not clear. In some cases it has been held that where the dependent is free to use the income for support or not, as he chooses, then the donor's estate is not liable for an estate tax. Estate of Saheide, 6 T.C.M. 1271 (1947); Commissioner v. Douglass' Estate, 143 F.2d 961 (3d Cir. 1944). However, it has been held that where the donor can require that the income be used to discharge a legal obligation, then the estate should include the property transferred. Helvering v. Mercantile Bank-Commerce and Trust Co., 111 F.2d 224 (8th Cir.), *cert. denied,* 310 U.S. 654 (1940). In the Second Circuit, such a power to require use to support, in the donor, was held not essential for the inclusion of the property in the estate. Commissioner v. Dwight's Estate, 205 F.2d 298 (2d Cir.), *cert. denied,* 346 U.S. 871 (1953). The custodian is not required to apply income at the request of the donor, but in view of the *Dwight* case, if it is so applied, it may be a basis for taxing the donor on the custodial property even where the donor is not the custodian. The tax court does not follow the *Dwight* rule and it is doubtful even if it will follow the *Mercantile Bank* rule. ALI FED. INCOME, ESTATE AND GIFT TAX STAT. § X2012(g), at 199. See also Estate of Sherman, 9 T.C. 594 (1947); Estate of Sessoms, 8 T.C.M. 1056 (1956).

[76] See SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 266 (1956 ed.).

[77] Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947). See 2 RABKIN AND JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION §§ 58.06(8), 58.08(1) (1954 ed.).

tated by the terms of the trust agreement when the contingencies provided for in the agreement occurred.[78] The application of this standard is not without difficulty and has caused litigation.[79] But if the custodian's powers are limited by an external standard, then it would appear that the ruling has incorrectly applied Sections 2036 and 2038 to him.

The statute provides that the custodian, as he deems advisable, can use all or part of the income or property held by him for the support, education, maintenance, and benefit of the minor.[80] To determine whether the external standard provided for by the statute is sufficient, it is necessary to consider some of the cases which have gone both ways depending on the nature of the standard involved.

In *Jennings v. Smith*,[81] the court held that if a trustee was empowered to invade the corpus when the beneficiary suffered "prolonged illness" or was overtaken by "financial misfortune" deemed by the trustee to be extraordinary, such a power did not involve unlimited discretion. The condition upon which the need to exercise the power would arise was held definite enough to be determinable by a court of equity. However, the opinion in this case also considered the fact that the power was subject to a contingency that had not occurred before the decedent's death and it is difficult to discern whether the basis for not levying the estate tax is the definiteness of the external standard or the fact that the power was subject to a contingency. A similar difficulty exists as to the court's treatment of the power to accumulate or distribute net income to maintain the beneficiary according to the station in life to which he belonged.

In *Estate of Wilson v. Commissioner* [82] the court held property transferred not includable in the estate where the income and principal from the property could be accelerated in case of need for "educational purposes or because of illness or because of other good reason." [83] The Tax Court regarded the power as limited by a sufficiently definite external standard whereas the power involved in the *Holmes* case was regarded as unfettered.

In *Estate of Wier v. Commissioner*,[84] the court found the power to distribute income or principal so that the beneficiary could be "properly maintained, educated and supported in the manner appropriate to her station in life" was limited by a sufficient external standard so that the trustee did not possess any power over the enjoyment

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[78] *Ibid.*
[79] SURREY AND WARREN, FEDERAL ESTATE AND GIFT TAXATION 313 (1956 ed.).
[80] N.Y. PERS. PROP. LAW § 266(2)(a).
[81] 161 F.2d 74 (2d Cir. 1947).
[82] 13 T.C. 869 (1949), *aff'd*, 187 F.2d 145 (3d Cir. 1951).
[83] Estate of Wilson v. Commissioner, 13 T.C. 869, 870 (1949).
[84] 17 T.C. 409 (1951).

of the trust. This case also mentioned that no express power to terminate was conferred, unlike the situation in the *Holmes* case.[85]

However, the courts have also gone the other way. For example, in *Estate of Yawkey*,[86] the Tax Court held the predecessor of Section 2038[87] inapplicable, but held the predecessor of Section 2036[88] applicable. The former was held inapplicable because the exercise of the power depended on a contingency. In neither case did the inapplicability depend on the sufficiency of the external standard provided, namely the "best interests of the beneficiary." The court felt that this norm for expenditure would be implied in any event.

Similarly, in *Hurd v. Commissioner*,[89] the estate was held taxable under the predecessor of Section 2038 where the principal could be paid in whole or in part for the beneficiary's comfortable support and maintenance, as circumstances required. The power to accumulate income was not considered in relation to the standard because it was felt that the same result would be reached under the then Section 811(c) [2036] as was reached under the then Section 811(d)(2) [2038].

In view of these cases, it must be admitted that no clear line emerges so that it cannot be definitively stated which side the custodian is on. However, in the opinion of this writer, the custodian's standard does not appear to be as precise as the prolonged illness or extraordinary financial misfortune standard of the *Jennings* case, or as the station in life standard of the *Wier* case. It would seem that he is empowered to use the principal or income for the support and maintenance of the minor in general and is not required to exercise it upon the occurrence of certain facts. The *Wilson* case provides a standard not as definite as the other two cases but does appear to be more than a power to appropriate for general maintenance of the minor. In both the *Yawkey* and the *Hurd* cases the standard involved was to provide for the general benefit and maintenance of the minor, but in neither was there a specific situation provided for that would make it mandatory upon the trustee to apply income or principal. This seems to conform to a requisite standard enforceable in equity, demanded by the courts. In the *Jennings* and the *Wier* cases the courts felt that it could be objectively determined when the agreement imposed upon the trustee the duty to exercise the power given to him. Therefore, though the existence of an external standard for the custodian cannot be categorically denied, neither can it be said that one exists that the courts could enforce. In view of the

[85] For a detailed presentation of the trust agreement involved in the *Holmes* case, see Estate of Holmes v. Commissioner, 3 T.C. 571 (1944).

[86] 12 T.C. 1164 (1949).

[87] INT. REV. CODE OF 1939, § 811(d)(1)(2)(3), 44 STAT. 71 (now INT. REV. CODE OF 1954, § 2038).

[88] INT. REV. CODE OF 1939, § 811(c)(1), 46 STAT. 1516 (now INT. REV. CODE OF 1954, § 2036).

[89] 160 F.2d 610 (1st Cir. 1947).

cases the government's position in *Rev. Rul.* 57-366 cannot be said to be contrary to the established trend of judicial decision, and in this writer's view, it is correct.

Conclusion

The utility of Article 8-A in the case of a small gift has been considerably diminished by the resignation requirements of the New York statute and the decision in *Matter of Strauss.* The estate tax consequences to the donor-custodian with the large estate are now no longer any better than those of trusts where a grantor-trustee is given powers similar to those of a custodian. Moreover, there is no preferential treatment accorded the custodian where income from custodial property is used to discharge a legal obligation. The donor is eligible for a gift tax exclusion. The gift tax credit mechanism,[90] on the other hand, does not provide an exact adjustment for the double tax that results when an estate tax is also levied. Hence, it would seem that the custodianship offers no real tax savings as compared to the trust and its utility is considerably limited.

However, although not especially attractive for small donors, or donors seeking tax savings, the Article does provide a great measure of protection for transfer agents and it is here that its greatest utility would appear to lie presently. This aspect alone would justify its existence. However, though there is little that can be done by the state legislature to better the tax picture, the state legislature can re-examine the need for the procedural protections provided by the New York statute, and, if possible, act to make the statute more useful, at least to the donor of a small gift, by cutting down on the expenses involved.

President's Disability and Succession

Introduction

In the light of the recent developments concerning the question of presidential disability, it is appropriate to discuss the present legislative proposals before the Congress. The President's genuine concern with his own physical condition should be sufficient to impress

[90] See Surrey and Warren, Federal Estate and Gift Taxation 255, 263 (1956 ed.); Int. Rev. Code of 1954, § 2012.