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The Doctrine of External Standards Under Sections 2036(a)(2) and 2038

I. INTRODUCTION

Sections 2036(a)(2) and 2038 of the Internal Revenue Code provide respectively that property transferred by a decedent during his lifetime over which he retained a right to designate who shall possess or enjoy the property or the income therefrom, or had the power at his death to shift enjoyment of the property between beneficiaries, shall be included in his gross estate. While the sections are broad in their application and closely limit the control which a transferor can maintain over property he transfers without causing it to be included in his gross estate, they do not require that a testator must relinquish all control over the property. The purpose of this Note is to discuss the scope of sections 2036(a)(2) and 2038, and examine the doctrine of external standards which allows a taxpayer to maintain partial control over property he transfers yet avoid inclusion of the property in his gross estate under these sections.

II. SCOPE OF THE SECTIONS

A. ANALYSIS OF THE SECTIONS

The two sections are very similar in purpose and effect. Section 2036(a)(2) provides that where a person transfers property during his lifetime but retains the right to designate the persons who shall possess or enjoy the property or the income therefrom, and dies possessed of that right, the property shall be included in his gross estate. Section 2038 states that there shall be included in a decedent's gross estate all property transferred by the decedent "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, revoke, or terminate . . . ."

The theories underlying the provisions are also very similar. The rationale of section 2036(a)(2) is that a right retained by a decedent to control enjoyment is equivalent to retention of the enjoyment itself; the basis underlying section 2038 is that possession of a power over an interest in the property at death is tantamount to retention of the interest itself. The purpose of

1. Decedent need not die possessed of the right if it exists for any period ascertainable without reference to his death. See text accompanying notes 8-11 infra.

2. ALI Fed. Income, Estate and Gift Tax Statute 99 (Tent.
both sections is to prevent avoidance of the estate tax\(^3\) by means of the inter vivos transfer of property over which the transferor controls use and enjoyment.\(^4\)

Both provisions are broad in application. They apply to all transfers of property,\(^5\) and they apply irrespective of the capacity in which the right or power is exercisable.\(^6\) It is immaterial whether the grantor holds the power alone or in conjunction with any other party, whether or not that party be adverse.\(^7\) The sole determining factor is whether the right or power exists,\(^8\) and it exists even if there is only an expressed or implied understanding at the time of the transfer that the right or power will later be conferred.\(^9\) Under section 2036(a)(2) the property is includible if the right exists during (1) the decedent's life, or (2) any period not ascertainable without reference to his death, or (3) any period which does not in fact end before his death.\(^10\) Section 2038 applies to powers of which testator dies


3. The types of property interests includible in a decedent's gross estate are defined by Int. Rev. Code of 1954, §§ 2033-44.

4. The primary purpose of the federal estate tax is to assess the transfer of property at death. See C. Lowndes & R. Kramer, Federal Estate and Gift Taxes 5 (2d ed. 1962). The levy is imposed on the value of the decedent's gross estate at death less certain allowable deductions and exemptions. The value of the assets included by reason of §§ 2036 and 2038 thus become part of the decedent's taxable gross estate.


8. Biscoe v. United States, 148 F. Supp. 224 (D. Mass. 1957). A power might even be within § 2036 if it exists subject to a contingency which has not taken place at decedent's death. See text accompanying notes 21-36 infra. In any case it is immaterial whether or not the power is exercised.


possessed and to powers which testator relinquished in contemplation of death.\textsuperscript{11}

B. \textbf{RELATIONSHIP BETWEEN THE SECTIONS}

There is considerable overlapping between sections 2036(a)(2) and 2038. This gives rise to problems where both provisions apply to the same transfer, because the two sections may require different amounts to be included in the transferor's gross estate. If a decedent transfers property during his lifetime but retains a right with respect to that property falling within the scope of section 2036(a), the value of the entire property is includible in the decedent's estate. This figure may be decreased, however, by an amount which is equal to any outstanding income interests not subject to decedent's control which are actually being enjoyed by other persons at decedent's death.\textsuperscript{12} Furthermore, if the decedent retained a right with respect to only a part of the property, only that part is includible under section 2036.\textsuperscript{13} On the other hand, taxability under 2038 is limited to those interests the enjoyment of which may actually be modified by the decedent at the time of his death through the exercise of the power. All other interests are not includible.

To illustrate the foregoing assume that $A$ creates a trust to pay the income to $B$ for life, remainder to $C$ or his estate. $A$ retains the power to accumulate income and add it to corpus. Under section 2036 the entire property would be included in $A$'s gross estate because he may designate who shall receive its income. If $A$ retains power to accumulate only half of the income, then only half of the entire property, corpus plus income, is includible. Under section 2038 only the value of $B$'s income interest is includible because $A$ retains only the power to modify income.\textsuperscript{14}

\textsuperscript{13} \textit{Id.}
\textsuperscript{14} In addition to the discrepancy between the amounts includible under each section, there was some early controversy over the amount includible under § 2036. Commissioner v. Estate of McDermott, 222 F.2d 665 (7th Cir. 1955), held that where the grantor retained the power to distribute or to add trust income to principal, accumulations of income on the assets transferred were not includible in the gross estate. United States v. O'Malley, 383 U.S. 627 (1966), overruled McDermott, however, holding that both the trust property and the accumulated income from the trust were includible in the gross estate.
C. LIMITATIONS ON APPLICATION

While sections 2036 and 2038 are broad in scope, several limitations circumscribe their application. Both because of the possible differences in amounts includible under the two sections and because exclusion from each is paramount in estate planning, an examination of these limitations is important.

1. Retained Powers

Section 2036 refers to rights or powers “retained” at the time of the transfer of the interest,\(^{13}\) while section 2038 applies to powers “without regard to when or from what source the decedent acquired such power.”\(^{16}\) Thus, if a testator does not retain a proscribed power at the time he transfers the property, but acquires one thereafter, the property will be included in his gross estate only if section 2038 applies. Only limited use can be made of this fact, however, since a right is treated as retained if there was an understanding, expressed or implied, at the time of the transfer, that the interest or right would later be conferred.\(^{17}\) Inclusion will also result if a right can be exercised indirectly\(^{18}\) through the medium of another person or entity subject to the decedent’s control.\(^{19}\)

2. Transfers in Contemplation of Death

Section 2038 provides specifically that if a power, taxable under that section, is released in contemplation of death, the interest subject to the power is includible thereunder. But section 2036 contains no counterpart to this provision.\(^{20}\) It would

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16. **Int. Rev. Code** of 1954, § 2038(a)(1). The fact that § 2038 is not restricted to cases in which a decedent expressly reserves a power is sometimes crucial. See, e.g., Rev. Rul. 683, 1955-2 **Cum. Bull.** 603, where it was held that contributions made by a decedent to a trust created by his wife were includible under § 2038 because his consent was required to revoke or modify the trust.
18. Rev. Rul. 67, 1967-1 **Cum. Bull.** 289, states that where decedent makes an inter vivos transfer of nonvoting stock in trust for the benefit of his children, retaining all of the voting stock until his death, and (1) either remains as trustee until his death, or (2) places restrictions on the trustee’s power to dispose of the nonvoting stock, this indirect retention of the right to designate enjoyment requires inclusion under § 2036.
20. Section 2036(a) (2) does expressly include property where the right to designate is retained for a period not ascertainable without
appear, therefore, that a testator could avoid inclusion under section 2036 by giving away his taxable right immediately before death. However, two cases and a Revenue Ruling arising under the 1939 Code's predecessor of section 2036, and the current Treasury regulations indicate that a release of a section 2036 right in contemplation of death may result in inclusion. Nevertheless, since the Revenue Ruling and the cases arose under the 1939 Code, it is possible that the courts will not find section 2036 applicable to transfers of control in contemplation of death.

3. Control over Income-Producing Property

Because section 2036 uses the phrase "possess or enjoy the property," it would appear to include as taxable a right to control the disposition of trust principal as well as income. However, its scope is actually limited to the right to designate who shall receive income from the property, or to possess or enjoy the property itself only if it is nonincome-producing property.

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reference to decedent's death. But this is not identical in application to the contemplation provision of § 2038.

21. Rev. Rul. 324, 1958-2 Cum. Bull. 999, held that relinquishment by decedent in contemplation of death of a right to designate who shall possess or enjoy property will render the property includible in the decedent's gross estate. In both Studebaker v. United States, 211 F. Supp. 263 (N.D. Ind. 1962), and Estate of Wardwell, 37 T.C. 1187 (1961), the § 2036 interests which had been released within three years of decedent's death were held not includible. In each case, however, the court applied the § 2035 contemplation of death provision, but excluded the property on the grounds that the presumption created under § 2035 had been overcome.

The literal language of § 2036(a) would seem to impose a tax even if decedent relinquishes his rights not in contemplation of death for, unlike § 2038, it does not explicitly require that the right continue until the grantor's death or be released on contemplation of death. Section 2038 could even be read to require that once a right is retained, that right cannot be excluded from testator's gross estate. This phenomenon is sometimes characterized as the "scotch tape theory," and finds support in the concurring opinion in United States v. Allen, 293 F.2d 916, 918 (10th Cir.), cert. denied, 368 U.S. 944 (1961). There is authority, however, that § 2036 will not extend this far. See, e.g., Estate of Cuddihy, 32 T.C. 1171 (1959).


23. Treas. Reg. § 20.2035-1(b) (1958) mentions §§ 2036, 2037, 2038, and 2041, while § 2035 refers specifically only to §§ 2038 and 2041. See Int. Rev. Code of 1954, § 2035. By implication this would seem to support the thesis that § 2035 does not encompass transfers in contemplation of death.

Thus, if the testator transfers property to X for life, remainder to Y, and retains only the power to change the remainderman, the trust property will not be includible under section 2036.25

4. Contingent Powers

If the grantor retains a power contingent on an event beyond his control which has not taken place before his death, section 2036(a)(2) will apply, but section 2038 will not.26 Treasury regulations provide specifically that section 2038 is not applicable "to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death . . .."27 The regulations illustrate this principle by reference to a power the exercise of which is contingent upon the death of another person during decedent's life.28 In addition, the following powers have been found not taxable because of the contingency concept: Where a trustee was given discretion to transfer any part of the principal from one beneficiary to another after the youngest beneficiary reached the age of thirty, the res was not included in the trustee's estate when he died before the youngest beneficiary attained the prescribed age.29 Also, the res was not included when a decedent could obtain the power to defer distribution of corpus only if he sur-

25. Some courts have not so limited § 2036, however. See, e.g., Bailey v. Ratterre, 144 F. Supp. 449 (N.D.N.Y. 1956), aff'd, 243 F.2d 454 (2d Cir. 1957).


27. Treas. Reg. § 20.2038-1(b) (1958). A power dependent on a contingency must be distinguished from two other types of dependent powers: a power conditional on precedent notice by testator, and a power which is effective only after a stated period. Section 2038 provides that any power thereunder shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice, or even though the exercise of such power takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice had been given or the power had been exercised. INT. REV. Code of 1954, § 2038(b). See generally C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES § 9.11 (1956). Courts have applied this provision not only to powers which are exercisable only after a precedent notice of a given period, but also to powers which become effective after the lapse of such a given period. Mellon v. Driscoll, 117 F.2d 477 (3d Cir.), cert. denied, 313 U.S. 579 (1941). Powers which are exercisable only during limited but regularly recurring periods are also includible. Rundle v. Welch, 184 F. Supp. 777 (S.D. Ohio 1960).


vived his wife but failed to do so.\textsuperscript{30} In a similar case the power to revoke was in decedent's wife, having been previously relinquished by him with the proviso that he would regain the power should he survive his wife. The res was not included in decedent's gross estate when decedent failed to survive his spouse.\textsuperscript{31} Finally, where a decedent held a power to appoint a new trustee only on resignation of the current trustee, the res was not included since the trustee never resigned.\textsuperscript{32}

Although the regulations apply the contingency concept only to section 2038, it is possible that the courts will disagree in the future with the Treasury's contention that contingent powers are taxable under section 2036(a)(2). While most of the cases holding contingent powers not taxable arose under the predecessor of section 2038 in the 1939 Code,\textsuperscript{33} there are cases which held that a contingent power was not taxable under the predecessors of either section 2036(a)(2) or 2038.\textsuperscript{34} The differences in wording between the sections\textsuperscript{35} would not seem to be a sufficient basis for distinguishing the sections.\textsuperscript{36} Furthermore,

\begin{itemize}
  \item \textsuperscript{30} Estate of Ballard, 47 B.T.A. 784 (1942), aff'd, 138 F.2d 512 (2d Cir. 1943).
  \item \textsuperscript{31} Estate of Matthews, 3 T.C. 525 (1944).
  \item \textsuperscript{33} See generally C. Lowndes & R. Kramer, Federal Estate and Gift Taxes § 9.11 (1956).
  \item \textsuperscript{34} Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947); Estate of Kasch, 30 T.C. 102 (1958).
  \item \textsuperscript{35} The language in § 2038 referring to a power "at the date of [decedent's] death" seemingly lends itself to the contingency concept more naturally than does the phraseology in § 2036 that a right "retained for [decedent's] 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 . . . ." Nevertheless, in a situation where the contingency concept is applicable, the right or power was never exercisable. Thus when viewed in retrospect at the time of death, there never was a right or power of value to the decedent. Consequently, the contingency concept would appear equally applicable to both §§ 2036 and 2038.
  \item \textsuperscript{36} Lowndes, supra note 7, at 991, offers two possible grounds for distinguishing between the sections on this question: (1) Section 2038 (b) expressly provides that notice or lapse of time before the power can be exercised will not prevent inclusion of the property subject to the power. It may be argued that by expressly including powers subject to certain contingencies, Congress intended to exclude all other contingent powers. Since § 2038 contains no mention of contingencies at all, this reasoning is not possible under that section. (2) Section 2036 (a)(2) does not by its terms tax the existence of the power to designate who enjoys the property; rather, it taxes the transfer of the property with retention of the power.
  
  The second ground for distinguishing between the sections goes too far. The result of this would mean that once the testator has retained a § 2036(a)(2) power, he could never elude the tax on such a right.
\end{itemize}
Estate of Kasch\textsuperscript{37} held that where the powers held by the grantor were subject to the occurrence of an event which had not taken place at grantor's death, the power did not make the property includible under either section 2038 or section 2036 (a) (2). With this broader application of the contingency concept, the estate planner can make good use of the concept in giving to his grantor-client powers he would like to retain for exercise only after the happening of specific events.\textsuperscript{38}

III. THE DOCTRINE OF EXTERNAL STANDARDS

While retained powers, contingent powers, and powers relinquished in contemplation of death somewhat restrict the application of sections 2036(a) (2) and 2038, they are of limited value to the estate planner. Although powers acquired subsequent to the transfer of testator's property are not includible under section 2036, they are includible under section 2038. Powers subject to a contingency are excludible only until the contingent event has taken place, and may even be included prior to that time under section 2036. While powers relinquished in contemplation of death may not be included under section 2036, they will certainly be included under section 2038. A combination of these powers may be helpful in protecting property transferred from taxation, but their confined use must be recognized. There is, however, a further restriction to the application of the relevant provisions which may save a power otherwise taxable thereunder: the doctrine of external standards.

The doctrine of external standards states that where a grantor's powers to designate enjoyment of property interests or to

\textsuperscript{37} See United States v. Allen, 293 F.2d 916, 918 (10th Cir.) (concurring opinion), cert. denied, 368 U.S. 944 (1961). While advancing these two grounds, Lowndes himself states that the distinctions are "exceedingly tenuous." Lowndes, supra note 7, at 992.

\textsuperscript{38} The following are two examples utilizing the contingency concept: (1) Grantor wishes his wife to be trustee of the trust into which he transfers property for his children. But if his wife dies, he would like to regain control of the property. A retained power exercisable "only in event of my wife's death" will accomplish this, yet insure exclusion of the property so long as grantor dies before his wife.

(2) Grantor would like to retain power to pay from the trust corpus to his daughter only if the husband should die or divorce her, thus leaving her without support. A transfer by grantor retaining such a power only "in event that my daughter should be divorced, or her husband should die or become incapacitated" will give the grantor the desired power without inclusion so long as the contingent event has not taken place.
modify such interests are ministerial or controlled by a standard, and thus are duties enforceable in a court of equity, the property so transferred is not includible in the grantor’s gross estate when he dies. The reasoning supporting the doctrine is entirely consistent with the policy underlying sections 2036 and 2038. The rationale previously stated for these sections is that since retention of powers over the interest transferred is equivalent to retention of the interest itself, they should be taxed as such. If, however, such powers over the interest are not freely exercisable by the transferor but are in effect limited ministerial duties enforceable in an equity court, such powers are not equivalent to holding the interest itself and should not require inclusion of the property in the transferor’s estate at death.

This doctrine can be quite valuable to the estate planner. It will allow the testator-client to retain a certain degree of control over property he transfers, yet exclude the property from his taxable gross estate. It is more useful than the contingency concept for, unlike that concept, it unquestionably applies to both sections 2036(a)(2) and 2038 and it does not lose its excludible effect upon the occurrence of some future contingent event. It may of course be desirable to apply both the external standards doctrine and the contingency concept to a single transfer to insure exclusion of the property, but this is not always con-

39. The word “modify” is used here to mean the power to alter, amend, revoke, or terminate under § 2038.
40. See 3 J. MERTENS, supra note 19, § 24.30.
41. See Gray & Covey, supra note 24, at 86. See generally 3 J. MERTENS, supra note 19, § 24.30. Other ways in which the principle has been expressed include: (1) the discretion in trustees to make distributions of trust properties according to specified and determinable standards is merely ministerial and does not constitute either the right to designate who shall possess or enjoy or the power to terminate the trust, Estate of Wier, 17 T.C. 409 (1951); (2) that the right is given in the instrument of transfer and can be enforced by the beneficiary when the need arises and, hence, no discretion is left to the decedent; therefore, there is no “power” to change enjoyment or to modify, Estate of Budlong, 7 T.C. 756 (1946). Accord, Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947). See 3 J. MERTENS, supra note 19, § 25.31.
42. Ironically, Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), discussed infra note 44 and accompanying text, is the leading case for both the contingency concept and the external standard doctrine. As in that case, the concepts are often hard to distinguish when applied to certain invasion powers. For example, a power to invade in case of “emergency” could be considered as limited by both the contingency concept and the external standard doctrine.
43. While the contingency concept and the external standards doctrine are both ways to exclude property subject to certain restricted powers, the two concepts differ in theory and application. The theory
sistent with testator's wishes. However, so long as a "sufficient" standard controls testator's power over the transferred property, the doctrine will itself insulate such property from estate taxation.

A. Establishment of the Doctrine

The external standards doctrine is entirely a judicial creation. In the leading case of *Jennings v. Smith*\(^4^4\) the trustees, of whom the deceased settlor was one, were empowered to invade the trust corpus if the beneficiaries "should suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary." The Commissioner contended that these discretionary powers to pay income and principal were taxable under sections 2036(a)(2) and 2038. The court held that since the trustees were not free to exercise untrammeled discretion, but were to be governed by determinable standards and thus controlled by the courts, the sections did not apply.\(^4^5\)

In a subsequent case, *Estate of Wier*,\(^4^6\) the grantor created individual trusts for his two daughters, and gave the trustees behind the contingency concept is that the relevant sections apply only when the power is actually exercisable. Hence, if exercise of the power is subject to a contingency which has not occurred at decedent's death, the power has not "vested" in the decedent and should not be included in his gross estate. The theory of the external standard doctrine is somewhat different. A power which is sufficiently limited and capable of determination by a court of equity, whether or not it is presently exercisable, is not the type of power which should require inclusion. This dissimilarity in theory between the two concepts also leads to a difference in application. When applying the contingency concept, one looks only to see if the contingent event has happened; if it has, the property will be included. On the other hand, when applying the external standard doctrine the controlling factor is whether the standard sufficiently limits the trustee's discretion so as to prevent free exercise of the power. Thus while the contingency concept applies only before the prescribed event, for example, "in event of sickness," the external standard concept, if it is sufficiently limited, also applies after such "event." See generally 3 J. MERTENS, *supra* note 19, § 25.31.

\(^4^4\) 161 F.2d 74 (2d Cir. 1947). The doctrine was first enunciated in *Estate of Budlong*, 7 T.C. 756 (1946).

\(^4^5\) The court stated that "a 'right' so qualified that it becomes a duty enforceable in a court of equity on petition by the beneficiaries does not circumvent the obvious purpose of § [2036]." 161 F.2d at 78. While *Jennings* applied to powers to pay income and principal, it has been accepted as standing for the external standard concept generally, which includes many other types of management powers. See, e.g., *State St. Trust Co. v. United States*, 263 F.2d 635 (1st Cir. 1959) (various management powers); *Estate of Wilson v. Commissioner*, 13 T.C. 889 (1949), *aff'd*, 187 F.2d 145 (3d Cir. 1951) (control over investments).

\(^4^6\) 17 T.C. 409 (1951).
power to expend first out of income, then out of corpus "as they may deem necessary or proper for the support, maintenance and education of our said daughter . . . ." The grantor retained the power to remove any or all trustees and appoint successors. The Wier court likened this standard to that in Jennings, holding that the powers of the trustees were governed by a sufficient standard and enforceable in a court of equity, and hence the property was not includible in the grantor's estate.

The doctrine as established in the Jennings and Wier cases has had broad subsequent application. It has recently been applied to a wide array of retained management and administrative powers in addition to the invasion powers present in Jennings and Wier. In both the management power and invasion power areas, the doctrine has great value to the estate planner, because it allows the testator to retain a certain degree of influence over property he transfers without incurring a tax thereon. For this reason, consideration will be given to the application of the external standards doctrine with regard to both retained powers of invasion and retained management powers.

B. Application of the Doctrine to Powers of Invasion

The external standards doctrine has often been used to exclude from taxation property subject to testator's power of invasion. For example, when transferring property to his children testator frequently wishes to be able to invade corpus for the benefit of the children in certain circumstances such as "in case of illness" or "in case of emergency." If such a power is sufficiently limited, the external standards doctrine will insulate the property subject to the power from estate taxation. The problem, of course, is to determine just what limitation must be placed upon the invasion power to accomplish this favorable tax result. The cases are by no means clear on this point. For instance, a provision that grantor may invade corpus for the "best interest of the beneficiary" has been held to be a sufficient standard in some cases, but not in others. Nevertheless, it will

47. Id. at 413.
48. Generally, an unrestricted power to remove a trustee and replace him is considered to be a taxable power. Walter v. United States, 341 F.2d 182 (6th Cir. 1965). But see United States v. Winchell, 289 F.2d 212 (9th Cir. 1961), where decedent's retained power to appoint a successor to a resigning trustee did not result in inclusion.
be helpful to consider, first, the reasons why given standards have not been found sufficient to require exclusion, and second, the various limitations to invasion powers which have been held to be sufficient standards.

1. Attributes of a “Sufficient Standard” Governing Powers of Invasion

There are a number of attributes which a standard must have in order to insure exclusion of property over which testator maintains a power. First, the standard must be enforceable in the state equity court. This factor is basic, since the external standards doctrine rests on the proposition that testator’s powers are actually duties enforceable in such a state court. This does not mean, however, that the state court has the final word as to the sufficiency of a standard; the issue of sufficiency is a federal question which can be decided only by a federal court.

A second requirement of a sufficient external standard is that it be expressed in the instrument itself. It cannot be supplied by the external circumstances. It is the power actually given to the testator that governs, not the likelihood of its use as shown by extrinsic circumstances. Consequently, where the executor argued that the testator’s power was limited because under the circumstances it was inconceivable that he would do

50. See United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (dicta); Estate of Frew v. Commissioner, 8 T.C. 1240 (1947).
51. Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960). See A. Casner, ESTATE PLANNING 196, n.96 (3d ed. 1961). While the ultimate determination of a standard is a federal question, it would seem that a federal court would be bound to hold a standard insufficient to exclude an interest if the state court had refused to enforce the interest. This reasoning is supported by the fact that the premise of the external standard is that the standard under consideration is enforceable in the state equity court. Nevertheless, the Supreme Court recently held in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), that where a federal estate tax is imposed on a state defined property interest, the state trial court’s determination of the interest is not binding on the federal courts. While the Bosch case arose in a different estate tax context than the problem being considered in this Note, the holding of the case would seem applicable. Even if a federal court is not bound by a state court’s negative determination as to the enforceability of a given standard, however, such a holding should have great weight in the federal determination.

52. A few cases have held that a standard is sufficient if it is imposed by state law, though such a standard was not incorporated in the trust instrument itself. See, e.g., Estate of Budlong, 7 T.C. 756 (1948). However, as stated in note 51 supra and accompanying text, the state determination is not binding on the federal court and may not be relied on as establishing a standard sufficient for exclusion.
anything but allow the property to go to his son, the court held the property includible.54

Third, the standard must place reasonable limits upon the testator's power; it must circumscribe testator's power in such a way that it is confined within allowable limits of discretion. Thus, powers left to the testator and other trustees to be exercised "if in their opinion the circumstances require"55 have been held to be includible. Similarly, powers to invade "as [the trustees] may consider suitable and necessary in the interests and for the welfare of the beneficiary" have been held insufficient to exclude the property.56

A fourth criteria is that the standard must be objectively determinable. The determinable requirement is intended to serve two purposes: it insures that testator will have well defined bounds within which he can exercise his discretion and it enables the state courts to determine when testator's power may be enforceable and when it may not. A number of cases have included property subject to a power with an inadequately determinable standard. Grantor-trustee's powers exercisable "as in [his] judgment [he] shall deem best"57 was held includible, as was testator's right to invade as he "may deem necessary or desirable having in mind my wife's greatest comfort and happiness."58 While there are cases which have excluded property subject to loosely drawn standards such as power to invade "for any good reason,"59 little reliance should be put upon such cases in drafting a determinable standard.

54. Id. at 225. In O'Malley v. United States, 220 F. Supp. 30 (N.D. Ill. 1963), the court rejected the plaintiff's contention that the required external standard was imposed generally by the law of Illinois. A similar argument was made and rejected in Estate of Varian, 47 T.C. 34 (1966).


56. Estate of Nettleton, 4 T.C. 987 (1945). There the court stated that "[i]n view of the wide range given to decedent, as trustee, to invade corpus, it would be difficult to place any reasonable bounds upon the possibility of his power . . . ." Id. at 993.


We can not regard the language involved as limiting the usual scope of a trustee's discretion. It must always be anticipated that trustees will act for the best interests of a trust beneficiary, and an exhortation to act 'in the interests and for the welfare' of the beneficiary does not establish an external standard.

Id. at 1170.

59. Estate of Wilson, 13 T.C. 869, aff'd per curiam, 187 F.2d 145 (3d Cir. 1951).
A fifth requirement is that the standard, as expressed in
the instrument, must be specific. However, courts are not in
agreement as to the degree of specificity required. While one
case held the power to invade in case of "a special emergency"
to be specific enough for exclusion,\textsuperscript{60} another found that this
was not a specific enough standard.\textsuperscript{61} Nevertheless, the planner
must be cognizant of the fact that courts have on occasion used
the "specific" requirement as a basis for holding a given stand-
ard insufficient to allow exclusion.

While none of the above criteria have been deemed solely
determinative in applying the external standards doctrine to a
given power of invasion, they have all influenced the courts
to various degrees in taxing retained invasion powers. The es-
tate planner thus should note these factors when he drafts an
instrument retaining transferor powers. In addition, it may be
helpful for him to examine standards which the courts have
held to be sufficient to exclude otherwise taxable invasion pow-
ers.

2. \textit{Standards Held Sufficient To Govern Invasion Powers}

The following standards have been held adequate to exclude
invasion powers retained by the testator: powers to invade in
case of "prolonged illness" or financial misfortune which the
trustees deem extraordinary,\textsuperscript{62} where income is "insufficient for
the proper maintenance and support of the beneficiary,"\textsuperscript{63} "mis-
fortune,"\textsuperscript{64} when it is necessary for the beneficiary's "mainte-
ance, welfare, comfort or happiness,"\textsuperscript{65} or for his "support, main-
tenance and education."\textsuperscript{66} One court has gone so far as to hold
that the power to invade for "educational purposes or because of
illness or for any other good reason" is excludible.\textsuperscript{67} Two cases
have, without explanation, held the following standards suffi-
cient for exclusion under section 2038, but \textit{not} under section
2036 (a) (2): "sickness or other emergency"\textsuperscript{68} and "for her proper

\textsuperscript{60} Estate of Budlong, 7 T.C. 756 (1946).
\textsuperscript{61} Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960),
\textsuperscript{62} Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).
\textsuperscript{63} Estate of Frew, 8 T.C. 1240 (1947).
\textsuperscript{64} Estate of Toeller, 6 T.C. 832 (1946), aff'd, 165 F.2d 665 (7th
Cir. 1948).
\textsuperscript{65} United States v. Powell, 307 F.2d 821 (10th Cir. 1962).
\textsuperscript{66} Estate of Wier, 17 T.C. 409 (1951).
\textsuperscript{67} Estate of Wilson, 13 T.C. 869 (1949), aff'd per curiam, 187 F.2d
145 (3d Cir. 1951).
\textsuperscript{68} Estate of Budlong, 7 T.C. 756 (1946).
maintenance, education and support, to purchase or build or furnish a home, allow her to engage in travel or enter a profession or commence a business."

It is obvious from the preceding discussion and a comparison with cases holding standards inadequate that the external standards doctrine has not been applied with much consistency. However, if the drafter keeps in mind the reasons why courts have found given standards insufficient and uses the "successful" standards as a basis for drafting, he can successfully reserve for his client-grantor a certain amount of invasion power and still insulate the property transferred from inclusion within the grantor's gross estate.

C. APPLICATION OF THE DOCTRINE TO MANAGEMENT POWERS

If powers of the grantor to manage the transferred property are held in a sufficiently limited fiduciary capacity, with ascertainable and enforceable duties owed to the beneficiaries, then the value of the property transferred is not includible in the decedent's gross estate. The powers retained by the grantor must be sufficiently limited. Unrestricted general management powers held by a testator in a fiduciary capacity cause the property thereunder to be included. Thus, the courts face the difficult task of determining when a power is restricted enough to come within the spirit of the external standards doctrine as it applies to management powers.

For many years courts allowed exclusion of property subject to numerous management powers. Then, in 1959, State Street...
Trust Company v. United States\textsuperscript{73} seemingly reversed this trend. There, the decedent, as co-trustee of three irrevocable trusts established for the benefit of his children, had the powers to invest and reinvest property without restriction, and to allocate receipts to either income or principal.\textsuperscript{74} The trustees were to be liable only for their own willful acts and defaults. The court held that the trust property was includible, reasoning that the wide array of discretionary administrative powers of the trustees were so broad that, within any limits a state court of equity could impose, the trustees could affect the interests of the life tenants and remaindermen.\textsuperscript{75} The case, broad in its application and wording, was a definite setback in the use of limited management and administrative powers retained by a testator over property he transfers. It has received considerable criticism from many writers\textsuperscript{76} and the American Bar A-


\textsuperscript{74} The decedent also had the power to invade and distribute to a child from principal as the trustees "may deem necessary or desirable" for the child's "comfort, maintenance and/or support." 160 F. Supp. at 880. The court followed the Jennings case as to this power, however, holding that this invasion power did not require inclusion in the gross estate because the standard set forth created enforceable rights in the beneficiary. \textit{Id.} at 880.

\textsuperscript{75} Perhaps no single power conferred by the decedent on the trustees would be enough to warrant inclusion of the corpora of the trusts in his estate. But we believe that the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trusts between the life tenants and the remaindermen.

State Street can be considered the low water mark in the application of the doctrine of external standards to management and administrative powers. Subsequently, the Tax Court has described the facts of the case as "unusual," the powers therein as "extraordinary," and the rule thereunder as "exceptional." In addition, the trend of cases has been toward a more extensive application of the doctrine to management powers. The most significant of these cases to date is Estate of Wurts, where property was transferred in trust with a wide combination of management powers retained by decedent. The court specifically refused to follow State Street and held that the trust was not includible, stating that the power to pay principal to the income beneficiary was limited by a determinable standard and that the discretionary powers held by the trustee were administrative in nature, trivial in amount, and enforceable by a beneficiary in a court of equity. While the Wurts court considered State Street distinguishable as to the powers retained by decedent, a close reading of the cases makes them difficult to reconcile. The testator-trustee in Wurts retained the power to (1) invest in income or nonincome-producing assets, (2) retain any investment or hold any part of the trust property uninvested, (3) charge trust expenses against income or principal, (4) allocate extraordinary cash dividends or any dividends payable in or any rights to subscribe to the stock of a corporation other than the issuing corporation to income or principal, and (5) do all acts which persons owning the property individually might do.

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77. See ABA Program of the Section of Taxation 59 (1959).
80. By retaining a right to appoint himself trustee at any time, the testator retained the powers given to the trustee. These powers are enumerated in the text accompanying note 82 infra.
81. The court stated that the rights of the respective beneficiaries in the Wurts trust were fixed and were ascertainable. Any determinations committed to the sole discretion of the trustee were administrative in nature and trivial in amount. A right of a beneficiary so qualified that it becomes a duty enforceable in a court of equity on petition by the beneficiary does not circumvent the obvious purpose of section [2036(a)(2)] to prevent transfers akin to testamentary dispositions from escaping taxation . . . . The administrative powers in the Wurts trust were not so broad that we may conclude that the grantor . . . had the power materially to vary the enjoyment of the interests as between the beneficiaries.
do. These seem no less extensive than the powers retained in *State Street* to (1) invest and reinvest in securities or other properties of a kind or amount not ordinarily considered suitable for a trust investment, (2) determine what shall be charged or credited to income and what to principal, including the right to so determine in regard to stock and cash dividends and other receipts, and to make deductions for depreciation, amortization, or waste, and (3) do all things which the testator could do individually.

Subsequent cases have further mitigated the seemingly rigorous result in *State Street*. In *Estate of Peters* the grantor retained as co-trustee very broad management and investment powers, including power to buy or sell any property or investment in her "absolute discretion," to exercise stock conversion and voting rights, to determine income and principal, to compromise tax claims, and to give binding determination of property values for purposes of distributing property among beneficiaries. The Commissioner argued that such retained powers were so sweeping that they gave the grantor the ability to shift possession or enjoyment among beneficiaries and hence should be includible. The court held for the taxpayer, however, stating that while the management powers reserved by decedent were "broad indeed, [they] were not such as to bring into play the exceptional rule of the State Street case . . . ."84

In *Estate of King*, the external standards doctrine was extended to trust-advisor powers. In *King* the grantor gave the trustees broad powers of management and investment, exercisable solely at decedent's direction, including the right to invest in any type of property, even though speculative, extra-hazardous, and unproductive. The court found the grantor had in effect made himself a fiduciary and that, under New York law, he was not at liberty to administer the trust for his own benefit or to ignore the rights of the beneficiaries. Hence it was held that the interest in question was not includible. The court distinguished *State Street* on the grounds that there, in addition to broad investment powers, the settlor as trustee had the unlimited power to allocate as between income and corpus and the power to deduct from the income for depreciation, amortization, and

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82. Id.
84. Id. at 1097.
85. 37 T.C. 973 (1962).
The foregoing cases clearly indicate that State Street no longer represents the law as to the extent to which the testator's retained management powers over property transferred must be limited. However, the extent to which the courts have retreated from the rigorous State Street position is less clear. The Wurts, King, and Peters cases indicate that retention of the following broad powers will not likely result in taxation: Powers to invest and reinvest trust assets, to determine which charges are against income and which against principal, to allocate extraordinary income between income and principal, to act as trust advisor in certain capacities, and to evaluate property for distribution purposes. On the other hand, State Street has never been overruled, and shows that if the powers retained are too numerous or too extensive, inclusion may result. With this caveat, it appears that fairly extensive management and administrative powers may be retained, yet estate taxation be avoided through application of the external standards doctrine.

D. Estate Planning Use for the External Standards Doctrine

The external standards doctrine has potential application to a wide spectrum of powers which the testator may wish to retain over property he transfers during his life. The spectrum extends from trivial powers, such as the power to change merely mechanical details of the transfer in the trust instrument, to more pervasive powers, such as the power to terminate the trust. In determining whether the external standards doctrine will successfully exclude property subject to a given retained power, a number of factors must be considered.

First, the pervasiveness of the power itself must be noted, without regard to any limitation on the power. For example, an extensive power, such as a power of invasion of corpus, will need an explicit and restrictive standard—"for the education of the beneficiary"—for exclusion. On the other hand, a less pervasive power, such as the management power to reinvest earnings in "legals," will not require this restrictive a standard. If it is enforceable under state law, the standard is sufficient. In weighing this factor, the estate planner should consider if the power retained is consistent with the policy underlying the external standards doctrine. If the retained powers over the interest are limited sufficiently so as not to be equivalent to holding the interest itself, the interest transferred will be excluded from the estate.
A second factor to be considered is the total quantity of power retained by the testator. This grouping-of-powers factor was considered important by the court in State Street, and appears to have continued importance. Third, the estate planner must investigate the precedent relevant to the particular power and the particular standard in question, dealt with in the earlier parts of this Note. However, because the external standards doctrine is still a developing and possibly expanding concept, the first two factors should be given equal consideration with the third.

The doctrine of external standards can be of considerable value to the estate planner. In applying the doctrine, the planner must analyze the various factors as discussed above, evaluate the possible risks in light of the analysis, and balance the possible risk of inclusion against the benefit accruing to the client-testator through the use of the external standard doctrine.