RETAINED CONTROLS OF A NON-PECUNIARY CHARACTER — SOME SUGGESTIONS FOR REFORM

If a donor of a gift retains control over it it falls back into his estate for estate duty purposes. But controls may take subtle and indirect forms and duty thereby avoided. Lindsay McKay, at present in Connecticut, looks at some sophisticated legislation in the United States to cope with the problem.

Scope of Paper

The most exhaustive treatment yet undertaken of the question of dispositions with strings for the purpose of the Estate and Gift Duties Act 1968[1] concludes with the observation that, as judicially construed, that legislation fails to render dutiable "benefits which are incidents of ownership" but which confer no "personal pecuniary benefit" on the settlor or donor.[2] Two examples are instanced:

> "(F)irst, the settlor, by controlling the disposition of trust funds, may discharge an obligation which he would otherwise have to meet personally. Secondly, by controlling the destination of property after its transfer to trustees, the disponor retains what is probably the major incident of ownership to a person who already has more wealth than he reasonably needs for himself."[3]

As the writer goes on to point out, the first of these retained, and presently non-dutiable, benefits may well be dealt with satisfactorily in the future within the framework of existing legislative principles and likely[4] judicial developments. No such hope however is — or could be — held out for the second category: the weight of authority is too great against the dutiability of this class of benefit for any different treatment to be achieved other than by amending legislation. The object of the first section of this paper is to take up where Grbich concluded, and to argue for such legislation.

In the second section the arguments in favour of the amendments to be suggested to the Estate and Gift Duties Act 1968 are carried over to the context of the Land and Income Tax Act 1954. With a few minor exceptions, representing little more than inconsequential irritations to the taxation or estate planner, and the big question-mark

1. Y.F.R. Grbich, *Dispositions with Strings; Essays on the Estate and Gift Duties Act 1968*, Sweet and Maxwell, Wellington, 1969.
2. Ibid., p. 142.
3. Idem.
4. See Grbich, ibid., p. 142-143 for a discusion of probable developments by the courts in relation to this specific problem-area.

posed by s.108, that legislation similarly fails to render liable for assessment benefits of a non-pecuniary character. Once again a change in the legislation is argued for.

In the third section consideration is given, briefly, to the manner in which the amendments suggested might be implemented. There, as in the earlier discussion, reference is made to, and assistance is derived from, the United States Revenue Code 1954 and federal decisions upon it.

Largely out of considerations of length, this paper deals with general principles and arguments and assertions of policy rather than with the details of the existing substantive law. In the estate-duty section, that treatment is facilitated by the availability to both writer and reader of Grbich's excellent essay, to which reference has already been made, as a statement of the existing position.

Non-Pecuniary Benefits for Estate Duty Purposes

Whether or not a reader familiar with the existing revenue laws is likely to be persuaded by the arguments forwarded in this paper depends largely upon his intuitive response, yes or no, to the questions of dutiability presented by the following hypothetical case. Let us suppose:

A. owns assets worth $200,000. His income return is $25,000 a year, of which about $10,000 is adequate to maintain A. and his wife B, in their accustomed standard of living. The remaining $15,000 is customarily applied in making gifts to their issue or is simply capitalised. In the expectation of effecting substantial estate duty and income tax savings, A. transfers $120,000 worth of assets to the Z trust, "for the benefit of my children, grandchildren and any other person or persons who in the opinion of the trustee is a worthy recipient of my bounty." The trustee is given a power to accumulate undistributed income, to apportion receipts between capital and income, and an absolute discretion as to how much (if anything) each beneficiary is to receive. The trustee is given a further power to invade capital "for the benefit" of any beneficiary. After the death of A., B. (or A's eldest child then surviving if B. predeceases A.), is given a power to appoint to the world at large, excluding herself, in default of appointment to designated persons. The settlement is irrevocable. A. is named trustee.

Let it first be established that the trust corpus would not be dutiable on A's death. Section 7 of the Estate and Gift Duties Act 1968 lays down the general proposition that "The dutiable estate shall include all property of the deceased . . . except property held by him as trustee for another person." No exception is made in this statement in relation to trustees receiving title from themselves as grantor. Sections 11 and 12[5] do not contain explicit exemptions from their

5. The "dispositions with strings" provisions themselves.

provisions in favor of such transactions. Yet any prospect that a settlor/trustee might be held to possess an "interest" or a "benefit" for the purposes of the latter or a "benefit" "by contract or otherwise" in terms of the former is removed by settled authority. In *Oakes* v. *Commissioner of Stamp Duties*,[6] a Privy Council decision on an Australian equivalent[7] to s.11, the settlor transferred property to himself as sole trustee with wide powers of management. The Privy Council rejected the argument that possession by the settlor *as trustee* was sufficient to bring s.11 into play.

Lord Reid said:

> "If property is held in trust for the donee, then the trustee's possession is the donee's possession for this purpose, and it matters not that the trustee is the donee himself."[8]

The same general approach is implicit in the earlier decision of the same Court in *Commissioner of Stamp Duties for N.S.W.* v. *Way*[9] and in many other cases.[10] *Way's* case also raised the same question in relation to s. 12[11] and is clear authority for the proposition that an "interest" in the settlement as trustee "is (not) the kind of benefit or interest with which [s. 12][12] is concerned."[13] Underlying these decisions and the exceptions established in favor of a settlor/trustee is the philosophy enunciated in an early Australian case[14] by Higgins J. in these terms:

> "I take it, therefore, that the 'benefit' referred to means a tangible benefit from the property, a commercial benefit — not necessarily vendible, perhaps, but not a mere sentimental benefit such as may be incident to the honor of being a trustee, or a person who has to be consulted in the administration of property for the benefit of others."[15]

Grbich has suggested that the *Oakes*[16] decision may be modified in future cases.[17]

---

6. [1954] A.C. 57 (P.C.).
7. Section 102 (2) (d), Stamp Duties Act 1920-40, New South Wales. For all relevant purposes the statutory language is the same as s. 11 of the Estate and Gift Duties Act 1968.
8. [1954] A.C. 57, 72.
9. [1952] A.C. 95.
10. See e.g. *C.S.D.* v. *Perpetual Trustee Co. Ltd.* (1943) A.C. 425 (P.C.); for an expression of a conflicting view, see *Att. Gen. for Alberta* v. *Cowan* (1926) 1 D.L.R. 29, which must be regarded as out of kilter with the decisions of the Privy Council previously quoted: see generally Grbich, supra 136-137 and Adams and Richardson's *Law of Estate and Gift Duties* (4th Ed.) paras 11/30-11/33.
11. Or at least in relation to s. 102 (2) (c) Stamp Duties Act 1920-40, New South Wales.
12. See f.n. 11
13. (1952) A.C. 95, 108 per Lord Radcliffe.
14. *Commissioner of Stamp Duties* (N.S.W.) v. *Thompson* (1927) 40 C.L.R. 394.
15. Ibid., 418-419 per Higgins J.
16. (1954) A.C. 57.
17. Grbich, supra, 143.

Whatever the merits of that suggestion, however, neither of the possible judicial developments he suggests would alter the fundamental attitude of the courts to the office of trustee *simpliciter* or would alter the conclusion, implicit in the preceeding paragraphs, that sections 11 and 12 would not apply to the A Trust supposed above. The position would be different if A. was entitled to remuneration for his services;[18] it might be different if trust income were to be applied to discharge his personal obligations;[19] but as a trustee who has no beneficial interest in the settlement and no prospect of deriving any income whatsoever from it, either directly or indirectly, he clearly falls without the letter of either provision.

It should also be noted that none of the remaining "notional estate" provisions of the 1968 Act could provide the basis of dutiability. The only other section which could possibly do so, s.15, is circumvented by the trust deed supposed in a number of ways.[20] Indeed, it is possible that that provision could have been avoided by A. in a manner that conferred upon him even greater control over the corpus than he enjoys under the deed as drafted.[21]

In the writer's submission, this is an unsatisfactory result. In no substantial or meaningful way has A. reduced his control over the income of the property; in no substantial way has he ceased to enjoy the corpus or the fruit from it. It was stated as part of the factual situation surrounding the creation of the trust that, the settled assets being surplus to A's day to day needs, they or the income from them were employed to benefit the class of persons named as beneficiaries or were, alternatively, capitalised. In substance the manner of their employment under the settlement is precisely the same. Precisely the same too is the character of A's enjoyment of the property. Prior to the settlement it was used to confer upon A. the benefits received and the power derived simply from the status of being a donor and from conferring bounty upon donees. To the donor, this benefit is the power to command obedience and affection, attention and the show of both respect from others and importance of oneself. This benefit continues under the settlement. The width of the discretion conferred ensures to

---

18. As in *Oakes v. C.S.D. (N.S.W.)*, supra, where the right to remuneration was reserved out of, and at the expense of, the interests given under the settlement.
19. See *Re Cochrane's Settlement Trusts* (1945) 1 Ch. 285 and the discussion by Grbich, *supra*, 142-143.
20. Most importantly, because no beneficial interest would accrue or arise "by survivorship or otherwise" on A's death. Clearly the power to the wife (or eldest child) is not a beneficial interest, it being "special" in character; the objects of the power, the world at large (excluding the donee) are highly unlikely to have such an interst (on the basis of the reasoning in *Gartside* v. *I.R.C.* (1968) A.C. 553); or, even if they have, an interest "arising or accruing" on death.
21. He could, for example, have more severely limited the class of objects from whom the selection could be made; or imposed criteria on which his donee's selection would have to have been based. Neither device, or others to a similar effect, would have altered the conclusion in the text.

A. that sufficient flexibility has been retained so as to run no risk of any lessening of that aspect of his enjoyment. If displeasure is incurred no distribution need be made to the object of it. If that displeasure is widespread and directed across the wide range of beneficiaries, then new (although notionally additional) beneficiaries may be brought in effectively to replace them. Flexibility, too, has been retained with regard to capital. Affection can be rewarded, lack of it punished, by employment of the power to advance. So little has A's position been affected by the settlement that one cannot do other than conclude of it, in the words of the United States Supreme Court in an analogous context,[22] "It is hard to imagine that (A) felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact."[23]

Both the underlying philosophy of the assertions in this discussion and the extent of the controls retained by A. in the case taken become clearer if we analyze the relative legal positions occupied by A. before and after the settlement. If the point is stretched, we can say that by executing the settlement A. has surrendered four aspects of his absolute power, or alternatively taken upon himself four new obligations: (a) He has forfeited the right to leave the trust corpus by will; (b) He has forfeited the right to use either corpus or the income from it for his own beneficial use; (c) As trustee, he may no longer act "capriciously" in relation to income distributions or capitalizations; and (d) As trustee he is subject to the enforceable obligation to act *bona fide* and in the best interests of the trust. That each of these points represents a change from his pre-settlement position is, strictly speaking, unquestionable. Yet how *substantial* a change?

Dealing first with the least meaningful, considerations (c) and (d). It is clear that a trustee, unlike an absolute owner, may not act "capriciously". But all that is meant by the Courts of Equity by the term "capricious" is an act inconsistent with what may be assumed to be the "sensible" intention of the settlor.[24] Leaving aside for one moment the fact that in the trust supposed the trustee is the settlor himself, when the settlor has chosen to frame the powers of his trustees in broad, virtually unfettered, terms it is obvious that the scope of the the capricious doctrine must be considerably reduced, for the reason that that decision in itself indicates that the settlor was prepared to leave the formulation and application of specific criteria of entitlement to his trustees. The greater the discretion conferred the harder it must be for a court to hold that any individual exercise of it lacks the requisite degree of "sense" — with the result that recent examples of the application of the doctrine in the realm of broad trust powers

22. I.e. A short-term trust with wide powers of administration retained to the settlor as trustee.
23. *Helvering* v. *Clifford* (1940) 309 U.S. 331, 337.
24. For the recent discussion of this concept in the areas of discretionary trusts and powers, see *Re Manisty's Settlement* (1973) 2 All E.R. 1203, per Templeman J. at 1210-1211.

have been totally extreme cases which are barely conceivable in practice.[25] There can be little doubt that in these circumstances *whoever* was trustee of a settlement defined as broadly as the A. Trust, the "capricious exercise" doctrine would hardly be a meaningful barrier. It cannot help but be even less substantial when the trustee is to be settlor himself, if only because of the evidentiary difficulties faced by a beneficiary obliged to argue that the course pursued by A. as trustee was contrary to any sensible contemplation by A. as settlor. Conceptually, of course, a trustee/settlor would still be subject to the rule: but the rule would have been narrowed to such a limited ambit as to be virtually meaningless as a check. Let this assertion be illustrated by two examples as extreme as are ever likely to arise out of the operations of the A. Trust. Suppose:

> A. disapproves of grandson X's decision to join the Labour party. He tells X "Unless you resign from it you'll get no more from my trust." "You can't do that!" says X. A. does, and X alleges capricious exercise.

Or suppose:

> A. disapproves of daughter Y living in a *de facto* relationship with a married man. "Stop it!" he says. She refuses and A. in turn refuses to make the customary distribution to her. She alleges a capricious exercise.

In the second of these cases there is no prospect whatsoever of Y's claim succeeding, for the Court cannot say that considerations of moral worth, as conventionally defined by the trustee, were *not* factors that the settlor might reasonably have accepted as "sensible" considerations. There is greater doubt in the first example, if only because it is difficult to see any reasonable objection to the course X has pursued. But reasonableness in the abstract or objective sense is not the test of capriciousness: rather, the criteria are the likely intentions of the particular settlor in the context of the particular settlement.[26] Given the undoubted legitimacy of trusts for particular political parties, given too the frequency with which individuals are committed to one political party and inexorably opposed to others, and given finally that in a broadly defined trust power it is the obligation of the trustee to translate his settlor's wishes as he knows them into his fiduciary administration, it is highly unlikely that the example taken would be set aside as capricious. It is dimly possible that some basis could be found for attaching the failure to distribute on the basis of public policy. But to that suggestion the obvious answer is that this action,

---

25. See *Re Manisty,* supra, 1210, where Templeman J. gave as examples of capricious exercise (presumably in relation to a general power) the cases where appointments are made on the basis of "height or complexion or by the irrelevant fact that (the object) was a resident of Greater London."
26. This is, at least, the clear impression derived from *Re Manisty,* supra, 1210, 1213.
27. Cases abound. See, for example, *Re Ogden,* (1933) Ch. 678, a discretionary trust in favor of organizations for "the promotion of Liberal principles in politics."

even if successful, cannot *force* a distribution to X, cannot prevent A. from in future disguising his refusal to benefit X under more reasonable explanations, or be calculated to earn A's goodwill in the future. And it is, of course, that goodwill that is of the essence in every respect.

These are extreme examples. But the inapplicability of the capriciousness doctrine to provide a meaningful obstacle to A. in them graphically illustrates the freedom retained by A. in far more likely, more everyday situations. Seldom will confrontations of the character seen in those examples appear: They will not have to. Both A. and his beneficiaries will know full well the relative strengths of their own positions, and the inevitable temptation for the latter will be to avoid them, usually with the attendant consequence of the solidification of A's position or the triumph of his point of view. It must be stressed that these results are likely to be achieved without any covert or improper use of A. of his dual position whatsoever. It is not a case of A. waving the trust deed above his head and angrily reminding his issue of his position as trustee in every family conversation. The power and the authority arise from the inherent circumstances of relationships and the width of the powers legitimately conferred.

Little need be said specifically in relation to the fourth limitation imposed on A. by the settlement, namely the duty to act *bona fide* and in the best interests of the trust. For while this obligation will significantly regulate his activities in matters of investment and administration generally it will have virtually no influence on dispositive acts. This consequence inevitably follows from the process of validation of the larger, more loosely regulated class of trust powers and discretionary trusts undertaken by the House of Lords in recent years.[28] In the context of such settlements, the "rights" of beneficiaries to challenge an exercise of discretion are severely limited.[29] It can no longer be true to refer, at least in those contexts, to the trustee's first duty being to his beneficiaries or to even define trusts of that character in the traditional manner of ". . . holds legal title for the use and enjoyment of beneficiaries . . ."[30] The reality of the situation is that in the type of discretionary trust typified by *Re Baden's Deed Trusts*[31] or the power situation exemplified by the hypothetical A. Trust, the trustee's first obligation is to the settlor and his primary responsibility the fulfillment of the settlor's purposes and intentions. Lord Wilberforce put it rather indirectly in *Re Baden* when he said of a broad and discretionary trustee power: "[The trustee] is most likely to have been selected as a suitable person to administer it from his knowledge and experience

28. Principally in *Re Gulbenkian's Settlement Trusts* (1970 A.C. 508 ("mere" powers) and *McPhail* v. *Doulton* (1971) A.C. 424, (discretionary trusts).
29. To narrow, non-qualitative bases such as (a) that the appointee was not within the range of objects described in the trust instrument; (b) that the exercise was "capricious"; (c) that the trustee, after being approached, did not consider the claims of the object thrusting himself forward.
30. See e.g. the definition of Underhill, *Law of Trusts and Trustees*, 11th Ed. 4, and of Story J. in *Wilson* v. *Lord Bury* (1880) 5 Q.B.D. 518, 530.
31. (1971) A.C. 424.

and would consider that he has a responsibility to do so according to its purpose";[32] but the overall drift is clearly in support of this contention. So too is a *dictum* of Templeman J. in a later High Court decision.[33] This is not to say that the trustee owes *no* obligations to the beneficiaries, for clearly he does. It is just that their benefit, as individuals or collectively, is not the principal criterion by which the validity of his acts is to be judged.

In this context it is manifest that the trustee's duty to act in the best interests of the trust cannot provide a significant limitation on A's ability to continue, as trustee, the same controls as those he formerly enjoyed as absolute owner. If achievement of purpose is his dominant role, and duty, he must of necessity pursue a course of conduct which promotes that end result. If that purpose is itself broadly defined — or not explicitly defined at all, as in the A. trust we are considering — it will be up to A. as trustee to define the particular course to be followed.[34] Thus he cannot be prevented from adopting criteria of entitlement, priorities or the like or challenged in their implementation unless he either breaks one of the few specific duties owed to the beneficiaries — which is improbable — or pursues a course of administration which is so at odds with the settlor's sensible intention as to be akin to the capricious. As with the issue of capricious exercise, the broad discretion conferred and the evidentiary difficulties presented by the fact that the trustee is also the settlor render the prospect of this point being successfully argued very remote.

Turning now to the other rights surrendered by A. His inability to treat the trust corpus and the income from it for his own beneficial use is doubtlessly of some consequence;; but, realistically, how much? It was stated as a fact that both capital and income were surplus to A's immediate requirements, and it has been asserted that, as a result, the use to which both are put under the settlement is of the same character as their employment prior to it. There is, it is conceded, the further argument that should the assets retained by A. diminish in value or should his general business fortunes suffer a reversal, neither he nor his spouse would have any call on the settled property. It is submitted, however, that there is no risk of any real consequence that A. may be said to be taking. True, his retained assets might depreciate in value. True, also, he has no beneficial interest under the trust. But while he cannot use the latter to make payments directly to himself there is no law which prevents his issue from using their trust income to maintain his wife and himself in their accustomed standard of life.

---

32. Ibid., 449.
33. *Manisty's Settlement* (1973) 2 All ER 1203: "(In regard to both trusts and powers) reasonable trustees will endeavour, no doubt, to give effect to the intention of the settlor in making the settlement . . .", ibid., at 1210. In addition, all of Templeman J's comments on the topic of capricious exercise rest on the assumption of a duty on the part of the trustees to promote the settlor's intention as their principal object.
34. For a detailed discussion of this question see a paper by the writer in 38 Conveyancer (N.S.).

This would probably occur in any event in the circumstances supposed. It is far more likely to occur, given the inducement to the issue to do so provided by A's retention of the discretionary power of distribution and his spouse's ultimate power of appointment over the corpus. Once again, it must be stressed that the course of events supposed, or the train of thought A. may have had when weighing the pros and cons of the settlement eventually executed, in no way brands the trust as fraudulent, a sham, or efficacious only through covert arrangements. All that has been suggested as being likely to occur is within the strict confines of legitimate dealing under the law as it presently stands. Accordingly, while the settlor's surrender in question is real enough the presence of ties of blood and the powers retained as trustee render it highly improbable that it will result in adverse consequences to him.

Somewhat the same comments can be made in relation to A's surrender of the right to leave the property settled by will. As we have seen, s. 15 of the Estate and Gift Duties Act 1968 obliges him to rest the ultimate decision as to its destination in his wife (or eldest child should she pre-decease A). This can, however, hardly be regarded as a serious loss of control on A's part. He remains perfectly free to exercise as much influence as he can on his wife as to the manner and substance of her eventual exercise. If he has any doubts about her judgment or her likely obedience to his wishes, he can adopt any number of devices in the drafting of the settlement to ensure that his general ideas in relation to that exercise are respected. Some have already been mentioned. Others include the creation of a joint power to minimize the likelihood of (from his point of view) an aberration or a "consent" power, which would serve the same end.[35] Or he may choose a combination of two or more of these checks and limitations.[36] None is a fool proof method, in the sense that A. has an absolute guarantee that the exact object or objects he himself would select will in fact be benefited, but he can ensure a large degree of correlation between the two. By conferring the power over capital on another he gains, in any event, a postponment of the necessity for selection which may well in his own mind offset the limited disadvantages referred to above. And as a final point, it cannot be over-emphasized that while deprived of will-making power over it, he retains control of the capital to the very moment of his death, a control most decedents would regard as infinitely more significant.

To conclude, it is unnecessary to deny the considerable *legal* surrenders in the A. Trust case to submit that in *actuality* A's position has changed very little, and to support the assertion that what he has given up is far less substantial than what he has retained. We have

35. None of the devices mentioned — nor any combination of them — run any risk of invoking dutiability under s. 15. The reasons against that section's applicability, noted in n. 20, would still apply.
36. The most probable being a limitation of the class of objects together with a vesting of the power in two persons, neither of whom is entitled to take as an object of the power.

seen that without sacrificing any powers of any great consequence a large slice of his estate over which tight, almost unchallengable control, is retained, is removed from his dutiable estate while being employed by him to secure precisely the same benefits — to him — as those received by him before the settlement. That result, I submit, is wrong in principle and should be remedied by legislation.

It is also absurd. The reports are littered with cases where the gifts made or settlements created by decedents were held dutiable yet in which the controls retained or benefits derived by the settlor were of far less consequence than those evident in the A. Trust case. *Oakes v. Commissioner of Stamp for N.S.W.*[37] is an example. There the settlor was held to have offended an equivalent to s. 11 of 1968 Act,[38] by reason of the insertion in the settlement of a remuneration-clause for his work as trustee. Although assuming that the amounts taken would have been "fair and reasonable" for any other trustee, the Privy Council held that the right to them was a reservation from and benefit out of the settled property and that estate duty was accordingly payable on the entire trust property. The decision seems reasonable enough. So too do those where the disponor has been held dutiable on the basis of a retained interest as *one* object of a discretionary trust.[39] But what seems improper is that dutiability should be held in these cases and not in the A. Trust class of situation. In only one respect — the inability of A. to receive trust income beneficially — is the interest retained by A. less than that of these other settlors; in all other respects his control, enjoyment and benefit are of an infinitely greater order.

"Yes", the counter-argument might go: "but that one respect in which the settlements do differ is the cornerstone of dutiability under the Act, and to advocate dutiability based on non-pecuniary benefits is to demand a fundamental change which the law has never previously adopted." To this hypothetical objection there are two responses. First, if the argument that the principle adopted by the Act is that dutiability only on proof of pecuniary benefit is a correct argument, then the Act is drawn too narrowly and under the influence of a shallow philosophy of interests and benefits. But, secondly, is the objection supposed a valid one at all? For several reasons, it is submitted, the writer's assertions are less radical than they seem and draw some support from the terms of the existing legislation.

First, let us examine the notional estate provisions of the Act and attempt to isolate their conceptual basis. It is at once apparent that no coherent or consistent principle lay behind their drafting or in the process of extension of the principle of s. 7[40] that they are part of. Section 8, bringing to duty general powers of appointment held by the

37. (1954) A.C. 57.
38. Namely, s. 102 (2) (d), Stamp Duties Act 1920-40 (N.S.W.).
39. *Att. Gen.* v. *Heywood* (1887) 19 Q.B.D. 326.
40. That basic principle being, of course, the inclusion within the dutiable estate of "all property of the deceased which passes under his will or intestacy."

deceased at the time of his death, represents the traditional view that powers which the holder can exercise in his own favor confer an interest tantamount to ownership. Section 9 brings *donationes mortis causa* into the dutiable estate, but on the basis that they are the clearest possible case of testamentary substitutes, not, as in the case of s. 8, on any extended notion of ownership. Section 10 is different again. It renders gifts subject to estate duty if made within three years of death. Its absolute provision — applicable irrespective of whether the gift was made to avoid estate duty[41] — brands it as more an anti-avoidance section than one directed towards testamentary substitutes *simpliciter*. Sections 11 and 12 are drafted upon yet another conceptual basis, namely the view that inter-vivos transactions cannot escape duty if the donor of them continues to enjoy benefit from them. And so on, through to s. 15. The first point to be made from the foregoing is a simple one: as earlier indicated, there is no coherent conceptual basis underlying the Act's notional estate provisions. Rather, they manifest a case-by-case process of extension involving a case-by-case consideration of quite different legal and policy factors. That is the very basis upon which this paper proceeds.

It is legitimate however to make more positive assertions than that. Subject to what is subsequently said in relation to s. 15, none of the existing notional estate provisions goes as far as to invoke dutiability on the basis of benefits which are totally non-pecuniary. But it must be stressed that they do *not* represent the extreme converse position that dutiability can rest *only* on *actual* pecuniary benefit. In regard to both s. 8 (powers of appointment) and s. 12 (1)(c) (reserved powers of revocation) the criterion of dutiability is placed somewhere mid-way between those two extremes, on the proposition that the existence of a power which would enable the deceased *if he so elected* to derive pecuniary benefit is in itself sufficient. To base liability on this ground and not on the ground of exercise *per se* is unexceptional: it is a basis which is found in other areas of the revenue legislation of New Zealand and other countries. But legislative acceptance of the proposition that the power is sufficient of itself necessarily involves a like acceptance of the principle that issues of ownership, benefit and enjoyment are to be judged by a more penetrating and sophisticated inquiry than merely seeking to find actual pecuniary benefits.

This in itself indicates the less-than-radical character of the writer's principal suggestions. But it also serves as the background for an even more significant point in relation to s. 15[42] of the 1968 Act. It is

41. It may be of interest to compare the treatment afforded gifts made within three years under s. 2035, Internal Revenue Code 1954 (U.S.). Fears of the unconstitutionality of a provision such as s. 10 Estate and Gift Duties Act 1968 (N.Z.) have led to the drafting of s. 2035 in terms of gifts "made in contemplation of death" as the basis of dutiability, together with a rebuttable presumption to the effect that gifts made within three years fall within this description.
42. Relating to beneficial interests provided by the deceased and arising or accruing on his death.

well settled that sub-section (1) of that provision may render dutiable property held in settlement if some change in beneficial interests occurs on the death of the settlor, should that change arise from the future inoperability of a power of revocation or a (divesting) power of appointment. *Adamson* v. *Att. Gen.*[43] illustrates the operation of the provision[44] in this context. There a settlement provided for income payments to be made to the settlor's children as directed by the settlor, in default of direction to be held on trust. After his death, capital was payable to children, in unequal shares, subject to an overriding power of appointment exerciseable over it by deed or will by the settlor. The settlor died without exercising the power, and the corpus was held to be dutiable.[45] The exact proposition for which the case is an authority is in some doubt,[46] but it seems unquestionable that at the very least it supports the proposition that in appropriate cases the settlor may possess powers which are the basis of dutiability *even though those powers may under no circumstances be exercised for the settlor's personal, pecuniary benefit.* The *Adamson* power was clearly in this category.[47] All that the settlor could do in that case was divest the beneficial interest of his children.[48] He could not appoint to himself.

It might be argued that any argument in support of the writer's general contentions which is founded on s. 15 is suspect, in that when s. 15 employs non-pecuniary powers as the basis of dutiability — as in the *Adamson* class of case — it does so *not* on the conceptual ground of the "benefit" or "enjoyment" those powers confer but on the basis that their retention characterizes the gift in question as a death or quasi-death benefit.[49] There are however two counter-arguments by way of rebuttal. First, it is submitted that even if that conceptual argument were made out, the fact would still remain that s.15 illustrates the employment of non-pecuniary powers as the basis of taxability, and that this serves, at the very least, to moderate what otherwise might be seen as the "radical" suggestions of this paper. Secondly, it is by no means clear that this conceptual argument is correct. As is suggested in Adams and Richardson's *Law of Estate and Gift Duties,* s. 15 does

43. (1933) A.C. 257.
44. The *Adamson* case was in fact concerned with s. 2 (1) Finance Act 1894, the "property deemed to pass on death" provision. The issues discussed by the House of Lords and the pronouncements upon them seem, however, to be directly relevant to the aspect of s. 15 under discussion.
45. Under the unusual method of valuation directed by s. 2 (1) (d); however this was "a Pyrrhic victory": see Adams and Richardson, n. 10, para. 15/17.
46. Both because the speeches therein did not clearly define the particular classes of powers which, if retained, led to dutiability and also because of the restrictions placed upon some aspects of the case by the High Court decision in *Bradhurst* v. *C.S.D.* (1950) 81 C.L.R. 199.
47. Under clause 5 (a) of the deed ((1933) A.C. 257, 260) the reserved power extended in its possible ambit only to the settlor's children living at his death.
48. And then only in the sense of rearranging the interests between them: no appointment outside the class they constituted was possible.
49. Arguably the chief concern of the section: but see Adams and Richardson, n. 10, para. 15/1, and the text following.

not fit easily into the overall scheme of the notional estate provisions,[50] and there is some degree of confusion as to the particular end it is intended to serve. In the writer's view the fact that it has been applied to a considerable number of unrelated transactions raising quite different legal issues — annuities, joint interests, life insurance policies and successive beneficial interests under trusts[51] as well as the *Adamson* type situation — indicates that any search for a single or coherent conceptual basis is futile and should be abandoned in favour of an analysis of the basis of its application in each of the particular areas to which it applies. If such an analysis is made of its operation in relation to retained powers of revocation or appointment, then, it is suggested, the section provides a considerable measure of support for the view that those powers incur duty because of the benefits that they confer on the settlor. A settlor in the *Adamson* situation clearly has two options open to him. One is to create vested interests free from his own "interference";[52] the other is to retain to himself the power to "destroy [the beneficiaries'] interests at will."[53] If he adopts the latter course, then the price he pays for the retention in question is dutiability. These propositions are implicit in the speech of Lord Blanesburgh in *Adamson* v. *Att. Gen.* itself, particularly in his reference to the "value in the settlor's eyes" of the retained powers.[54]

If these s. 15 cases may indeed be construed in this manner, they obviously provide considerable support for the arguments earlier presented in relation to the A. Trust case. They reject the notion that dutiability must be based on the reservation of pecuniary benefits to the settlor. They support the argument that powers to control the beneficial enjoyment of others are legitimate and proper concerns of revenue legislation. The only proposition they do not support is the notion that a power to control enjoyment may be the basis of dutiability notwithstanding the holder's inability to exercise it so as to *defeat* beneficial interests, which proposition of course must be accepted to bring dutiability to the A. Trust case. But then, they do not oppose that proposition either, and, in substance, there is little distinction between powers of the *Adamson* character and those retained by A.

Non-Pecuniary Benefits Under SS. 2036 and 2038 Internal Revenue Code 1954, (U.S.)

The validity of the assertions in favor of estate-duty liability in the A. Trust case would be treated as self-evident in the United States. Indeed, particularly in relation to income-tax liability, the 1954 Code subjects powers of the character retained by A. to more stringent control than the more formal and technical reservations with

50. Idem.
51. Ibid., 15/11.
52. The term used in *Adamson, supra,* per Lord Blanesburgh at 268.
53. The description of the settlor's reserved power adopted by McTiernan J. in *C.S.D.* v. *Bradhurst, supra,* at 216.
54. (1933) A.C. 257, 271.

which the New Zealand legislation is preoccupied in the 1968 Act. The same pattern is emerging in the estate-duty field. It is not proposed, however, to discuss the substantive principles of the 1954 Code relating to retained powers in any more detail than is necessary to display the general approach taken to them.

The two provisions most directly relevant to this question are SS. 2036 and 2038. The former provides, *inter alia;*

> "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death —
>
> (1) . . .
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

Section 2038, under which most claims for duty are brought, is more broadly expressed. The material portions of it provide:

> "(a) The value of the gross estate shall include the value of all property —
>
> (1) To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exerciseable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate . . ."

Provisions to similar effect have been contained in United States Revenue legislation for several decades; during that time a considerable body of case law has developed in which these two provisions have been tested in relation to a vast array of retained controls, with the result that it is now possible for the estate planner to predicate with a substantial degree of certainty the "safe" powers he may allow his client to retain. The overall drift of both legislative and judicial principles is illustrated by the case of *Commissioner* v. *Hager's Estate,*[55] a case bearing some similarities to the hypothetical A. Trust we have earlier considered, and so a useful basis for comparison of the approaches of our jurisdiction and that of the United States. The reader will, however, note at once that the *Hager* settlor retained far less control than A.

---

55. (1949) 173 F. 2d. 613.

Hager and his wife contributed to the capital of five trusts, each in favor of a child or grandchild. The beneficiaries were given life interests in income with power to appoint remainders by will. The trusts were irrevocable.[56] Wide powers were conferred upon the trustee. "In particular, he was authorized . . . to determine, as it pleased him, whether gains realized from the sale of securities in the trusts should be treated as income or retained as part of the corpus. (In addition) he could pay out or accumulate income at his sole discretion, and could treat the accumulations as corpus or income."[57] Hager named himself as trustee. The Commissioner alleged that these powers rendered that part of the corpus contributed by him dutiable under S. 2038 on the ground that they constituted powers to "alter or amend" beneficial enjoyment. The U.S. Court of Appeals agreed. It reasoned quite simply:

> "(The decedent) could allocate gains to income, so the life tenants would get them, or to corpus, so that the remaindermen would get them. This we think is a very substantial power. So, too, is the power to determine whether or not the life tenants are to get anything at all . . ."[58]

And concluded:

> "Our conclusion is that the grantor of these trusts retained to himself as trustee a sufficient power to alter or amend to affect very substantially the interests of the life tenants and the remainder men."[59]

The decision illustrates several typical features of the approach of the Courts in this area and their treatment of the statutory provisions previously stated. First, it indicates that no actual or realiseable pecuniary benefit need be reserved as a precondition to assessability. Secondly (and contrary, perhaps, to the statutory language) it shows that "fatal" retained powers need not necessarily take the form of powers to revoke or powers to defeat or divest beneficial interests. Thirdly, it indicates an appreciation that powers which on a superficial view (such as that to allocate between corpus and income) may appear to be essentially administrative in character are capable of being exercised so as significantly to affect the value of beneficial interests. And fourthly, the decision evidences a fundamentally different view of the role of a settlor/trustee than that accepted in the United Kingdom and Australia. It will be remembered that Higgins J. once described the office of trustee even if held by the grantor as one of "honor", or as "sentimental" in character.[60] Not so the United States Court of Appeals in *Hager's* case, nor any American Court in this field. In the leading Supreme Court decision of *Helvering* v. *Clifford*[61] the strict distinctions

56. As they had to be to avoid being struck down, for duty purposes, under s. 2038.
57. Supra, 615.
58. Idem.
59. Ibid, 616.
60. *C.S.D. (N.S.W.)* v. Thompson (1927) 40 C.L.R. 394.
61. (1940) 309 U.S. 331.

between the decedent as grantor and the decedent as trustee were, by implication, branded as "legal paraphernalia (constructed by) inventive genius as a refuge from surtaxes"[62] and the substantive dominion and control retained elevated to the position of the dominant and determinative consideration.

The fundamental distinctions between the approach typified by *Hager's* case and that of the New Zealand courts may best appear from a statement of the grounds upon which the A. Trust, previously discussed, would be dutiable in the United States. There are at least six of these, namely:

1. A's retention of the power to designate the beneficiaries to whom a distribution would be made.[63]
2. A's retention of the power to withhold income and accumulate it.[64]
3. A's power to determine whether accumulated income should capitalized or paid out in the form of subsequent income distributions.[65]
4. A's power to extend the range of beneficiaries.[66]
5. A's power to advance capital.[67]
6. A's power to allocate receipts between capital and income.[68]

No further comment on the clear distinctions manifest in this list is thought necessary, other perhaps than to stress the obvious point that these powers are those calculated to confer upon A. the benefits which it has been alleged are sufficiently weighty to justify his dutiability for the trust capital.

The points made in the above analysis do not of course render it impossible for a resident of the United States to create a discretionary trust which is effective to remove the corpus from his estate at death. Quite the contrary. But they do render it difficult for the settlor himself to act as trustee of such a settlement and make it necessary, if he wishes to occupy that position, that he surrender sufficient dominion and control to achieve a substantial alteration in his pre-execution position of unfettered discretion.[69] It is submitted that such a change is reasonable to demand as a pre-requisite to escape from dutiability.

---

62. Ibid., 336.
63. Clearly void for duty purposes under s. 2036.
64. A 'fatal" control on the authority of the *Hager* case itself.
65. On the basis that this is a power to affect "substantially" the relative values of income and remainder interests; *Hager's Estate.*
66. *Porter* v. *Commissioner* (1933) 288 U.S. 436.
67. *Jennings v. Smith* (1947) 161 F. 2d. 74. The position would be otherwise if the power was exerciseable only in accordance with an objective standard prescribed in the trust instrument: *Budlong* v. *Commissioner* 7 T.C. 758. For further discusion of the significance of such a standard see post.
68. On the authority of *Hager* itself: the position is different, for no logical reason, in relation to income tax liability; se I.R. Code, s. 674 (b).
69. As to whether the Code requires the surrender of *sufficient* controls, see post.

Non-Pecuniary Benefits For Income Tax Purposes

Let us now examine the A. Trust from the point of view of income tax liability. This analysis will be brief, for in most respects it raises the same considerations and assertions as those already canvassed in the estate duty context.

Would A. achieve income-tax savings by effectively splitting his income between two taxpayers, the trust and himself? The answer to that query is obviously in the affirmative, unless the Commissioner could invoke one of the anti-avoidance devices at his disposal. Of those devices, most are clearly inapplicable. Section 105, notoriously easy to circumvent in any case, is not appropriate since the settlor has neither retained a beneficial interest nor has any prospect of a reversion of the corpus to him.[70] What is usually called the *Arcus*[71] principle is similarily inapplicable since, notwithstanding the extensive powers retained by the settlor, those powers do not include the ability to withdraw the capital from the fund.[72] There is no prospect of the rule which prohibits the alienation, for tax purposes, of personal services income being invoked since we may assume that the trust corpus is income-producing property.

The invocation of s. 108 of the Land and Income Tax Act 1954 is, accordingly, the Commissioner's only recourse. It is not proposed to analyze in any details whether that provision would avoid the A. Trust for tax purposes, for that discussion would inevitably become protracted and could, on the present state of the authorities, lead to nothing but an extremely tentative conclusion. This doubt arises from the difficulties presented by the appearance in the case at hand of two rivalling considerations; one, the irrevocable and thus "permanent" character of the settlement, and one, the lack of any fundamental change in the "overall situation" brought about under it. The first is a strong consideration against the applicability of the section,[73] the second a strong argument in favour of its application.[74] It will at once be appreciated that the question of which of those factors is to be given most weight is the s. 108 context is an issue closely analagous to that posed by this paper on a more general, and policy, level.

Anything short of a positive declaration that s. 108 would apply to the A. Trust must be regarded as sufficient mandate to press for

---

70. One of which is an essential prerequisite to the applicability of the section: see s. 105 (1) (b) and s. 105 (2) (b).
71. [1963] N.Z.L.R. 324.
72. The aspect of control at the heart of the *Arcus* principle: see [1963] N.Z.L.R. 324, 326-327 per Hardie-Boys J.
73. At least by inference: The temporary or short-term character of the settlement was the most significant consideration *against* the tax payer in *Mangin* v. *C.I.R.* [1971] N.Z.L.R. 591. See in particular the Privy Council opinion at 597, where the view of the facts taken by Turner J. in the Court of Appeal ([1970] N.Z.L.R. at 235-236) is quoted with approval.
74. See for instance *Marx* v. *C.I.R.* [1970] N.Z.L.R. 182, 213 per McCarthy J.

the specific legislative reforms of the same character as those advocated in the estate duty context. But there is in fact no real necessity to justify the ongoing of this paper by any ground as narrow as that. For there will clearly be cases in the future where, for various reasons, s. 108 is inapplicable and yet wherein the degree of control retained is sufficient to fall within the specific suggestions for reform to be made in the third section of this paper. This must, inevitably, be so. While the degree of control retained by the settlor is a significant consideration in determining the applicability of s. 108, it is but *one* consideration. Under s. 108, its significance may be negated by the ability to show it to be one aspect of "ordinary family dealing"; it is also possible, perhaps probable, that in the context of an irrevocable settlement motivated so strongly by estate — duty considerations, s. 108 might be inapplicable on the more technical ground that controls legitimately retained under the Estate and Gift Duties Act 1968 cannot provide the basis of assessment for income-tax purposes. These and other aspects of s. 108 and its judicial construction render it preferable that, on the assumption that non-pecuniary reservations *may* properly be regarded as of sufficient benefit to tax the holder of them for the income out of which the benefit arises, a separate code is established for their treatment. The alternative is to face the prospect of the policy decision assumed being constantly frustrated.

Should that decision be made? That the benefits accruing to A. under the settlement are substantial has already been asserted in the earlier, estate-duty section. So to has the proposition that to excuse A. from taxation liability on the basis that he has no prospect of enjoying any pecuniary benefit is to take an unduly and unrealistically narrow view of value to him of those benefits. Indeed, the case for income-tax liability of A. for the trust income is arguably stronger that that for estate-duty liability of the corpus, for the reason that A's control over income is somewhat stronger and more direct than his power over the ultimate capital distribution — which, it will be recalled, was a power conferred on his wife. The degree to which the status of trusteeship limits A's unfettered judgment, an issue also discussed in the earlier discussion, holds equally true in the income context. But again, in this latter context, the case for A. having surrendered sufficient rights by virtue of assuming that role is weaker in at least one respect-namely, the consideration that he can no longer leave the corpus by will, would seem to be of even less significance here than for estate duty purposes. Nothing further need be said on this point, other than to refer the reader directly to that earlier analysis, and to the earlier recommendations for reform.

Once again, there will be those who are reluctant to countenance a proposal which might appear to be substantial departure from existing and well-established bases of assessability. Yet in the same manner as s. 15 of the Estate and Gift Duties Act 1968 and one or two other considerations were seen to remove the "radical" taint from the proposals of the earlier section, so too there are a number of considerations which serve the same end in this phase of the dis-

cussion. These arise principally from an analysis of s. 105 of the Land and Income Tax Act 1954.

It would be improper to attempt to construe this section as an explicit recognition by the legislature, that non-pecuniary benefits may be the basis of assessability, if for no other reason than that the provision does not require evidence of them as a pre-condition to its utilization. Nor does the section require evidence of retained controls either in the form of a dispositive power or in the more indirect ways contemplated by the *Arcus*[75] principle. On the contrary: it reads as a broad (though very poorly drafted) anti-avoidance provision which does not differentiate between the various classes of controls that may be enjoyed by a settlor over income and is concerned only with the fact that *corpus* has been retained by him and/or will ultimately be available once more for his unfettered and beneficial use. In the United States a provision such as this would be conceptualized on the ground that a settlor or assignor who retains control over the capital at all stages of the settlement or assignment period is deemed to be "enjoying" and hence "realizing" the income and thus is assessable for it.[76] This has not been the conceptual approach of New Zealand courts or commentators to s. 105: when it has been analyzed at all, it has simply been described as being concerned with nullifying the beneficial tax advantages secured by short-term transfers with retained rights over corpus.[77]

How does this lend support to the writer's contentions? The point is this. The actual personal pecuniary advantage to the settlor of a short-term trust is, in a great many cases, nil. Personal profit can only arise in those situations where a substantial proportion[78] of the income derived by the beneficiaries and (leaving aside s. 105) assessable to them at lower rates than the settlor is then either given to the settlor for his own beneficial use or used by the beneficiaries to discharge the settlor's personal legal obligations. Both methods of securing pecuniary benefit to the settlor are of doubtful validity of effectiveness[79] and for this and other reasons they are far from universally adopted. In many, perhaps most, cases the income is paid for the beneficial use of the beneficiaries with little or nothing returned to the settlor.

Yet notwithstanding a settlor's loss in terms of real purchasing power which frequently results from a short term trust, it is never suggested that that fact alone should excuse him from assessment under s. 105. On the contrary, any taxpayer putting forward such an assertion would be met with the arguments that, first, the section does not require evidence of personal gain to the settlor and, secondly, that the "loss"

---

75. [1963] N.Z.L.R. 324.
76. See the leading decision of *Helvering* v. *Horst* (1940) 311 U.S. 112.
77. See Richardson, 5 V.U.W.L.R. 26, 36.
78. How "substantial" depends of course on the rates of taxation applicable to settlor and beneficiaries respectively.
79. Evidence of a repetitive course of conduct along these lines would be a strong indication that the settlement was a sham or at the least, an "agreement" within the ambit of s. 108.

to the taxpayer is more than compensated for by the "benefits he gains through retention in the family unit of income allocated to its members,"[80] the second of these arguments presumably providing the conceptual justification for the first. The writer has no quarrel with the validity of those arguments. But the second presupposes a concept of benefit which is far broader than mere pecuniary; indeed a concept of much the same character and definition as that suggested by the writer as worthy of adoption in the context of retained powers. Both certainly share the decisive element of a rejection of financial gain as an exclusive basis of assessment, and both also share the presupposition that the conferring of such a gain on others may be legitimately viewed as giving rise to occasions for sufficient "benefit" to the settlor to render him assessable for that gain.

At the same time, it is not contended that this argument on the basis of s. 105 is unanswerable or absolute support for the particular propositions favored by the writer. Such a concession is essential in view of the fact that the inferences from the section are just that — inferences — and are based upon suppositions as to the actual effect of the section in particular cases, rather than logically necessary propositions drawn from the statutory language itself. But those qualifications recognized, it is submitted that the above analysis has illustrated that there exists in the present legislation a precedent for the notion of treating non-pecuniary benefits as a separate basis of assessability in themselves.

Non-Pecuniary Benefits Under SS. 672-676 Internal Revenue Code 1954 (U.S.)

The bases of the approach of both legislature and courts in the United States to the issue of retained controls and non-pecuniary benefits for estate duty purposes, earlier discussed, are repeated in the income-tax provisions of the Code. Those provisions are too lengthy to set out in full here, since Congress has been far more specific in its treatment of them in the tax field than the duty field. Indeed, there would be little point in doing so, since the writer's principal concern is simply to indicate that in a different, but historically related, jurisdiction, a fundamentally different approach from our own is adopted. It is thus necessary to state only the "general rule" laid down by the Code on this topic, and make one or two equally general observations about it. That rule is expressed as follows:

"(a) The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exerciseable by the grantor of a non-adverse party,[81] or both, without the approval or consent of any adverse[82] party."[83]

80. Richardson, 5 V.U.W.L.R. 26, 27.
81. Defined in s. 672 (b) as a party who is not an "adverse" party. See n. 82.
82. Defined in s. 672 (a) as "any person having a substantial beneficial interest in the trust which would be adversely effected by the exercise or non-exercise of the power which he possesses respecting the trust."
83. Section 674 (a).

To this general rule there are two important exceptions worthy of note. First, an independent trustee (other than the grantor) may be given a power to distribute or accumulate according to his or their discretion, without the consent of an adverse party.[84] And secondly a non-independent trustee[85] (though still excluding the grantor) may be conferred the same power if its exercise is limited" by a reasonably definite external standard."[86] The object of these and other complicating qualifications is obviously to strike some acceptable balance between the desirability of allowing a person with knowledge of the settlor's affairs, intentions and family circumstances to act as his trustee while preventing the settlor from casting a "subordinate",[87] capable of influence by him, in that role. More important for the purposes of this paper, however, is the fact that neither of these exceptions extend the capacity of the grantor himself to act as trustee or lessen the stringency of the conditions attaching to that status (as laid down by the general rule set out above) should he decide to so act.

As in the case of the analogous rules in the estate duty context, one of the fundamental bases which underlies this severe regulation is the belief that a settlor who continues to exercise dispositive powers has retained to himself right of extreme substantive importance. This belief has been expressed by judges and commentators in various ways. Mr Justice Frank, for instance, put it this way:

> "To make a gift is the essence of selfishness and the most effective way of asserting dominion over property; that remark, stripped of its cynicism, seems to epitomise the views of the Supreme Court in the *Horst*[88] case; taxable income, said the court, is to be measured by the 'satisfactions which are of economic worth'[89] and chief among them, it held, is the power to make gifts. We understand the Supreme Court to say that, certainly where the family — entente element is present, the elimination of the donor's power to expend the income for satisfactions flowing from his personal consumption does not afford him shelter from the tax."[90]

As the context makes clear,[91] Frank J. obviously intended the word "gift" in this extract to include a distribution under a discretionary trust by a settlor/trustee. Much the same view was expressed more shortly by L. Hand J. in *Littel* v. *C.I.R.*[92] when he said

> "The power which can be exercised over the lives of others by

84. Section 674 (c).
85. The difference between independent and non-independent trustees relates to any given trustee's position of "subordination" or otherwise to the settlor. A "subordinate party" is defined in s. 672 (c).
86. Section 674 (d).
87. Section 672 (c).
88. *Helvering* v. *Horst*, supra.
89. Ibid., 117.
90. *Commisioner* v. *Buck* 120 F. 2d. 775, 778-779.
91. The case concerned a settlement in favour of the settlor's wife and children.
92. 154 F. 2d. 922.

> the ability to give or withhold money is a substantial enjoyment . . .,"[93]

a comment prefaced by the observation that

> ". . . The spectacle of the beneficiary's material enjoyment, was the most important . . . of those satisfactions whose congeries constitute property."[94]

Acceptance of this philosophy would in itself be regarded in the United States as sufficient to justify provisions such as s. 674 of the Revenue Code (the "general rule" provision). Also arguing for the same type of regulation, however, is the equally prevalent sentiment, prompted by the "realities" of intra-family transactions, that to ignore the fact that a trustee is also a settlor is "to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance (to) household arrangements."[95]

The reasonableness of either proposition cannot be denied.

Implementation

The discussion to this point has concentrated on establishing the propositions that settlements such as the hypothetical A. Trust are inadequately regulated under existing estate-duty and income-tax legislation; that the basis of that inadequacy is a legislative preoccupation with reservations conferring pecuniary benefits; and that reservations of a non-pecuniary character may confer powers upon a settlor of so substantial and, virtually, absolute a nature that any legislation which treats them differently from rights of absolute ownership is drawing an erroneous and unrealistic distinction.

Assuming these propositions to be made out, and to be valid, it is now necessary to discuss the manner of their statutory implementation. On the assumption that something short of an absolute prohibition on any retained control will suffice to meet these objections, there are two principal choices available. One is to adopt the course taken in the Internal Revenue Code 1954 (U.S.) in relation to controls in the income-tax field; namely, to provide in some detail the reservations that may be made absolutely, those that can be made in favor of some persons but not others (e.g. independent trustees but not the grantor), those then can be made if qualified (e.g. to the grantor but exerciseable only with the consent of another) and so on. The other is to lay down a general principle which states in broad terms the overall character of reservations which are prohibited. This is, roughly speaking, the course adopted in the state-duty provisions of the U.S. Code.

Of these alternatives, the first would appear preferable. While few revenue statutes or revenue provisions can ever be drafted in terms

93. Ibid., 924.
94. Ibid.
95. *Helvering* v. *Clifford* (1940) 309 U.S. 331, 336.

that their application or otherwise to particular cases is never in doubt, when it is possible to do so legislation bearing so profoundly on large sections of the public should provide as clearly and precisely as possible the path to validity and efficacy for the taxpayer to follow. New Zealand's experience with s. 108 is a caution in this regard. So too is that of the United States in relation to the period 1940-1946 when the area of the law now so exhautively detailed in ss. 672-676 was governed by a short, vaguely expressed Supreme Court decision[96] which resulted in "countless cases" which "monopolized" the time of the inferior courts for those years.[97] In addition, it is thought desirable in principle that the legislature, on the advice of the executive and in accordance with an overall, unified and inter-related scheme prepared by the latter, should act rather than leave the details of liability to be devised by a number of individual judges working independently of one another.

The question of form is a relatively easy one to answer. Of far greater difficulty is the substantive issue of the context of the rules to be drafted in that manner. Indeed, one aspect of that latter inquiry is whether the general problem posed by reserved benefits ought not be dealt with by a blanket prohibition on settlors occupying the role of trustee of their own settlements, rather than a series of specific prohibitions. To those issues we must now turn.

As a minimum it is essential to prohibit the extensive controls retained in the A. Trust class of case from being possessed in a settlement which remains effective for tax and duty purposes. But what degree of *lesser* control should also be prohibited? In addition to, or as one aspect of, that inquiry we must also consider the significance and reliability (as checks upon otherwise broad powers) of the various methods whereby reserved powers may be qualified or limited in their exercise. Three principal issues arise for determination.

1. The significance of "discretionary" trusts as compared with "fixed" trusts

The A. Trust was of course "discretionary' in the extreme, as were those settlements in most of the American decisions we have considered. It is axiomatic that the greater the discretion conferred upon himself as trustee by a settlor, the greater the scope for "enjoyment" and "benefit". Yet any legislative amendments to implement the writer's proposals would have to extend beyond the regulation of "discretionary" trusts as that term is usually understood (i.e. as a trust in which the trustee has *dispositive* discretion). For, as we have seen in the context of an American case,[98] the fact that a trustee has no discretion as to the destination of distributable income serves not a jot to restrain his unfettered control if he has the power to determine,

96. Idem.
97. Bittker, *Federal Income, Estate and Gift Taxation* (2nd.Ed.) 316.
98. *Commisioner* v. *Hager's Estate* (1949) 173 F 2d. 613.

at an earlier stage, what receipts, if any, *will be* income for the year in question.[99] It is thus essential that both direct and indirect methods of controlling beneficial enjoyment be regulated, and that a realistic view is adopted of those seemingly innocuous powers, with which most settlements abound, which may be legitimately employed to secure benefits and retain control to the settlor. A power of advancement clearly falls within this category. So too does a power to determine whether receipts shall be deemed capital or income. Both may be exercised so as vitally to affect the quantum of income available for distribution and from the viewpoint of control exercised by the settlor over the beneficiaries, secure to the former just as substantial a domination as a discretionary dispositive power, or a power to accumulate, or a power to add new beneficiaries to the class.

The inclusion of a power so frequently conferred as a power of advancement within the description of impliedly "fatal" powers raises the issue of whether there are in fact any trusts which do *not* contain powers which permit the trustee substantially to affect, or control, the beneficial enjoyment of the beneficiaries. With the exception of those purely passive trusts wherein the trustee acts as a mere repository of legal title and has as his obligation little more than the eventual transfer of that legal title, the answer must be in the negative. We have to look no further than the power to invest to ascertain that. True, that power is subject to control by the courts of equity; but within the context of that control there is a wide area of discretion, frequently extended by the trust instrument itself, reserved to the trustee. There is no question that that reserved power may be exercised so as to substantially affect the enjoyment of the beneficiaries, particularly the relative value of life and remainder interests.

If this is so then the conclusion which must be drawn from the above analysis is obvious: no settlor should be permitted to act as trustee of a settlement of his own creation if that settlement is to be effective for duty or tax purposes. That is a somewhat extreme contention to maintain, and goes considerably further than the United States Internal Revenue Code 1954, but one is forced to it for two reasons. First, any power which may be employed to affect in a material way the relative interests of income and remainder beneficiaries must be of the same character as those powers possessed by A. in the hypothetical A. Trust. It will be remembered that in the *Hager's Estate*[100] case the United States Court of Appeals declared a power to allocate receipts between capital and income "a very substantial power",[101] one capable of exercise so as to "affect very substantially the interests of the life tenants and the remaindermen."[102] Precisely the same description must be given to the power to invest, particularly when the trustee's discretion in its exercise is extended by (his own)

99. Se on this point Grbich, n. 1, 142.
100. (1949) 173 F 2d. 613.
101. Ibid., 615.
102. Idem.

trust instrument. It must also be said of the power to advance capital. The second general reason in favor of the extreme proposition favoured is a more negative one. As indicated, the Internal Revenue Code 1954 does not impose an absolute ban on a settlor who wishes to act as his own trustee. Indeed, at least in the income-tax context, it goes so far as to indicate powers which he may retain and still render the settlement effective for tax purposes. These powers are, *prima facie*, far less substantial than those which he must forfeit to comply with the "general rule" established by s. 674[103] But on analysis they allow the settlor, as trustee, the opportunities to regain in considerable measure the powers and benefits he was obliged to forgo to comply with s. 674. This, clearly,[104] was not the intention of the Treasury draftsmen of these exceptions. But what other result can a power

> "(E)xercisable . . . during . . . the period during which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus,"[105]

have, other than to provide the settlor with the opportunities for securing benefits of the same character as the "general rule" in s. 674 was intended to prevent? The same is true of many of the other conceptions.[106]

The point is this. Once *any* exceptions are made to the general prohibition against a settlor holding office as trustee a capacity for rendering that prohibition nugatory or, at the least, for its substantial avoidance is inevitably introduced. No amount of assertion that the permissible powers, are less meaningful than the prohibited can obscure the fact that the former are *sufficiently* meaningful to allow the accomplishment in an indirect, but not illegal, way, of most of what was directly prohibited. It matters not at all what the quality or the character of the exception is, for as we have seen powers which seem purely administrative on their face may be employed to secure the same benefits as direct, dispositive discretions.

2. Settlor/Trustees Powers Limited by a Standard

Do these objections apply if the settlor's powers must be exerciseable in accordance with an objective standard? Under the Internal Revenue Code 1954 several powers which would otherwise be "fatal", may be retained if limited in this way.[107] Yet the Code's treatment is, it is submitted, subject to criticism in two respects. First, it does not require

---

103. Set out in text for n. 83.
104. For a discussion of the probable intentions underlying the regulations now given a legislative basis in s. 672 *et seq.*, see 2 Tax L.R. 327.
105. Section 674 (b) (7).
106. E.g. the power to distribute corpus in s. 674 (b) (5) and the power to withhold income temporarily in s. 674 (b) (6).
107. E.g. Those described in s. 674 (d) (relating to broad, discretionary powers to distribute or accumulate conferred upon trustees); and s. 675, relating to administrative powers.

that powers of a non-dispositive kind be limited in this way and, as we have seen, they are every bit as capable of being used to secure benefits and controls to the settlor as those which are dispositive in character. Secondly, the requirement of an objective standard by which distributions or other acts of administration are to be judged cannot totally, or even largely, obviate the discretion enjoyed by the settlor and which is the essence of his power and enjoyment. This latter point is clear from the cases. While the phrases "in the best interests of the beneficiaries"[108] and "if in ("the trustees") opinion the circumstances so require"[109] have been held to fall short of being sufficiently objective standards, clauses such as "the interest and advantage of the beneficiary"[110] "educational purposes or because of illness or for any other good reason"[111] and "overtaken by financial misfortune"[112] have been held to fall within the concept, as has the standard set by the word "needs".[113] It is by no means inevitable that a New Zealand court, administering the same class of rule, would reach these particular conclusions. But whatever the particular determinations made in the course of its administration there must always remain some area of discretion left to the trustee. For to impose an "objective standard" on a trustee is far from making the task of his annual distribution a formal and mechanical one. This is seen in the following example.

> A. as trustee, has a power to distribute income to promote the health, education and welfare[114] of A's (as grantor) grandchildren. There are 12 grandchildren. The income available for distribution for this purpose is $1500 per annum.

Little comment is needed to substantiate the assertion with which this example was introduced. Doubtlessly, A (as trustee) is less free in his exercise of discretion than he would be if the trust had been expressed in terms of *"welfare"* simpliciter or in a totally unqualified form. If one grandchild is desperately ill, and the others are not; if one grandchild is sorely in need of funds to continue his education and the others are not; or if one grandchild is left destitute by the death of its parents and the others are not, A. *might* be obliged to make a payment. But even in relation to these extreme cases, that qualification must be made, for even in them A. would be justified in refusing to do so in the light of other circumstances. Let us suppose:

> A. has decided (as trustee) to pay the annual distributable income to sponsor 6 of the beneficiaries to a summer camp, whereat they will derive benefits of recreation, sport, contact with other children and the like. Grandchild X becomes desperately ill and a long period of hospitalization is needed.

---

108. *Estate of Yawkey* v. *Commissioner* (1949) 12 T.C. 1164.
109. *Hurd* v. *Commisioner* 160 F. 2d. 610.
110. *Estate of Wier* v. *Commissioner* 17 T.C. 409.
111. *Estate of Wilson* v. *Commissioner* (1949) 13 T.C. 689; 187 F. 2d. 145.
112. *Jennings* v. *Smith* (1947) 161 F. 2d. 74.
113. *Funk* v. *Commissioner* (1950) 185 F. 2d. 127.
114. Undoubtedly an "objective" standard.

How limited is A. by the objective term "health" in the trust instrument? The answer must be, not sufficiently to *oblige* him to make a payment to X in this case. He is entitled to have regard to other programs he is sponsoring; he is entitled to have regard to the number of beneficiaries that would benefit from his distributions; no doubt he is entitled too to have regard to alternative funds available for the use of each beneficiary (in the case supposed, those of X's parents and social security for example).

All in all, it is submitted, the device of limiting dispositive powers by an objective standard by which their exercise may supposedly be judged does not provide a sufficiently substantial check on a settlor to justify his escape from tax or duty.

3. **Limitation by Adverse Party's Consent**

The Internal Revenue Code 1954, on several occasions in the general area with which we are concerned, adopts the device of "adverse party consent" as a means of controlling settlor/trustees without absolutely prohibiting that dual status. The "general principle" laid down by s. 674 is, as we have seen, one such case. The apparent belief is that by requiring a person "having a substantial beneficial interest which would be adversely affected by the exercise . . . of the power which he possesses"[115] to consent to acts of discretion of the settlor, the latter is severely circumscribed in the extent to which his unfettered judgment can be given full reign.

The difficulty with this concept is that, particularly in the realm of the intra-family transactions with which we are principally concerned, those who hold rights and interests cannot always be relied upon to assert them or to protest when another desires to adopt a course prejudicial to them. This is recognized by the United States Courts: in *Commissioner* v. *Prouty*[116] Magruder J. referred to the "element of unreality in the inquiry whether a beneficiary's interest in substantially adverse to the grantor."[117] Why? For the obvious reasons, first, that the grantor's goodwill towards the notionally adverse beneficiary is often worth a great deal more in monetary terms to the latter than the assertion of his strict equitable rights; and secondly, in the words of Magruder J. again, in an analogous context:

> "The very fact that the grantor reserved a power to revoke indicates a mental reservation on his part as to the finality of the gift, and if the grantor wishes to hold on to a power of recapture, it stands to reason he will vest the veto power in someone whose acquiescence he can count on."[118]

---

115. In part the definition of "adverse party" in s. 672 Internal Revenue Code 1954.
116. (1940) 115 F. 2d. 331.
117. Ibid., 335.
118. Idem.

Though said in the context of a power of revocation, this view must also hold true with regard to discretionary powers to control beneficial enjoyment.

In substance, it is suggested, "the adverse interest" concept is an unsatisfactory and inefficacious perpetuation of a philosophy rejected in other provisions of the Code, namely, the philosophy that an analysis of legal and equitable rights and interests "tells it all" in the family-settlement context.[119] Clearly it does not. Built upon the substructure of interests of that class is a complex, interwoven set of social, family, personal and psychological relationships which have the capacity for rendering nugatory the substructure itself. It is submitted that the only satisfactory solution to these difficulties is to deny them any opportunity to become difficulties at the outset by the imposition of the total prohibition previously suggested.

Conclusion

Many matters relevant to the topic of this paper have not been discussed, or, if discussed, have been subjected to brief and cursory analysis. Chief among these is the problem posed by the settlor's "subordinate" relatives and friends, who may often be employed by the former to act as his *alter ego* in cases when he himself is prohibited from acting. This problem is in turn but part of the wider field of inquiry posed by intra-family dealings generally and the difficulties arising from the frequent failure of parties to them to regard their strict legal rights and obligations as the sole regulators of their conduct with other parties to the same arrangement.

Accordingly, the writer makes no claim that the suggestions made in the previous pages are all that are necessary to bring back an air of reality to the manner of treatment of intra-family settlements under the revenue legislation. Clearly, there will be others arising from somewhat broader studies than have been undertaken here. But within the narrow topic selected there are, as have been illustrated, some meaningful reforms that could be implemented by relatively straightforward legislative amendments which are no more drastic in their substance than many other provision of the present estate duties and income tax legislation.

It was stated at the outset that any particular reader's support or opposition for the proposals to be made in this paper might depend on his intuitive response to a number of questions posed by a hypothetical case taken. Such an unorthodox, perhaps pretentious, emphasis is thought necessary in this field if only because the orthodox

---

119. It is worth repeating the observation of the U.S. Supreme Court on this point: "[We cannot] treat the wife as a complete stranger; . . . [or] let mere formation obscure the normal consequences of family solidarity; [or] face concepts of ownership to be fashioned out of legal niceties which may have little or no significance in . . . household arrangements,": *Helvering* v. *Clifford* (1940) 309 U.S. 331, 337.

is the very basis of the existing, and unsatisfactory, position wherein strict analyses of legal and equitable interests, strict issues of enforceability and strict notions of benefit prevail. If we do not, occasionally, ask ourselves "But is the decision we reach as a result of those considerations a *proper* one" we are in the Revenue field at least, condemning our legislation to be forever half a step behind adroit tax planners with a greater grasp of the power of non-legal interests than the framers of that legislation. We also, perhaps, are quoted a price which as lawyers we should be even more reluctant to pay. Section 108 of the Land and Income Tax Act 1954 is in the process of being rendered workable by the courts. The attendant uncertainty on many aspects of tax planning are well known. At least in part that result is caused by the failure of the Act to provide adequate specific anti-avoidance devices for the Revenue authorities, or to amend existing devices — such as s. 105 — to keep them up to date with modern, sophisticated avoidance techniques. Unless we are prepared to countenance more s. 108s in other areas of revenue legislation it is imperative that the latter process be reversed. The suggestions in this paper might be a start.

LINDSAY McKAY*

* L.L.M. Lecturer in Law, Victoria University of Wellington.