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PLANNING INCOMPETENTS' ESTATES VIA INTER-VIVOS DISTRIBUTIONS

I.

INTRODUCTION

The inflation of recent decades has precipitated an increase in the number of estates subject to potential estate and inheritance tax liability.¹ In response to this development, individuals desirous of making the most efficacious distribution of their wealth have employed special trust devices, transfers through gift before death, and many other similar methods to avoid such taxation wherever possible. The inter-vivos gift, because of its liberal exemption provisions and low-rate structure, has proven particularly attractive and practical.² Its recent utilization by guardians of the property of mental incompetents to effect tax-saving objectives has infused a new legal significance into this mode of transfer. The purpose of this comment is to explore the employment of this tool by the guardian. Consideration will be directed to the historical framework within which he must operate and the problems facing him as a result of its progression.

II.

THE HISTORICAL SETTING

The jurisdictions of our courts over the property of persons *non compos mentis* can be traced to our English predecessors. Originally, the king possessed such jurisdiction as part of his executive power, and the chancellor administered the proceedings as the personal representative of the king.³ The Chancery courts themselves enjoyed no inherent equitable power over the property of an incompetent.⁴ Only after an adjudication of incompetency and the appointment of a committee to care for the ward's property did they acquire further jurisdiction, which enabled them to supervise the conduct of the committee.⁵ American courts, on the contrary, viewed their power as arising from various sources. Some asserted that jurisdiction was inherent in the court of equity;⁶ others concurred in a variant of the English view and contended that any power was purely statutory.⁷ Whatever the position originally espoused, statutes now regu-

1. INT. REV. CODE OF 1954, § 2052. An exemption of \$60,000 is allowed from the value of the gross estate before the estate tax is computed.

2. INT. REV. CODE OF 1954, § 2052. The gift tax rate fluctuates between a low of 2¼% and a high of 57¾% with the first \$5,000 exempt. The Code recognizes a specific exemption of \$30,000, § 2521; a deduction for gifts to charity and similar purposes, § 2522; and an exclusion of \$3,000 for gifts to any one person during a calendar year, § 2503. On the other hand, the estate tax commences at 3% and concludes at 77%, and equals 1½ times the comparable gift tax rates, § 2001.

3. 3 POMEROY, EQUITY JURISPRUDENCE 1311 (4th ed. 1918).

4. *Ibid.*

5. *Ibid.*

6. *In re Hudelson's Estate*, 18 Cal. 2d 401, 115 P.2d 805 (1941).

7. *Hamilton v. Traber*, 78 Md. 26, 27 Atl. 229 (1893); 3 POMEROY, *op. cit. supra* note 3, § 1313.

late to a large extent the control courts may exercise over the estate of the incompetent and generally define the purposes for which expenditures may be authorized.⁸

The first reported decision permitting distributions from an incompetent's estate to benefit persons other than the ward was *Ex parte Whitbread*.⁹ These payments were predicated on the principle that the court would not refuse to do for the incompetent that which he himself would probably have done were he mentally sound. The so-called doctrine of substitution of judgment enunciated in this case was employed to approve allowances out of surplus income to relatives. Subsequent English decisions extended the application of the principle to sanction similar gifts to non-relatives¹⁰ as well as those to charitable and religious institutions.¹¹ American courts further developed the doctrine and permitted distributions from the principal of the ward's estate;¹² the few decisions that declined to countenance this view ultimately attributed their inertia to the absence of any statutory authorization.¹³

III.

THE CURRENT CASE LAW

The need of prospective donees provided the impetus for most of these grants, but distributions for other reasons¹⁴ indicated that impoverishment, although dominant, was not a *sine qua non*. The cases present two requirements that must be satisfied before any awards will be approved. First, the incompetent must be amply provided for in the manner to which he is accustomed,¹⁵ and secondly, the probability that he would have pursued this course of conduct, had his capacity to act not been impaired, must be reasonably demonstrated.¹⁶

The first reported case to consider a guardian's petition for permission to distribute some assets of the incompetent in order to effect a contemplated tax saving for the heirs was *Bullock Estate*.¹⁷ The estate consisted of about \$47,000 in bonds and other assets, including a disability insurance policy and a pension, which in the year prior to the petition had

8. *E.g.*, DEL. CODE ANN. tit. 12, § 3921 *et seq.* (1953).

9. 2 Mer. 99, 35 Eng. Rep. 878 (1816).

10. *Re Carysfort*, 1 Cr. & Ph. 76, 41 Eng. Rep. 418 (1840) (servant); *Re Whitaker*, 42 Ch. Div. 119 (1889) (fulfill a moral obligation).

11. *Re Strickland*, L.R. 6 Ch. 226 (1871).

12. *In re Bond*, 198 Misc. 256, 98 N.Y.S.2d 81 (1950); *In re Fleming's Estate*, 173 Misc. 851, 19 N.Y.S.2d 234 (1940). *But see Re Whitaker*, 42 Ch. Div. 119 (1889), where this position was implicitly recognized.

13. *Kelly v. Scott*, 215 Md. 530, 137 A.2d 704 (1958) (decision changed by subsequent statutory enactment); *Binney v. Rhode Island Hosp. Trust Co.*, 43 R.I. 222, 110 Atl. 615 (1920).

14. *Re Sparrow*, L.R. 20 Ch. D. 320 (C.A.) (1882) (to maintain the donee according to his status).

15. *E.g.*, *Ex parte Whitbread*, 2 Mer. 99, 35 Eng. Rep. 878 (1816).

16. *E.g.*, *In re Flagler*, 248 N.Y. 415, 162 N.E. 471 (1928).

17. 10 Pa. D.&C.2d 682 (Orphans' Ct. Delaware County 1957).

produced a surplus income of over \$1,000. The incompetent, who was then sixty-two years of age and who had been under mental treatment for a period of twenty-five years, was confined to a veteran's hospital, where he was subject to no charge for his maintenance. An immediate distribution of \$2,500 to the ward's wife and to each of his two daughters was requested, as well as such further periodic distributions from income as the guardian deemed prudent. The Pennsylvania statute provided that "[t]he court, for cause shown, may authorize or direct the payment or application of any or all of the income or principal of the estate of an incompetent for the care, maintenance or education of the incompetent, his spouse, children or those for whom he was making such provision before his incompetency. . . ."¹⁸ The court advanced several reasons for their denial of the petition. They cited the aforementioned statute as rigidly circumscribing their range of discretion. The possibility that the incompetent might recover and make a new will were given as additional deterrents. Furthermore, the court noted that if one of the prospective donees predeceased the ward, it would effect a change in the anticipated heirs of his estate. Finally, the court suggested that tax avoidance was not a proper motive for permitting an inter-vivos gift.

When the issue was next presented, a New York court reached a different result. In *In re Carson*¹⁹ the court approved that part of a prior order which authorized a gift of a portion of the corpus of the incompetent's estate to the ward's son, but declined to sanction the part of the same order which directed that a similar gift be made to the daughter. The distinguishing factor offered was that the latter order would directly conflict with a specific provision of the ward's will. The potential donees were the incompetent's next of kin, his only known relatives, and the principal legatees under his will. Though the ward was *in extremis*²⁰ at the time of the petition, the corpus remaining after the distribution would have been ample to provide for him if death did not follow as speedily as predicted. The court concluded that the existence of the will naming the prospective donees as the objects of her bounty was sufficient evidence to indicate that the incompetent, if sane, would have made a similar gift to effect the substantial savings in taxes and administration expenses.

*In re duPont*²¹ followed *Carson* and arrived at a similar conclusion. There, the desired distributions were to be made to the children and grandchildren by way of an inter-vivos trust, which substantially conformed to the terms of the ward's will. The ward was eighty-six years old and permanently disabled both mentally and physically. His estate, which was valued at some \$176,000,000, produced a surplus income of about \$600,000 a year. The tax-saving gifts would deplete the ward's estate by about \$57,000,000,

18. PA. STAT. ANN. tit. 50, § 3644 (1956).

19. 39 Misc. 2d 544, 241 N.Y.S.2d 288 (1962).

20. The ward died shortly after the granting of the order. *Id.* at 545, 241 N.Y.S.2d at 289.

21. 194 A.2d 309 (Del. Ch. 1963).

but undoubtedly would leave him with sufficient income to maintain him munificently. The evidence indicated that the ward was sophisticated in the ways of taxes, had made sizeable gifts to his family in the past, and, in all probability, would have made the proposed gifts except for the pendency of the Du Pont–General Motors anti-trust action.²² The court concluded that the ward, if competent, would have made the requested grants and, substituting its judgment for that of the ward, approved the guardian's petition.

Finally, *In re Trusteeship of Kenan*²³ provided the opportunity for an articulation of the limits of the doctrine. The guardian petitioned the court for authorization to make substantial gifts, of both income and principal, to charity and to surrender the right to revoke a trust reserved by the incompetent. Both steps were designed to provide substantial savings in estate taxes. The ward was a widow with no lineal descendants, and probably would never regain sufficient mental capacity to manage her affairs. Her annual taxable income substantially exceeded \$2,000,000 a year, and making the proposed gifts would leave income adequate to maintain her in the manner to which she was accustomed. The ward had retained a competent tax advisor who testified that she was well aware of the impact of taxes; her will and the trust arrangement had been drafted by an attorney well versed in the field of estate and trust work and taxation. The court ordered continuance of the gifts to charity which had been undertaken previously by the ward, but since no evidence was produced to indicate that the ward would have made the proposed gifts, if sane, they refused to authorize the further gifts. The mere fact the legislature or the court thought they should be made could not replace evidence of the ward's intent.

IV.

THE METHOD OF DECISION

A. *Preliminary Determinations*

Two preliminary determinations face the court in deciding whether the funds of the incompetent should be applied to the use of others. First, it must find that it has the power to grant such allowances. If it possesses jurisdiction, the second step is to decide whether it desires to adopt and apply the doctrine of substitution of judgment. As previously mentioned, the decided cases are in conflict over the source of this power, but a number of jurisdictions hold that the courts possess it independent of statute.²⁴ Some state statutes, recognizing the public benefit to be derived from

22. The ward was one of the defendants in the DuPont – General Motors anti-trust action charged with trying to keep the control of DuPont within the family. The court reasoned that the pendency of this action kept the ward from instituting an earlier plan to distribute the Christiana Securities stock. When the action terminated, the ward was no longer able to effectuate such a plan. *Id.* at 312.

23. 261 N.C. 1, 134 S.E.2d 85 (1964).

24. *E.g.*, New York *Re Willoughby*, 5 N.Y. Chan. Rep. 254 (1844).

contributions to charitable, religious, and governmental institutions, specifically authorize such gifts from the incompetent's estate.²⁵ Both the *Kenan* and *duPont* cases exemplify exercises of purely statutory jurisdiction. In *Kenan*, the minuscule amount of the ward's present income that would have ultimately accrued to her heirs and legatees as a result of federal income and estate taxes, induced the guardian to invoke the aid of such a statute. *In re duPont* reflects the liberal attitude of the judiciary in applying the principle of substituted judgment where the power to so proceed is purely statutory. There, the court found authorization to order the distributions in a statute providing that "a trustee may do whatever is necessary for the care, preservation, and increase of his ward's estate."²⁶ The court reasoned that the interest of the eventual successors to the ward's estate was implicitly identified with the ward's interest. Such a statute could have been construed as merely restating the traditional refusal to recognize the doctrine of substitution of judgment founded on the theory that an increase in the assets of the estate of the incompetent is the guardian's undeviating duty.²⁷ On the basis of *duPont*, the Pennsylvania statute,²⁸ construed by *Bullock Estate* as circumscribing the court's discretion, could be interpreted as embracing gifts solely for tax-saving purposes. Should the guardian present more evidence of the incompetent's intent, that Pennsylvania decision might not preclude such a liberal application in the future.²⁹

B. *The Standards of Determination*

Assuming the court decides it has the requisite power and desires to invoke the doctrine of substitution of judgment, it arrives at a more perplexing problem of properly applying the doctrine. Authorization of the gift does not follow as a necessary corollary. Rather, the court must determine what the incompetent would have done. An analysis of the cases in the non-tax field has led one author³⁰ to suggest that the courts have employed three standards in making their determination:

25. N.C. GEN. STAT. ch. 35, § 29.1-29.10 (1955).

26. DEL. CODE ANN. tit. 12, § 3705 (1953).

27. *In re Rieley's Estate*, 194 N.E.2d 918 (Ohio Prob. Ct. 1963) (dictum) (The court permitted the estate of the wife to pass directly to her legatees and devisees under the provisions of her will rather than directing the guardian of her affluent husband to elect to take under the law of descent and distribution, when it was demonstrated that this would be consistent with the plan of the husband and wife to minimize their estate and inheritance taxes.)

28. PA. STAT. ANN. tit. 50, § 3644 (1954).

29. The opacity of the court's discussion on the ambit of the statute and the enumeration of several reasons for denying the petition suggest that the absence of statutory power might not have been a truly determinative factor. The court stated, with reference to the statute: "The foregoing statutory provision circumscribes the power and authority of the guardian to make dispositions of the principal and income of the incompetent's estate. There is no ambit of discretion except within the orbit of the powers expressly conferred or necessarily implied from the statute. . . . [giving additional reasons for their decision]. For the reasons herein stated, the court is without power to grant the relief prayed for." *Bullock Estate*, 10 Pa. D.&C.2d 684-85 (Orphans' Ct. Delaware County 1957).

30. Comment, 17 CALIF. L. REV. 175, 177-78 (1929).

1. Objective standard — A determination of what the average, reasonable man would do under the circumstances and a continuation on that basis, without regard to the past conduct or practices of the lunatic.

2. Strict subjective standard — An ascertainment of the donees and the extent of gifts made by the lunatic, while sane; the resulting order would authorize a continuation only of such gifts.

3. Liberal subjective standard — A consideration of the past course of this particular incompetent's conduct, and, based on such facts, a determination of his probable action in this particular instance.

As universal standards to be applied to every case, each of these tests possesses certain patent defects. By disregarding the past conduct of the ward, the reasonable man rule ignores the liberality or niggardliness of the very individual who accumulated the funds sought to be distributed. Thus, his already circumscribed right to manage and dispose of his estate as he might wish is further impinged. The North Carolina court suggests that such a practice would venture beyond the province of the judiciary and constitute a deprivation of property without due process of law.³¹ Certainly, some limits must be imposed upon the courts in these matters. On the other hand, the subjective tests, by focusing solely on the past conduct and practices of the lunatic, overlook the likelihood of future conduct at variance with his prior activity. The passage of time between an adjudication of incompetency and a petition for a distribution render it probable that an individual might be more disposed to distribute his property in this manner. Experience bears out the proposition that liberality in such matters of beneficence increases with the age of the donor.³²

C. *Additional Factors For Consideration*

Rather than adhering to any one of these standards, the court should appraise pertinent factual matters and determine whether it would be reasonable for this particular person to make the desired distributions. Relevant factors³³ to be considered would be the age and life expectancy of the incompetent; his present and probable future requirements for his own maintenance; his relationship and intimacy with the prospective donees, both before and during incompetency; the incurability of his condition; his concern for tax minimization and estate planning; and such other factors as the incompetent would consider in making a similar decision. In the absence of evidence indicating a contrary intention, it does not seem unreasonable for the court to presume that an older person, recognizing the disparity between gift and estate taxes, would desire to distribute some of

31. *In re Trusteeship of Kenan*, 261 N.C. 1, 134 S.E.2d 85 (1964). The court implicitly recognized such a position when it held that it could not authorize the gifts merely because of a personal belief that they should be made, since this would be in derogation of the incompetent's constitutional rights.

32. See ALLEN, *ECONOMICS OF PUBLIC FINANCE* (2d ed. 1954).

33. A number of these factors cited are taken from the brief of the Amicus Curiae filed in the *In re DuPont* decision pp. 113-15.

his estate by way of inter-vivos gifts to the natural objects of his bounty.³⁴ The primary element tending toward a contrary result would be provision for his own maintenance. Obviously, this would be of primary importance among the aforementioned factors.

Testing the decided cases by a standard of reasonableness, *In re duPont* and *In re Trusteeship of Kenan* certainly contain sufficient evidence of the incompetent's past conduct to determine his putative intent and support their disparate conclusions. Although *In re Carson* lacked such abundant evidence, the impending death of the incompetent, combined with the fact that the prospective donees were the only children and the beneficiaries under her will, rendered the decision, directing the distribution, reasonable. The advanced age of the ward, the gratuitous maintenance provided him, the size of the requested distributions, the relationship of the prospective donees, and the content of his will indicate that the application of the principle would have been apposite in *Bullock Estate*.

D. Considerations Against Flexibility

While intelligent estate planning for the incompetent demands a certain degree of flexibility, the facility with which involuntary guardianship can be imposed necessitates some adherence to the traditional policy of restraint in dealing with requested distributions. Most state statutes³⁵ provide that a relative or any interested person may petition the court for the appointment of a guardian to manage the property of an alleged incompetent. The test employed in making an adjudication of competency is whether the alleged incompetent can rationally manage his business affairs.³⁶ A minimal amount of mental impairment plus any errant economic conduct will often satisfy this criterion.³⁷ The liberality of the court in decreeing wardship³⁸ and the non-adversary nature of the proceedings³⁹ offer predatory heirs a propitious opportunity to protect their expectant interests by initiating proceedings. An unrestrained attitude in granting inter-vivos gifts will only stimulate and encourage petitions for involuntary guardianship by heirs and legatees desirous of reaping a windfall through a premature distribution of their aged benefactor's estate.

To deter any unsavory practice, the court should appoint a guardian *ad litem* to protect the ward's interest, both before the initiation of guardianship proceedings and before considering a petition for distribution. This latter procedure was pursued in *Kenan*. By contrast, the opinion in

34. See BUCHANAN, *THE PUBLIC FINANCES* (1960).

35. *E.g.*, PA. STAT. ANN. tit. 50, § 3307 (1954).

36. *Graham v. Clapp*, 191 Iowa 1224, 184 N.W. 329 (1921); 45 IOWA L. REV. 360, 366 (1960).

37. Note, *The Disguised Oppression of Involuntary Guardianship: Have the Elderly Freedom to Spend?* 73 YALE L.J. 676, 680 (1964). A guardian can be appointed in Delaware even though the ward is only physically incapacitated. (DEL. CODE ANN. tit. 12, § 3914 (1953).)

38. Note, *The Disguised Oppression of Involuntary Guardianship: Have the Elderly Freedom to Spend?* *supra* note 37, at 676.

39. *E.g.*, PA. STAT. ANN. tit. 50, § 3301 (1954).

Carson does not disclose whether anyone represented the ward; and in *duPont*, an Amicus Curiae served as the only shield against impropriety. The solicitude of both of these courts in insuring that the incompetent's present and probable wants would be satisfactorily supplied cannot be glossed over; but, a court-appointed guardian representing only the ward's interest would have been a more effective safeguard.

V.

LIMITATION ON TAX AVOIDANCE

Even if the court authorizes the proposed gifts, the estate planner's efforts in minimizing taxes will be somewhat negated if the gifts are held to be in contemplation of death.⁴⁰ The Supreme Court in *City Bank Farmers Trust Co. v. McGowan*⁴¹ held that the court-authorized gifts to the children of the incompetent, which were obviously intended to accelerate enjoyment of the estate, were includable in the gross taxable estate. On the contrary, gifts to the same children commenced prior to incompetency and donations to destitute collateral relatives were held not to be in contemplation of death and thus were excluded from the estate for tax purposes. Such exclusion can be achieved only if the ward survives the making of the gift by three years or the representative of the estate is able to prove that a life-time motive prompted the distribution.⁴² A settled policy of the incompetent to make liberal gifts to children,⁴³ an intent to avoid high income taxes⁴⁴ or the burdens of managing the donated property,⁴⁵ and an intent primarily to provide independent income or security for dependents or family⁴⁶ have been construed as motives adequate to distinguish these from gifts in contemplation of death and might be applicable in the guardian-ward context. Moreover, where the dominant motive is other than the thought of death, an additional motive to avoid estate or inheritance taxes will not cause the gift to be considered in contemplation of death.⁴⁷

VI.

CONCLUSION

The decisions sanctioning such distributions promote economic stability by stimulating the distribution of capital. Blind insistence that the estate of an incompetent remain intact throughout the entire period of incompetency seems to ignore reality. Certainly, situations can be conceived where

40. Some tax saving will probably be realized even if the gifts are held to be in contemplation of death. See INT. REV. CODE OF 1954, § 2012.

41. 323 U.S. 594 (1945).

42. INT. REV. CODE OF 1954, § 2035.

43. *U.S. v. Wells*, 283 U.S. 102 (1931).

44. *Becker v. St. Louis Union Trust Co.*, 296 U.S. 48 (1935).

45. *Welch v. Hassett*, 90 F.2d 833 (1st Cir. 1937).

46. *Delaware Trust Co. Exec. (Wm. DuPont Est.) v. Handy*, 53 F.2d 1042 (3d Cir. 1931).

47. *Allen v. Trust Co.*, 326 U.S. 630 (1946).

the incompetent would desire to make distributions prior to his death. Changes in the estate, in the needs of distributees, in the tax laws, or merely in the age of the donor may well have an impact on his donative intentions. By analyzing the factors dominant in each case, courts can come to a reasonably valid judgment of the incompetent's probable intent. Effective limitations and safeguards are available to insure proper judicial discretion. Use of the doctrine of substituted judgment enables courts to transform restrictive legal principles into effective tools for administration.

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