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Revocable Inter Vivos Trusts versus the Statutory Share

William C. Owen
University of Nebraska College of Law

REVOCABLE INTER VIVOS TRUSTS VERSUS THE STATUTORY SHARE

I. INTRODUCTION

In Nebraska as in many other states, a person, during his lifetime, may dispose of personal property either by gift or otherwise so as to completely vitiate the statutory share of a surviving spouse.[1] One method employed by donors in attempting to effect inter vivos transfers of property is the so-called living revocable trust. This method is particularly attractive to the settlor since he not only enjoys a power of revocation, but may also reserve a life interest in the income arising from the investment of the trust *res*.[2] While most courts are agreed that such a trust is a valid non-testamentary disposition,[3] there seems to be some disagreement as to whether this type of trust device should also prevail against the claim of a surviving spouse.[4] The dispute on this question does not arise from a propensity by some courts to restrict the alienability of property in the favor of the surviving spouse. The dispute arises because some courts have held that in a revocable inter vivos trust, the settlor, so far as his or her spouse is concerned, has not in fact departed with the substantial rights and powers of ownership so as to effectuate an alienation of the trust property.

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[1] NEB. REV. STAT. § 30-107 (Reissue 1964) provides that a surviving spouse may elect in lieu of a will to take by "descent and distribution the interest in the estate of the deceased provided by law." NEB. REV. STAT. § 30-103 (Reissue 1964) entitles a surviving spouse to a statutory share of the personal property of the deceased spouse. This distribution is the same as a spouse is entitled to under NEB. REV. STAT. § 30-101 (Reissue 1964) which provides for a statutory share in real property.

[2] A typical example of such a trust is as follows: Settlor, by an inter vivos conveyance, transfers certain personal property to *T* as trustee to manage and invest at *T*'s discretion. The trust is to be paid to the settlor for life, and on death of the settlor, *T* is to pay the principal to *C*. The instrument further reserves in the settlor during his lifetime the power to modify or entirely revoke the trust. This trust is similar to the example given in RESTATEMENT (SECOND), TRUSTS § 57, comment c (1959).

[3] Whalen v. Swircin, 141 Neb. 650, 4 N.W.2d 737 (1942). See generally RESTATEMENT (SECOND), TRUSTS § 57, comment d (1959); 1 SCOTT, TRUSTS § 57.2 (2d ed. 1956); Annot. 49 A.L.R.2d 521 (1956).

[4] The Restatement provides that such trusts are valid against the claim of a surviving spouse: RESTATEMENT (SECOND), TRUSTS § 57 (1959); See 1 SCOTT, TRUSTS § 57.5 n.4 (2d ed. 1956); *Contra*, Bolles v. Toledo Trust Co., 144 Ohio St. 195, 58 N.E.2d 381 (1944), overruled in Smyth v. Cleveland Trust Co., 172 Ohio St. 489, 179 N.E.2d 60 (1961); Ackers v. First Nat'l Bank, 192 Kan. 319, 387 P.2d 840 (1963); Smith v. Northern Trust Co., 322 Ill. App. 168, 54 N.E.2d 75 (1944). See also Newman v. Dore, 275 N.Y. 371, 9 N.E.2d 966 (1937).

Although Nebraska has not become a participant in this dispute,[5] the probability is great that it will be compelled to do so in the near future.

II. THE FRAUDULENT TRANSFER TEST

There are numerous cases employing the words "fraudulent" or "colorable" to designate transfers which have been held to violate the statutory interest of a surviving spouse.[6] In some of these cases it is apparent that the courts have used this terminology to describe a mere device by which the husband attempts to keep for himself the benefit of his property during his lifetime and at the same time, deprive his spouse of her statutory interest at his death. Although use of the term "fraudulent" in such cases varies substantially from its usual connotation, its use is not entirely ill-chosen for the purpose of describing a test based on the intention of the donor. The exact meaning of the term "fraudulent" and its related test is well expounded in *In re Sides' Estate*,[7] a Nebraska case.

In the *Sides* case a father, during his lifetime, gave money to each of his children by a former marriage and immediately took in return promissory notes for the full indebtedness. Each note contained a written provision that such note should be cancelled on the death of the payee and not be a claim against the maker. The father then delivered the notes to a trustee with directions to collect and remit the interest to him during the remainder of his lifetime and to surrender the notes to the makers on the father's death. Thereupon, the father never exercised any dominion or control over the notes. On the father's death his widow sought to include the notes in the estate for the purpose of attaching her statutory share. After first holding that the trusts constituted absolute inter vivos gifts, the court discussed the contention that the transfers were fraudulent as to the widow. On this issue the court stated the applicable test as follows:

> [S]ubstantially all authority is to the effect that the question of good faith is controlling. If the transfer of personal property by the husband during his lifetime is a mere device and means by which he retains to himself the use and benefit of the property during his lifetime, and at his death seeks to deprive the widow of her statutory share, it is fraudulent as to the wife.[8]

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[5] *In re* Sides' Estate, 119 Neb. 314, 228 N.W. 619 (1930), discussed *infra*, concerned the marital rights of a surviving spouse in relation to an irrevocable trust.

[6] See generally, Annot., 49 A.L.R.2d 521 (1956).

[7] 119 Neb. 314, 228 N.W. 619 (1930).

[8] *Id.* at 323, 228 N.W. at 622.

If the court had simply applied the foregoing statement, the *Sides* case could be read to mean that the term "fraudulent" was used to describe the method or device utilized to effectuate the transfer and had nothing to do with the motive of the donor in making the transfer. Under this interpretation, the critical question in any case would be whether the powers and beneficial rights of ownership reserved in the donor or settlor are of sufficient extent to render the transfer a mere device and therefor ineffective against the claim of a surviving spouse. However, the court was not content to conclude its opinion with the quoted portion above. In the next paragraph it reasoned that the burden was on the widow to prove that the settlor, in making the gifts to the beneficiaries, was actuated by bad motive and fraudulent intent.[9] Thus, the true test emerging from the *Sides* case is two-fold: (1) The trust transaction must appear as a mere device by which the settlor retains the use and benefit of the property to the exclusion of the widow's interest, and; (2) the intent of the settlor in creating the device must be substantially directed toward depriving the widow of her statutory share—there must be substantial evidence of bad faith or ill-will against the widow.

So far as the *Sides* case typifies the cases adhering to the fraudulent transfer test, it was precisely the bad motive element of the test that eventually led to its complete rejection in the leading case of *Newman v. Dore*.[10] It was this case that set out the doctrine of illusory transfers.

III. THE ILLUSORY TRANSFER TEST

In *Newman* the settlor, a few days prior to his death, conveyed substantially all of his real and personal property to trustees, retaining not only the income for life and the power to revoke the trust, but also the power to control the trustees in the management of the trust. The court specifically rejected motive or fraudulent intent as a proper test on the grounds that there must first exist some right accruing to the widow which is capable of being defrauded.[11] The court reasoned that the only sound test was wheth-

[9] "On the issue of fraud presented, the burden of proof is upon the surviving widow to establish by a preponderance of the evidence that, in making these gifts to his children, the father was actuated by bad motive and fraudulent intent, and that the entire transaction was a mere device by which he sought to defraud her." *Id.* at 323, 228 N.W. at 622.

[10] 275 N.Y. 371, 9 N.E.2d 966 (1937).

[11] "Motive or intent is an unsatisfactory test of the validity of a transfer of property . . . . Intent may, at times, be relevant in determining whether an act is fraudulent, but there can be no fraud where no

er the husband had in good faith divested himself of ownership of his property or had made an illusory transfer.[12]

While the *Newman* case completely rejects the fraudulent intent requirement, it does not completely abandon all requirement of intent. Under its doctrine, a transfer is said to be illusory when the settlor did not intend a good faith divestment of the property, but this does not mean that there has to be a finding of actual intent. Such intent may be determined by the extent of actual divestment of the property.

So far as the *Newman* case rejects the requirement of a finding of bad motive or fraudulent intent its logic would appear sound and should be followed in Nebraska. This would entail a healthy explanation if not an express overruling of the *Sides* case. However, before Nebraska extends complete approval to the illusory doctrine, it should consider the various ramifications implicit in the doctrine concerning testamentary and non-testamentary transfers.

IV. SOME RAMIFICATIONS OF THE ILLUSORY TEST

Briefly, the illusory test can be stated in terms of whether the settlor intended in good faith to divest himself of the property. As indicated by the *Newman* decision the test may be independent of an inquiry as to whether the trust is testamentary in the conventional sense.[13] Thus, it is conceivable that a given trust may be reached by a surviving spouse yet at the same time remain impervious to an attack by the personal representative of the settlor. As a corollary to this conclusion, it is also conceivable that a given trust, when attacked by a spouse, may only be declared invalid to the extent necessary to satisfy the spouse's statutory share—the remainder of the trust property passing unaffected to the designated beneficiary. Both of these conclusions, however, depend on the existence of a real difference between an attack by a surviving spouse and an attack by the personal representative of the settlor.

Historically, the tests for determining the testamentary or non-testamentary nature of inter vivos transfers were developed

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right of any person is invaded. 'The great weight of authority is that the intent to defeat a claim which otherwise a wife might have is not enough to defeat the deed.' " *Id.* at 379, 9 N.E.2d at 968.

12 *Id.* at 379, 9 N.E.2d at 969.

13 "We do not now consider whether . . . the reserved power of control is so great that the trustee is in fact 'the agent of the settlor.' We assume, without deciding, that except for the provisions of section 18 of the Decedent Estate Law the trust would be valid." *Id.* at 380, 9 N.E.2d at 969.

along lines to insure and protect the intention of the donor. Because of the stringent and inflexible formalities and requirements of the Statute of Wills, courts strove to avoid the statute by subtle distinctions between interests created inter vivos but subject to future enjoyment and interests which were not intended to arise at all until the death of the donor. However, in no way were the various rules designed to afford protection to the designated heirs of the donor claiming through his personal representative. Thus, a donor by a revocable trust device was enabled to retain almost all the benefits of ownership and at his death effectuate a transfer of the property free and clear of his estate.

With the advent of the statutory share accruing to the surviving spouse coupled with the right of election, complete protection was accorded the spouse against any and all donative intent of the donor as contained in a valid will. The question that immediately arises and the real question that confronted the court in the *Newman* case was whether the conventional tests for determining the testamentary nature of a given transfer can be applied so as to give adequate protection to the interest of a surviving spouse. Obviously, in *Newman* the court reasoned that the conventional tests were inadequate for this purpose, for the court assumed that the trust was valid except for the challenge by the widow.[14] In setting out a test to accord protection to a surviving spouse, the court was concerned with the substance of the transfer—the degree of retention of the important elements of ownership—rather than the mere form and appearance of the transfer.[15] Having satisfied itself that the trust did not suffice to divest the settlor of the important rights and powers of ownership, the court was prepared to say that insofar as the widow alone is concerned, the trust property is to be treated as part of the settlor's estate.

To the extent that the illusory test is directed only toward the protection of the interest of a surviving spouse, it reasonably follows that once the test has served this purpose, its application should terminate, leaving the remainder of the transfer—the portion not needed to satisfy the claim of the surviving spouse—to be adjudicated in accordance with the general rules relating to testamentary and non-testamentary transactions. This may mean that

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[14] *Ibid.*

[15] "Perhaps 'from the technical point of view such a conveyance does not quite take back all that it gives, but practically it does.'. . . Judged by the substance, not by the form, the testator's conveyance is illusory, intended only as a mask for the effective retention by the settlor of the property which in form he had conveyed." *Id.* at 381, 9 N.E.2d at 969.

the remainder of the trust will pass to the beneficiary free and clear of the claims of the personal representative of the estate.

V. ACCEPTANCE AND GROWTH OF THE ILLUSORY DOCTRINE

Although *Newman v. Dore* has been widely accepted as setting forth a correct test for determining the effectiveness of an inter vivos trust against the claims of a surviving spouse, most jurisdictions have been somewhat hesitant in extending recognition to the various ramifications of the doctrine.

In New York the distinction between the validity of a trust per se and the validity in relation to the claim of a surviving spouse was expressly rejected in *In re Halpern's Estate*,[16] decided some fourteen years after the *Newman* case. The precise issue before the court was whether a "Totten" or tentative trust was illusory under the rule of *Newman*. After first overruling the Appellate Division by deciding that such trusts were not illusory, the court went to great lengths to reject the lower court's conclusion that the trusts were illusory only to the extent necessary to satisfy the widow's claim.[17]

Although the distinction was completely repudiated in New York, it did receive some recognition in other jurisdictions. One such case is *Bolles v. Toledo Trust Co.*[18] In this case a husband transferred personal property to a trustee under an agreement whereby the husband reserved the income to himself for life and also the right to amend or revoke the trust. The settlor's spouse was made a life beneficiary of the trust to the extent of 500 dollars per month. The validity of this type of trust was established by statute with an exception in favor of creditors. In holding the trust invalid against the claim of the settlor's widow, the court reasoned that a widow had a greater interest than a creditor even though her interest was not expressly protected by the statute; nevertheless the court was careful to point out that it was not declaring the trust totally invalid but only voidable at the instance of the widow to the extent necessary to satisfy her distributive share.[19]

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16 303 N.Y. 33, 100 N.E.2d 120 (1951).

17 "We see no power in the courts to divide up such a Totten trust and call part of it illusory and the other part good. The only test is that quoted above, from Newman v. Dore, . . . and the result of its application would necessarily be either total validity or total invalidity, as to any one transfer." *Id.* at 40, 100 N.E.2d at 123.

18 144 Ohio St. 195, 58 N.E.2d 381 (1944).

19 "Therefore, we are led to the conclusion that as to the widow, trusts

The *Bolles* case was good law in Ohio until 1960 when it was expressly overruled in *Smyth v. Cleveland Trust Co.*[20] Part of the grounds relied on in rejecting the *Bolles* case apparently rested on the court's inability or unwillingness to recognize a trust as partially valid and partially invalid.[21]

The *Smyth* decision had a definite dampening effect on the growth and acceptance of the dual validity characteristic of a given trust in respect to the claim of a surviving spouse. However, other decisions have done much to lend vitality to the distinction.[22] A recent and interesting case is *In re Jeruzal's Estate.*[23] This case involved numerous savings account trusts which the settlor had created for the obvious purpose of reducing his wife's share of his estate. Previous decisions following the doctrine of *Matter of Totten*[24] accorded validity to this type of trust. Although the Minnesota cases dealing generally with fraud on the marital rights were confusing, the court concluded that the applicable test for adjudicating the rights of a surviving spouse was whether the transaction was real or illusory. However, under this doctrine, as it was interpreted in the *Halpern* case, a widow could not reach the balance remaining in trust since the trust was real. At this point instead of rejecting the interpretation of the illusory test as contained in the *Halpern* case, the court abandoned the test in favor of the Restatement rule,[25] which in the case of "Totten" trusts, permits

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Nos. 331 and 520 were illusory. . . . This criticism does not necessarily affect the validity of either of these trusts . . . but it is intended to show that such trusts may not be used as a device to deprive the widow of her distributive share of the property possessed by her husband at the time of his death. To the extent that such an arrangement, if allowed to stand, would deprive the widow of her distributive share of the property, it is voidable at the instance of the widow." *Id.* at 212, 58 N.E.2d at 390.

20 172 Ohio St. 489, 179 N.E.2d 60 (1961).

21 "It is here observed that the statute gave validity to Bolles' trust and made no exception in the wife's favor. Furthermore, if . . . the wife was entitled to her share in the 'property possessed by her husband,' then the entire trust should have failed, as the trustee was possessed of no property." *Id.* at 500, 179 N.E.2d at 68.

22 *Accord,* Ackers v. First Nat'l Bank, 192 Kan. 319, 387 P.2d 840 (1963); Smith v. Northern Trust Co., 322 Ill. App. 168, 54 N.E.2d 75 (1944).

23 269 Minn. 183, 130 N.W.2d 473 (1964).

24 179 N.Y. 112, 71 N.E. 748 (1904). This case held that where a person deposits funds in a savings account in his own name as trustee for another, in the absence of evidence that an irrevocable trust was intended or that no trust at all was intended, the law will infer from the form of the deposit that the depositor intended to create a revocable trust.

25 "We would prefer the Restatement rule, by which the beneficiaries

the surviving spouse to reach the trust *res* to the extent necessary to satisfy his or her statutory share. Due to the widespread use of "Totten" trusts and the reliance which was felt to have been doubtlessly placed on its former decisions dealing with marital rights, the court reasoned that it could not apply a new rule of law in the instant case. Although the plaintiff widow was not accorded relief, the court made it clear that it would feel free to adopt the Restatement rule should the legislature fail to act on the matter.

This case is interesting from the standpoint that it offers an illustration of the position that courts might work themselves into by failing to appreciate the real nature of the illusory test. In the *Jeruzal* case, had the Minnesota court recognized that the illusory test is limited solely to the interest of a surviving spouse and is not applicable to a determination of whether a transfer might otherwise be valid, it might have easily accorded the widow relief without the risks of upsetting the reliance placed on its former decisions. If this approach had been followed the caveat would have been unnecessary.

VI. WHEN IS A TRUST ILLUSORY

What has been said so far is merely to emphasize two points which should be considered by the Nebraska court in attempting to resolve the statutory claim of a surviving spouse. (1) The court should reject the fraudulent transfer test as contained in the *Sides* case in favor of the illusory test as stated in *Newman v. Dore.* (2) The court should recognize that a determination of a transfer as illusory does not necessarily mean that the transaction is entirely invalid, but only voidable at the instance of the surviving

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receive what the decedent intended them to have except so far as the trust funds are necessary to satisfy the statutory interest of the spouse after the general assets of the estate have been exhausted." *In re* Jeruzal's Estate, 269 Minn. 183, 195, 130 N.W.2d 473, 481 (1964). The court is referring to RESTATEMENT (SECOND), TRUSTS § 58, comment e (1959). This section provides in part: "Although the surviving spouse in claiming his or her statutory distributive share of the estate of the decedent is not entitled to include in the estate property transferred during his lifetime by the decedent in trust for himself for life with remainder to others, even though the decedent reserves a power of revocation, the surviving spouse of a person who makes a savings deposit upon a tentative trust can include the deposit in computing the share to which such surviving spouse is entitled.

"Although the amount which the surviving spouse is entitled to receive is measured by the sum of the decedent's owned assets and the amount of such deposits, the owned assets are to be first applied to the satisfaction of the claim of the surviving spouse. . . ."

spouse to the extent necessary to satisfy his or her statutory share. With these points in mind, the real difficulty will arise in ascertaining whether a given trust is real or illusory.

While the illusory test is couched in terms of "intent to divest", it is submitted that a finding of "intent" or lack of "intent" is dependent entirely on the extent to which the challenged trust has in reality removed the operative powers of ownership from the settlor. Basically, such powers can be classified into two categories: (1) dominion; (2) control. As the term dominion is here used, it refers to the power and the right of the settlor to restore the trust property to his exclusive use and control free and clear of the trust. As the term control is here used, it refers to the power and right of the settlor to direct the management of the trust property without terminating the trust.

In the trust involved in the *Newman* case, the settlor surrendered neither dominion nor control. He was as much the owner of the property in trust as if nothing had occurred despite the fact that by a declaration of trust, the law vested legal title in the trustee. It is difficult to see how this situation is materially changed where the settlor only surrenders control such as occurs in the usual revocable trust and also in the "Totten" or tenative trust cases.[26] By surrendering the right to control, it may be argued that the settlor has evidenced some intent that the transaction is not a mere sham. Undoubtedly this is true and some courts have limited the illusory doctrine to situations where the trust transaction appears to be no more than a mere sham.[27] However, there is no good reason to warrant such a narrow application of the doctrine. By retaining the power to revoke, the settlor may restore the trust property to his exclusive and complete ownership by the exercise of his own volition. In the dynamic sense, the settlor is the owner of the trust *res* and should be treated accordingly for the purpose of satisfying the statutory share of a surviving spouse.

VII. CONCLUSION

Presently, in most jurisdictions a person by means of a revocable inter vivos trust may control and benefit from property until death and at the same time successfully prevent his or her

[26] In a tentative or Totten trust, in reality the settlor has no control over the management and investment of the trust since the funds are in the hands of the bank. In order to exercise control, the settlor must revoke the trust either in toto or in part. Of course, these trusts can be easily revoked since the formalities involved are rather simple.

[27] *E.g.*, Kerwin v. Donaghy, 317 Mass. 559, 59 N.E.2d 299 (1945).

surviving spouse from asserting any interest whatsoever in the trust property. At least one state has been swayed by the policy in favor of the surviving spouse and has passed legislation removing the effectiveness of such a device.[28] The problem has not yet arisen in Nebraska. It is submitted that the question can be soundly resolved in this state by judicial means. One approach which the court may adopt is the illusory doctrine. Applied in its most logical form, this test permits the court to invalidate a given trust only to the extent necessary to satisfy the claim of a surviving spouse. In this regard, the test measures the interest of a surviving spouse by the substance of the transaction without placing undue restrictions on the alienation of property.

William C. Owen '67

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[28] PA. STAT. ANN. tit. 20, § 301.11 (Supp. 1965).
"Conveyances to defeat marital rights.
(a) In general. A conveyance of assets by a person who retains a power of appointment by will, or a power of revocation or consumption over the principal thereof, shall at the election of his surviving spouse, be treated as a testamentary disposition so far as the surviving spouse is concerned to the extent to which the power has been reserved, but the rights of the surviving spouse shall be subject to the rights of any income beneficiary whose interest in income becomes vested in enjoyment prior to the death of the conveyor. . . ."