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OBVIOUSLY the draftsmen of the first Revenue Act under the Sixteenth Amendment could not foresee every possibility of tax avoidance and adequately prevent such avoidance by express statutory provisions. Since the enactment of the Revenue Act of 1913, Congress has made constant efforts in each succeeding Revenue Act to close the loopholes discovered by tax lawyers. The success of these efforts has been most remarkable, particularly in comparison with the similar efforts of England under her income tax laws. Indeed, it may fairly be said that the enactment of the Gift Tax Act in 1932 wrote the final chapter of the history of serious tax avoidance.

Nevertheless, as long as the right to own and acquire property remains a part of our social scheme, lawyers will be confronted by problems of tax reduction. Of less significance before the World War, the reduction of taxes now seems more important than ever in view of increased tax rates caused by the mounting costs of government.

Many incomes are subjected to large demands from charities, dependent relatives, and like subjects of benefaction. Donors frequently desire to dispose of their income for the above purposes so that such income is not taxable to them, and yet at the same time retain some ownership or control over their income-producing property. In other cases no retention of ownership or control is desired, but efforts will often be exerted to reduce both the taxes of the donor and the taxes on the interests created.

The endeavor of the writer is to discuss in detail possible plans to...
save income taxes through the use of trusts. One cannot be certain that the suggested methods will reduce taxes, for undoubtedly the courts will not sanction all. But from an examination of the judicial precedents, the language of the statute, and the intent of Congress in enacting the various sections of the Revenue Acts, conclusions can be reached that seem relatively sound.

At the outset, caution must be given in view of *Gregory v. Helvering.* There the taxpayer had meticulously planned a corporate reorganization with the avowed purpose of effecting a sale of the property with the least possible taxation. The Supreme Court held that the creation of the new corporation was without substance and should be disregarded. This case requires that whatever is done must be genuine or have independent significance. If we find this element, the purpose to reduce taxes will have no legal effect. As was aptly said in *Chisholm v Commissioner:*

"In *Gregory v. Helvering* . . . the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world."

The trust device provides two main sources of income tax reduction. Where contributions to charity form a substantial part of the disposition of income, Section 162(a) of the Revenue Act of 1934, allowing full deduction for charitable contributions out of irrevocable-

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*293 U. S. 465, 55 S. Ct. 266 (1935).*


*8 The definition of the term "trust" considerably concerned the courts at the outset, but in Stoddard v. Eaton, (D. C. Conn. 1927) 22 F. (2d) 184 at 186, a satisfactory definition seems to have been laid down: "After all, the word 'trust,' as used in section 219 of the Revenue Act of 1918 . . . can hardly have been intended to comprehend every instance in which a trust is recognized in equity. A trust ex maleficio, a resulting trust, or a constructive trust are examples of trusts which do not fit into the frame of the statute. A trust, as therein understood, is not only an express trust, but a genuine trust transaction. A revenue statute does not address itself to fictions." Cf. Hart v. Commissioner, (C. C. A. 1st, 1932) 54 F. (2d) 848.

*7 48 Stat. L. 728, 26 U. S. C. § 162 (a).*
trust income, is important. Of greater use is the source founded on the progressive surtax arrangements: by drawing out part of the settlor's property into an irrevocable trust, the creation of a separate taxable entity avoids high surtax brackets. The settlor must obviously pay exacting attention, however, to the gift tax rates applicable to the irrevocable trusts that he creates. He must avoid the creation of a trust that will be classified as an "association" within the definition of the Revenue Act of 1934. And finally he must be certain that his tax savings are greater than the fees of the trustee, seldom less than five per cent of the income of the trust. Consideration will be given to these problems in the latter part of this article.

I

Deductions for Charitable Contributions

Even in a period of prosperity the number of individuals who are able to reduce income taxes because of large charitable contributions is probably small. But where charitable contributions form a substantial part of the disposition of the taxpayer's income, possibilities are available that seem to accomplish a saving for those few individuals.

Section 162(a) of the Revenue Act of 1934 provides that charitable contributions authorized by Section 23(o) and "pursuant to the terms of the will or deed creating the trust" shall be allowed without limitation as deductions from the gross income of an irrevocable trust. Section 120 of the Revenue Act of 1934 provides for unlimited deduction for charitable contributions in case the individual has for the present taxable year as well as the ten preceding taxable years contributed ninety per cent of his net income to charities. But a donor rarely comes within the provisions of the latter section, and hence is

9 See pp. 839-840, infra.
10 See pp. 836-839, infra.
11 See p. 840, infra.
13 48 Stat. L. 690, 26 U. S. C., § 23 (o). In Helvering v. Bliss, 293 U. S. 144, 55 S. Ct. 17 (1934), it was held that in deducting the 15 per cent allowed for charitable contributions the taxpayer is entitled to include capital net gains in net income in determining the base for computing the 15 per cent, even though the taxpayer elected to be taxed on capital net gains at a flat rate of 12½ per cent under the Revenue Act of 1928.
limited to the maximum deduction of fifteen per cent of net income allowed by Section 23(o).

Thus a donor may give to designated charities a part of his income-producing property in trust without retention of any ownership or control, and thereby entirely eliminate such income from his taxable income. Furthermore, if the income was paid "pursuant to the terms of the will or deed" to charities, then in such a trust the trustee would deduct without limitation these payments and, consequently, no income taxes would be paid by the trustee on income so distributed.

Although the settlor must irrevocably divest himself of the property for the duration of the trust, the problem of gift taxes does not arise in the case of charitable contributions because charitable gifts are not taxable. On the other hand, a considerable block of capital assets is required to yield the desired income to the charity. For example, if the rate of return is five per cent, approximately $300,000 of capital must be set aside in an irrevocable trust in order to yield $15,000 annually to the charity. In many cases a settlor may not desire to divest himself irrevocably of that much property. It thus becomes the individual problem of each settlor to determine whether this disadvantage is of more significance than the reduction of income taxes thereby effected.

The advantage of reducing his taxable income by charitable trusts does not conclusively appear beyond the reach of the settlor who desires to retain some element of ownership and control. The income tax regulations expressly provide that where the grantor remains "in substance the owner of the corpus" he is taxable on the income of the trust.

The problem of the gift tax does not arise here. Section 505 (a) (2) of the Revenue Act of 1932 provides that in computing net gifts of any calendar year the amount of all charitable gifts made during the year shall be deducted. 47 Stat. L. 247, 26 U. S. C., § 554 (a) (2).

Let us suppose throughout this article that a Mr. Brown has a net income of $25,000. $10,000 is salary, and he owns realty that yields $15,000. He lives with his wife and three adult children, one of whom is an invalid. He also supports his mother, who is entirely dependent on him. If Mr. Brown gave $15,000 directly to charities for the taxable year, his income tax would ordinarily be $1,672.50. If, however, he provided for that $15,000 to be paid from an irrevocable trust, the tax would be only $343, a saving of $1,329.50. Now suppose that a Mr. Smith has a net income of $105,000. $10,000 is salary, realty yields $90,000, and stock dividends $5,000. He lives with his wife and three adult children, one of whom is an invalid. He now supports two dependent relatives. If Mr. Smith gave $60,000 to charity each year, his income tax would ordinarily be $25,412.50. But if the $60,000 were income of an irrevocable trust of realty assets, his tax would be $6,844. He would thus effect a saving of $18,568.50.

even though the only interest which the grantor retains arises "on the elapsing of a period of years." Whether this provision of the Regulations has a statutory basis will be considered in another section of this article dealing with "term" trusts. However, in United States v. First Nat. Bank of Birmingham, the taxpayer conveyed property to the Alabama Educational Foundation "for the term of one year, beginning with the first day of October, 1928, and ending with the 30th day of September, 1929." The Circuit Court of Appeals for the Fifth Circuit held that the instrument of conveyance created an irrevocable trust and did not come within the provisions of Section 166 of the Revenue Act of 1928. As the income was being used by a charity pursuant to the instrument creating the trust, the income of the trust was not taxable either to the fiduciary or the beneficiary. It is noteworthy that the trust was irrevocable for a definite period and no power to vest the corpus or income in the grantor during that period was retained by the trust indenture. The Birmingham case illustrates the opinion of one circuit court to the effect that some degree of ownership and control can still be retained.

But in setting up these trusts, litigation is invited, the cost of which might possibly offset any theoretical tax saving.

The clause, "pursuant to the terms of the will or deed," must not be overlooked. Charitable contributions made by a trustee who has discretion to distribute for private purposes are not deductible from the income of the trust, for it must appear from the will or deed that such income is permanently set aside for a charitable use or paid pursuant to the terms of the instrument.

In cases where it is desired to give only part of the equitable inter-

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18 See pp. 817-821, infra.
22 Sec. 20 (1) (b) of the Finance Act, 1922, of England, provides that if a trust "cannot exceed six years" the income shall be taxable to the "person, if living, by whom the disposition was made." Thus, any trusts for charities must be for a period longer than six years under English law to prevent such income from being included in the income of the settlor.
est to charity, the words "paid or permanently set aside" become significant. In *Moorman Home for Women v. United States*, the testator directed that so much of the income as necessary should be used by the trustee for the proper and comfortable support of his son, and the balance was given for a named charitable purpose, not at the end of each calendar year, but at the death of the son. The court held that the whole income of the trust was taxable to the trustee under a provision of the Revenue Act of 1924 which was substantially similar to Section 162(a) of the 1934 Act. In *Boston Safe Deposit and Trust Co. v. Commissioner*, named charities were to take the corpus and accumulated income of the trust at the designated time of distribution, but certain annuities and expenses constituted charges on both income and corpus. The balance of the income could not be distributed to the charities until the termination of the trust. It was held that the surplus income was not permanently set aside for charity and was taxable under a section of the Revenue Act of 1926 which was substantially the same as Section 162(a).

These cases are to be contrasted with *Hartford Connecticut Trust Co. v. Eaton*, in which the settlor's widow was entitled during her life to the net income on an estate valued at $1,000,000, the residue at her death to be distributed among certain charitable institutions. The trustee was given power to pay over to her any part of the principal that he might deem necessary for her comfortable support and maintenance. During the duration of the trust, securities were sold which realized a taxable gain, and the question presented was whether this capital gain was permanently set aside by the terms of the will for charitable purposes. The court found that under no reasonable possibility, considering the income of the trust fund, the widow's mode of living and her personal estate, would she ever require, or the trustee be

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24 E. Sohier Welch, 9 B. T. A. 1370 (1928). See also note 23, supra.
25 (D. C. Ky. 1930) 42 F. (2d) 257.
26 Sec. 219 (b) (1), 43 Stat. L. 276 (1924).
29 Sec. 219 (b) (1), 44 Stat. L. 33.
warranted in paying to her any part of the principal for her comfortable support and maintenance, and that all of the principal of the trust fund was certain to be used for charitable and educational purposes. It was held, therefore, that any income which became a part of the corpus was exempt under Section 219(b)(1) of the Revenue Act of 1926, which was substantially similar to Section 162(a). The same result was reached by the Supreme Court in a case interpreting the Income Tax Law of 1916. A trust fund had been set aside to pay an annuity and upon the annuitant’s death to transfer the fund and the accumulated interest to a hospital corporation. The trustees lent the money to the hospital upon mortgage security, receiving back only interest sufficient to satisfy the administrative charges and the annuity. The surplus income retained by the hospital was held to be nontaxable.

But to rely on these latter decisions invites uncertainty and litigation. Where the trust income will be definite, and it seems certain that it will exceed the amount needed or desired to be given by the grantor to the private beneficiaries, the power to appropriate part or all of the accumulated income to private purposes should be avoided.

II

Avoidance of High Surtax Brackets

Trust income is subject to the same tax rate as the income of individuals. Indeed, if it is income from a trust that is revocable within the meaning of Section 166 of the Revenue Act of 1934, it is taxable to the individual settlor. But the income from a trust not thus revocable is taxed to the trustee or to the beneficiaries, depending on the manner in which the income is distributed. By Section 161 of the Revenue Act of 1934, income accumulated for unborn or unascertained persons, or contingent remaindermen, or income held for future distribution is taxable to the trustees. Income currently distributed to

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86 Revenue Act of 1934, § 162 (b), (c), 48 Stat. L. 728, 26 U. S. C., § 162 (b), (c).
87 In considering § 219 (a) (1) of the Revenue Act of 1921 (which is substantially the same as § 161 (a) (1) of the 1934 Act), the Supreme Court held that the beneficiary was liable only for income taxes on such income which was properly
the beneficiaries and income held or distributed by a guardian as the court may direct is taxable to the beneficiaries.\textsuperscript{38} Income which the trustee may distribute or accumulate in his discretion is taxable to the beneficiaries to the extent that it "is properly paid or credited during such year to any legatee, heir, or beneficiary."\textsuperscript{39} Whether taxable to the trustee or beneficiaries, the income from an irrevocable trust is thus taxed to one or perhaps several entities distinct from the settlor, to whom such income was formerly taxed. With higher surtax rates imposed by the Revenue Act of 1935 than ever before,\textsuperscript{40} the advantage of dividing even a moderate income into several entities for income taxation purposes is apparent.

distributed to him, pursuant to the instrument or order governing the distribution. Therefore, if the trustee negligently or by mistake pays the beneficiary more than he is entitled to, the trustee is still liable for the taxes on that income which was improperly distributed or credited. Freuler v. Helvering, 291 U. S. 35, 54 S. Ct. 308 (1934). In St. Louis Union Trust Co. v. United States, 78 Ct. Cl. 194, 3 F. Supp. 650 (1933), the trust provided that the trustee should apply such funds as the trustee deemed necessary and proper for the beneficiaries' education, support, and maintenance until they became 25 years of age. During the taxable year the trustee neither paid nor credited any beneficiary, and the trustee kept one account for the entire trust. The court held that such income for the year was accumulated for future distribution and was taxable to the trustee. See Canal Bank and Trust Co., 30 B. T. A. 390 (1934). In a very recent case before the Board of Tax Appeals the testator created a trust and provided that income of the trust was to be paid semi-annually on June 15th and December 15th to the beneficiaries living on such dates and could not be assigned or anticipated. In event of the death of a beneficiary between such dates the share he would receive if he had remained alive would go to the other beneficiaries. The Board held that the income from December 15th to December 31st was accumulated income under § 161 (a) (1) of the Revenue Act of 1928 for the benefit of unascertained persons or for persons with contingent interests. Augustus H. Eustis, 30 B. T. A. 820 (1934). See G. C. M. 8724, X-2 Cum. Bul. 197, modified by G. C. M. 15,401, Cum. Bul. XIV-41-7735, (1935). In Malloy v. Comm. of Int. Rev., 28 B. T. A. 716 (1933), the testator made his wife the trustee of all his separate property with directions to hold the same and in her discretion to sell, lease, exchange the property, and with the direction to hold the same and any increase until the youngest child reached twenty-one and then to distribute to named devisees. The court held that the income taxes arising out of the gains in the hands of the trustee are payable by the fiduciary. To the same effect, see Anderson v. Wilson, 289 U. S. 20, 53 S. Ct. 417 (1933); James J. McCabe, 23 B. T. A. 1005 (1931); Valentine Bliss, 26 B. T. A. 731 (1932).

\textsuperscript{39} Id. § 162 (c), 48 Stat. L. 728, 26 U. S. C., § 162 (c).
TRUSTS TO REDUCE INCOME TAXES

A. Savings to the Settlor

Although the trust device offers possibilities for saving taxes to the recipients of the settlor's benefactions, its use in reducing the grantor's own taxes will probably interest him most. The simplest device to accomplish this result would be an outright gift in trust. Obviously, however, such an arrangement would not permit any retention of ownership, and such control over the income as might be feasible would encounter the possibilities of double taxation.\textsuperscript{41} The revocable trust, a device which would overcome this difficulty, is also unsatisfactory here because not taxable separately from the settlor.\textsuperscript{42} Several other arrangements, however, may be available. One of the most useful of these would be the irrevocable trust for a term of years. The objection that such a device falls within the definition of revocable trusts found in Section 166 of the Revenue Act of 1934 would seem doubtful. This provision of the 1934 Act is the same as Section 166 of the Revenue Act of 1932 except for the deletion of the italicized words:

"Where at any time during the taxable year the power to vest in the grantor title to any part of the corpus of the trust is vested—
(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
(2) in any person not having a substantial adverse interest in

\textsuperscript{41} If the donor made an outright gift in trust with no retention of a power of revocation, then under Burnet v. Guggenheim, 288 U. S. 280, 53 S. Ct. 369 (1933), the amount put in trust would be subject to the gift tax rates of § 301 of the Revenue Act of 1935. If the settlor tried to retain control of a power of modification, that is, the ability to shift the interests from the various beneficiaries, he would be taxable for the value of the trust fund at his death under the estate tax, § 201 of the Revenue Act of 1935; Porter v. Commissioner, 288 U. S. 436, 53 S. Ct. 451 (1933). But it might be forcibly contended that the gift tax was enacted to tax only those transactions which were escaping the estate tax. Therefore, if this intent of Congress is to be given effect, no gift tax should be imposed where it is clear that the property will be subjected to the estate tax. The argument based on the intent of Congress, however, is somewhat counteracted by a clear expression in § 801 of the Revenue Act of 1932, 47 Stat. L. 278, which, to a limited extent, allows as a credit any gift taxes which have been assessed against the property included in the decedent's gross estate. See the English case of Nettleford v. Commissioners of Inland Revenue, 18 Tax Cas. 235 (1933), which case is contra to Porter v. Commissioner, supra.

the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." (Italics supplied.)

The very wording of the section is directed against reserved powers. The interest that the grantor retains after creating an irrevocable trust for a limited period of years, however, is not a power but a reversion; title reverts to the grantor upon the termination of the trust by operation of law and not because of any power.

The proposition that Section 166 does not apply to term trusts finds support in the legislative history of the section. The whole purpose of striking out "during the taxable year" was to include trusts with a power of revocation which required a year and a day's notice before the power could be exercised. No declaration on the part of Congress or its committees can be found to support the theory that by the words "power to revest" was meant the "right of reversion." Even if such a declaration could be found, the unambiguity of the term used would seem to preclude such an interpretation of the section.

The section deals specifically with a power in the grantor, or in conjunction with one not having a substantial adverse interest, or both. The history of the section through the various Revenue Acts further substantiates this.

"By the very terms of its definition, a reversion arises only by operation of law, and cannot be created by act of the party, though it arises as a consequence of such act. If, upon creating a lesser estate, the grantor does attempt to limit a reversion to himself or his heirs, such limitation is by the common law, null and void, it being merely a statement of what is done by the law." TIFFANY, REAL PROPERTY 271 (1903). See also Co. Litt. 226 (1659); 2 BLACKSTONE, COMMENTARIES 176 (1794).

In explaining the amendment made to the section in the Revenue Act of 1932, the Conference Report said, "the House bill . . . has been extended to include cases where the power to revest title to any part of the corpus is wholly vested in a person not having a substantial adverse interest . . ." H. Rep. 1492, 72 Cong., 1st Sess., p. 16 (Conference Report, 1932).


In Iselin v. United States, 270 U. S. 245 at 250-251, 46 S. Ct. 248 (1926), it is stated: "Its language is plain and unambiguous. What the Government asks is not a construction of a statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function." -See also Wilkinson v. Leland, 2 Pet. (27 U. S.) 627 (1829); South Carolina Produce Assn. v. Commissioner, (C. C. A. 4th, 1931) 50 F. (2d) 742; First Nat. Bank of Chicago v. United States, 69 Ct. Cl. 312, 38 F. (2d) 925 (1930), affd. 283 U. S. 142, 51 S. Ct. 378 (1931).
This argument has been strengthened by *United States v. First Nat. Bank of Birmingham*,\(^48\) in the Circuit Court of Appeals for the Fifth Circuit. In reference to the nature of the trust the court said:

"By that instrument the entire property rights in the described real estate for the period stated were irrevocably vested in the grantee. The estate granted being one limited to endure for a definite and ascertained period, fixed in advance, is what is known as an estate for years. . . . The corpus of the trust was the granted estate in the described property for the stated period. The income from that property during that period was the grantee's income, not the grantor's income, as it was subject to the unfettered command of the grantee, not subject to any power over it exercisable by the grantor; the source of it being a property interest or estate irrevocably vested in the grantee. . . ."\(^49\)

Fortified by this legal argument, it seems more than doubtful whether Congress has effectively taxed the income of term trusts to the settlor by Section 166 of the 1934 Act.\(^50\) Nevertheless, the recent income tax regulations state that where the grantor remains "in substance the owner of the corpus," the income of the trust is taxable to him.\(^61\) The regulations minutely cover detailed situations and close loopholes in a manner which seems to many highly desirable; furthermore, they probably accomplish this purpose more effectively than any statute that Congress would enact. But the power to tax is lodged by the Constitution in the legislative and not the executive branch, and, therefore, all rulings of the Commissioner must have a statutory basis. Section 166 uses in unequivocal terms the words "power to revest."\(^62\) For a period of over ten years, this section has been subjected to very minor changes and during that time the Commissioner has issued substantially the same rulings under each Revenue Act. It does not seem that by the very minor change of striking out "during the taxable year" the result was to tax the income of a term trust to the grantor. It seems relatively clear that the purpose of the deletion was to reach trusts in

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\(^49\) 74 F. (2d) 360 at 362.


which the grantor had retained a power to revoke and not trusts in which the grantor had retained a reversion or an interest which might result in the reversion of the trust corpus at some future time. Certainly neither the wording of the statute nor the expressed intent of Congress is the foundation of the Commissioner’s rulings.

But the tendency of the courts to look to substance rather than form in problems of taxation renders the conclusion in regard to term trusts somewhat doubtful. By creating a short-term trust the grantor retains many of the attributes of ownership which essentially constitute “control” of the trust property. “Control” as here used means that the income of a short-term trust remains in substance that of the grantor despite the fact that the income was payable to another person by an irrevocable deed of trust. Some courts might conclude that the test of taxability to the grantor under Section 166 was whether he exercised such “control” over the trust property. Although this interpretation would not literally fall within the wording of the statute, the language of many tax decisions would reach this result with facility by disregarding the trust on the theory that the income in substance remained that of the grantor.

With the interpretation of the statute doubtful, the advocate should not advise the creation of term trusts as a sure means to reduce taxes. But if they are attempted in an effort to reduce income taxes, the exact number of years for which the trust is to be created should be carefully considered. Two years would seem the most desirable period for this purpose; it seems absurd to say that five years or longer would receive more favorable consideration from the courts. In addition, such a longer period would run greater risks from the possibility of new legislation taxing to the grantor the income from irrevocable term trusts.

Although the amount of income taxes saved by the use of term trusts would be quite substantial if the courts refuse to tax the income from them to the grantor, the problem of placing the settlor’s income-


88 Such taxation of these trusts would not seem to be unconstitutional. See DuPont v. Commissioner, 289 U. S. 685 at 688-689, 53 S. Ct. 766 (1933).

84 In our suppositional case (supra, note 16), if Mr. Brown was not of a philanthropic nature he would ordinarily have to pay a tax of $2,343 on his net income of $25,000. If he created a two-year irrevocable trust yielding $10,000, none of which was used to discharge his legal obligation, the combined income tax of Mr. Brown
producing property in a straight-jacket for the duration of the trust must be considered. Numerous individuals abhor placing beyond their control even a portion of their income-producing property for a short duration. This disadvantage should be considered in determining whether "term" trusts will be created. Then, too, the fact that each irrevocable transfer in trust will be subject to the gift tax will substantially reduce the possible income tax savings. In addition, the creation of a "term" trust invites litigation, the cost of which would overcome the possible income tax saving to a grantor whose income was taxable only in the lower surtax brackets.

Section 166 reveals another device for retaining the rights of ownership and control frequently desired: the trust revocable only in conjunction with one who has a "substantial adverse interest." Neither a trustee nor a beneficiary having a mere nominal interest would be substantially adverse. A beneficiary having a contingent interest would likewise probably not be considered adverse. But that a trust revocable only in conjunction with a beneficiary having a substantial adverse interest would be "irrevocable" within the meaning of Section 166 and hence not taxable to the grantor would seem clear from the

and the beneficiary of the trust would be $1,535—a saving of $808 for the taxable year. If he created a similar trust yielding $15,000, with the above beneficiary to receive $5,000, each of his children $2,500, and his mother $2,500, the combined income tax of all would be only $843; this would therefore effect a saving of $1,500. Mr. Smith, who has a net income of $105,000, would ordinarily be taxed $34,566, if he made no charitable contributions. If, however, he created a two-year irrevocable trust yielding $50,000 per year, none of which was used to discharge his legal obligations, the combined income taxes of Mr. Smith and the beneficiary of the trust would be $19,603—a saving of $14,963. If the trust yielded $75,000, $20,000 to be paid to the above-named beneficiary, $15,000 to each of his three children, and $5,000 to each of his two dependent relatives, the combined tax would be only $9,173, thus effecting a saving of $25,393.


A beneficiary with a nominal interest is specifically included by the statute, for it requires one with a substantial adverse interest. This position was taken even in earlier regulations where the statute did not read so specifically. See U. S. Treas. Reg. 65, Art. 347 (1924); Reg. 69, Art. 347 (1926).

Revocation by the grantor in conjunction with a contingent beneficiary might result in taxing the income of a trust to the settlor under the 1934 Act. It seems that the interest could be contingent, yet so substantial as to make the trust irrevocable. Former acts had been interpreted by the courts so that a beneficiary as used in the act meant a contingent beneficiary. Smith v. Commissioner, (C. C. A. 1st, 1932) 59 F. (2d) 56 (Revenue Acts of 1924 and 1926); Iola Wise Stetson, 27 B. T. A. 173 (1932) (Revenue Acts of 1924 and 1926); Francis J. Stokes, 28 B. T. A. 1243 (1933) (Revenue Act of 1928).
face of the statute, and in Margaret A. Holmes\(^{58}\) the Board of Tax Appeals so held. In that case the settlor created a trust for his wife, revocable with her consent, and which was to terminate at his death. A similar trust was created by the wife in favor of the husband. As a device for reducing income taxes, this particular arrangement is of no value if all of the income of the trust is to be paid out currently. Assuming the trusts are of equal amount, the incomes of the husband and wife are both as large as if the trusts had never been created; hence high surtax brackets are not avoided. In fact, an increase of taxes and not a reduction would result because of the gift tax on the irrevocable transfers in trust. But if it is desired to provide for accumulations, the device effects savings, since accumulated income is taxable to the trustee and not to the beneficiary.\(^{59}\)

Where there are several beneficiaries, a trust revocable with the consent of any one of them who has a substantial adverse interest would also seem to fall outside Section 166, since this provision contains no requirement that the “substantial adverse interest” consist of the entire equitable ownership.\(^{60}\) The desired control seems to be sufficient where the grantor can revoke in conjunction with one of his children who holds, for example, a one-third interest in the trust. A power of revocation so conditioned can be attached to a limitation in fee or for life, and makes such extended trusts an adequate alternative to the term trusts that are doubtful as a method to reduce income taxes. Or, indeed, such a power of revocation might advantageously be inserted in the two-year trust device.

Of similar use, either in connection with a trust for a short term of years or for life, or in fee, would be a contingent power of revocation device. But the validity of this device as a tax-saving scheme is very doubtful. According to Section 166 of the Revenue Act of 1934, a trust is revocable when “the power to re vest . . . is vested . . . in the

\(^{58}\) 27 B. T. A. 660 (1933).

\(^{59}\) Sec. 20 (1) (a) of the English Finance Act, 1922, provides that where the grantor is able “without the consent of any other person, by means of” a power of revocation “to obtain for himself the beneficial enjoyment” of trust income, such income shall be his for income tax purposes. Any other person does not include a husband or a wife as the case may be, unless they are living apart by agreement or order of court. See Commissioner of Inland Revenue v. Firth, 17 Tax Cas. 603 (consent of “person appointed by settlor other than his wife” not within statute); Ormonds v. Brown, 17 Tax Cas. 333 (consent of trustee not within statute); Wiggins v. Watson’s Trustees, [1934] A. C. 264.

Two illustrations of contingent powers are typical of what could be created: first, a trust for two years or for life, or in fee, the income to the settlor's wife for her life, remainder to their children, but the settlor to have the power of revocation only if and when his wife predeceases him; second, a similar trust with the settlor to have a power of revocation at the end of one year, but only if the settlor so long lives.

The marked plethora of authority upon the meaning of the word "vest" in the field of conveyancing is strikingly in contrast to the paucity of authority when the term is used in relation to powers of revocation. The rigid and crystallized common-law concept of the "vesting of estates" should not be superimposed upon the more pliable theories of taxation, such as the vesting of a power of revocation. The intent of Congress was probably to tax trust income to the grantor where he retained "control" over such income. Through the use of contingent powers the grantor could retain that "control." True, illustrations can be given where no control would remain—i.e., a power of revocation to arise if Rome falls—but to let the bars down once only results in creating precedents that will govern cases where "control" is retained by an insidious contingent power.

The meaning of the term, however, is not to be dismissed too summarily. The court might be inclined to believe that Congress used the term in the rigid concept of the common law. If such is accepted, therefore, a trust with a contingent power would be held an irrevocable trust and its use would offer great possibilities as a method of retaining some control over one's dispositions, yet reducing income taxes. Not only is the creator of such a contingent power beset with the precariousness of its effectiveness to reduce income taxes, but some consideration must be given to the applicability of the gift tax to such a transfer and of the income tax after such a transfer. Unless it is desired to exercise the power on the event stated, it should be released before the event occurs. On that occurrence the power would become

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61 48 Stat. L. 729, 26 U. S. C., § 166 (1934). The Revenue Act of 1928 used the word "has" instead of "vested," § 166, 45 Stat. L. 840. "Vested" was first used in the Act of 1932. § 166, 47 Stat. L. 221. The purpose of this change seems to have been to make it clear that trust income should not be taxed to the grantor if his power to revoke is subject to a condition which may never happen. See H. Rep. 1492, 72d Cong., 1st Sess., p. 16 (Conference Report, 1932). And the deletion of the words "during the taxable year" in § 166 of the 1934 Act does not necessitate a contrary result. See p. 818, supra.

vested and thenceforth, by Section 166 of the Revenue Act of 1934, the income of the trust would be taxable to the settlor. Furthermore, a possibility of double taxation under the gift tax would be avoided. If it is not desired to relinquish control for the full balance of the life of the trust, the periodic arising of such powers could be provided. Such a series of powers would be more appropriate to a trust for a period longer than two years, but trusts of greater length are undesirable because of the risk of greater taxation under the gift tax. That tax is prepayable on the income accruing during the entire life of the trust, and an early revocation of a long-term trust would thereby entail great loss. It, therefore, seems that even if these contingent powers are effective to reduce income taxes, the practical limitations of their use would prevent their ever assuming an important place in the schemes to reduce income taxes.

In creating irrevocable trusts to reduce the settlor's income taxes, a stone wall is faced if an attempt is made to discharge legal obligations from trust income. In Douglas v. Willcuts an irrevocable trust was created by a husband, the income of which was to be used to discharge his anticipated obligation to pay alimony if his wife secured a divorce. By the trust instrument the settlor agreed that his wife should receive a stated annual income, and that if the net income from the trust fund should prove insufficient, he would make good the deficiency but that excess income should be paid to him. The settlor and the trustee jointly controlled the investment of the trust property. The trust was to terminate at the wife's death, whereupon the fund was to revert to the hus-

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64 A trust for years, revocable only upon the happening of a contingency, would seem taxable to the settlor as a gift. See U. S. Treas. Reg. 79, Art. 3. Release of a vested power of revocation is likewise subject to the gift tax. Burnet v. Guggenheim, 288 U. S. 280, 53 S. Ct. 369 (1933); see U. S. Treas. Reg. 79, Art. 3. Hence, if, upon the happening of the contingency during the term, the power vests and the settlor thereafter wishes to release it, he may be subject to a second gift tax. Since revocation would seem not to entitle him to any refund, the same result would appear to follow if he exercises the power and then wishes to set up a new trust.

65 Thus a ten year contingently revocable trust revoked at the end of one year would seem to result in a loss of the gift tax paid for the remaining nine years. It would therefore be advisable to create such trusts for only two years.

The divorce decree incorporated the provisions of the trust instrument.

The Supreme Court held that the income of the trust was taxable to the grantor under Section 213 of the 1926 Act. As the Supreme Court aptly said:

"The creation of a trust by the taxpayer as the channel for the application of the income to the discharge of his obligation leaves the nature of the transaction unaltered. In the present case, the net income of the trust fund, which was paid to the wife under the decree, stands substantially on the same footing as though he had received the income personally and had been required by the decree to make the payment directly." 67

The principle that trust income must be taxed to the grantor where it is used to discharge his legal obligations has been applied where the trust income is used to support, maintain and educate the grantor's children 68 and where the trust income is used to discharge a debt of the settlor. 69

The application of the above principle is of no practical difficulty where the grantor creates a trust to discharge alimony payments or in lieu of alimony, for in either case the entire amount is used to discharge his legal obligation. But where a trust is created for a wife or a minor child to whom the grantor is legally obligated, many serious problems arise if the income is in excess of the amount necessary to discharge the obligation. 70 In such cases a presumption is probably available to the Government that the entire trust income was used by the beneficiary to discharge the grantor's legal obligations. 71 If the grantor is able to overcome the presumption as to some of the income, only the remaining amount should be taxable to him. This conclusion seems to follow be-

67 296 U. S. 1 at 9.
70 England has partially solved this problem by Sec. 20 (1) (c) of the Finance Act, 1922. Unless the trust is for the life of the settlor's child, the entire income is taxable to the grantor so long as the child is an infant and unmarried. A power of revocation in a trust for the life of the child would not cause the income to be taxed to the grantor. Wiggins v. Watson's Trustees, [1934] A. C. 264. See also Gillies v. Commissioners of Inland Revenue, [1929] Sess. Cas. (Scot.) 131.
cause the basis of the Douglas case is Section 213 of the Revenue Act of 1926 which defines "gross income." Therefore, if the method employed to satisfy a legal obligation of the grantor results in income, only the amount of income so used should be included in the grantor's income.

No difficulties seem to arise in the administration of this principle and the above mentioned presumption in the first year of such a trust. But difficulties may be encountered after that year. If only part of the trust income is used the first year, and the remainder the second, it might be contended that the remainder is not taxable either year to the grantor. But it is the opinion of the writer that the courts might hold that the income is impressed with a trust; and so long as any legal obligation of the grantor is discharged from that income in any year, the amount so used in the respective year is taxable to him. Grave problems of administration are forecast by those adversely affected, but by some means a rule of thumb will be worked out so that this addition to the definition of income can be easily applied.

Furthermore, Kaplan v. Commissioner must be considered. Here the settlor created a trust and made himself trustee. The income of the trust was payable to his wife for life, and, if the settlor outlived her, then to him. The settlor-trustee had also the power to accumulate a reasonable portion of the income, such accumulation to be payable, at his discretion, to persons entitled to the trust income at the time of payment. A provision of the Revenue Act of 1924, substantially identical to Section 167 of the 1934 Act, provided that where the income of a trust "may, in the discretion of the grantor or of any person not having a substantial adverse interest" be distributed to the grantor or held or accumulated for future distribution to the grantor, it should be included in computing the grantor's net income. The court held that the entire trust income, less the irreducible minimum of which the trustee had no right to deprive the wife, was taxable each year to the settlor because of the possibility that he, as trustee, could rightfully pay over the accumulated income to himself.

In drawing up a trust the normal disposition of the accumulation is

74 Sec. 219 (h), 43 Stat. L. 277.
ordinarily to the wife if she be living, but if not then to the children; and this will probably occur according to the terms of the instrument. The safeguard of a reversion to the settlor hardly seems of sufficient practical necessity to justify the additional income tax burden thereby caused. If the main beneficiaries should not take, distribution according to the laws of descent and distribution will generally be an adequate substitute for the tax-increasing device of an express reversion. If a term trust is created and it is not desired to pay the accumulation over to the beneficiaries at the termination of the term trust, it can be put into a further trust for their benefit.76

Once a sizeable portion of income has been separated into a distinct taxable entity, the drawing off into this of more of the settlor's individual income yields diminishing returns in tax savings. This results from the smaller progression in the lower surtax brackets. But the saving would be decidedly not de minimis. For example, where a man with a net income of $30,000 uses half to support certain persons to whom he is not legally obligated, the creation of a trust for their benefit that yielded $15,000 rather than $5,000 would effect greater income tax savings to him. But when there is only a single beneficiary, creation of a trust with income that exceeds the settlor's income would be equally unwise. If the subjects of the settlor's benefactions are numerous, the trust should be of sufficient size to produce income for as many of them as possible. Since income paid to each beneficiary is separately taxable to him, it is immaterial that the total amount produced by the trust income may exceed more than half of the settlor's original income.

B. Savings to the Beneficiaries

Although most grantors are interested primarily in reducing their own income taxes, a settlor who cares enough to give at all would probably want his donees to get the largest net amount possible. Methods of minimizing taxation on the interests of the beneficiaries, therefore, are not usually disregarded.

Where all of the trust income is to be paid over currently, no device is available to reduce the taxes on the beneficial interests.77 Indirectly,
however, this could be accomplished in cases where the beneficiary himself has a separate income which is so substantial as to subject the distributed trust income to the higher brackets. Sections 161 and 162 of the Revenue Act of 1934 provide that the beneficiary must pay the tax on income paid out or credited currently, but that accumulated income is to be taxed to the trustee. An irrevocable trust could be created; therefore, with the income to be accumulated and the trustee to have a discretionary power to distribute this accumulation beginning with the second year of the trust. After the lapse of the first year, the trustee could in his discretion distribute the entire accumulated income of the preceding year to the beneficiaries. By this device the income of the trust is taxable to the trustee, and the higher surtax which would be imposed if taxed to the beneficiary is avoided.

Where the situation of one or several beneficiaries and the size of the trust are such that an accumulation of some of the income is possible and consistent with the settlor's wishes, a provision for such an accumulation will effect surtax savings by the creation of trusts—separate income tax entities. If it be impossible to predict with accuracy either the amount of the trust income or the needs of one or several beneficiaries, his interest in the trust and make the income taxable to the assignee. Helvering v. Coxey, (C. C. A. 3rd, 1935) 79 F. (2d) 661, revd. (U. S. 1936) 56 S. Ct. 498; Young v. Gnichtel, (D. C. N. J. 1928) 28 F. (2d) 789; Edith H. Blaney, 13 B. T. A. 1315 (1928); petition for review dismissed, (C. C. A. 1st, Jan. 17, 1930) unreported. But cf. O'Malley-Keyes v. Eaton, (D. C. Conn. 1928) 24 F. (2d) 436. The assignor can assign less than the whole of his interest. Commissioner v. Field, (C. C. A. 2d, 1930) 42 F. (2d) 820; Shellabarger v. Commissioner, (C. C. A. 7th, 1930) 38 F. (2d) 566; Lowery v. Helvering, (C. C. A. 2d, 1934) 70 F. (2d) 713; Grace S. Clark, 16 B. T. A. 453 (1929). But where one who has a beneficial interest in a trust makes a gift of the income therefrom, it has been held that the income is taxable to the donor and not the donee. Wood v. Commissioner, (C. C. A. 6th, 1934) 74 F. (2d) 78; Power v. Commissioner, (C. C. A. 8th, 1932) 61 F. (2d) 625, cert. den. 288 U. S. 612, 53 S. Ct. 1056 (1931); Bing v. Bowers, (C. C. A. 2d, 1928) 26 F. (2d) 1017. Even though an assignment is made of the property interest, in the case of a spendthrift trust it is not effective to render the income taxable to the assignee. Commissioner v. Blair, (C. C. A. 7th, 1932) 60 F. (2d) 340, cert. den. 288 U. S. 602, 53 S. Ct. 405 (1933); King v. United States, (D. C. Mass. 1935) 12 F. Supp. 614.

48 Stat. L. 727 and 728.

the amount to be accumulated can be placed in the discretion of the trustee instead of being mandatory. Although the courts generally hold the amount actually accumulated to be taxable to the trustee even when it is not clear from the instrument that income not paid out is to be accumulated as part of the corpus, an explicit provision for accumulation is preferable. If the settlor desires the beneficiaries to exercise their discretion as to the amount of accumulation, there must be an express provision that income not claimed by the beneficiary is to be accumulated as part of the corpus; otherwise the entire income, including that actually accumulated, will be taxed to the beneficiaries.

An additional advantage of discretionary accumulation provisions is that variations in the amount of the beneficiary’s other income can be taken into account in making the distributions, so that the income taxed to the beneficiary and that taxed to the trustee can both be kept in the lowest possible surtax brackets. If the beneficiaries are expected to have no other income than that from the trust, for example, the most advantageous arrangement would be to accumulate half and distribute half.

The above device naturally lends itself only to those beneficiaries whose financial positions are such that they do not require the use of all of the income from the trust. The circumstances might seem to be rather unusual, yet many personal holding corporations were organized after the World War for this specific purpose. Since Section 351 of the Revenue Act of 1934 now prevents the improper accumulation of surplus by the imposition of an additional high surtax thereon, this arrangement should appear to present a solution to that group of wealthy individuals who desire to minimize their income taxes by setting aside a part of their income-producing property, and whose children or other subjects of benefaction do not require the entire income from that property.

It should be indicated, however, that at the time most of the personal holding corporations were organized, no tax liability resulted from the transfers to the corporation or of the shares of stock of the

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81 Esty v. United States, 63 Ct. Cl. 455 (1927), held that all the income of a trust was taxable to the beneficiary where he could request any amount of the income that he desired. The court referred to the fact that the trustees were not authorized to add any of the income not drawn by the beneficiary to the principal. To the same effect see Lelia W. Stokes, 28 B. T. A. 1245 (1933).


corporation to the subjects of the incorporator's benefactions. The enactment of the Gift Tax in 1932, however, considerably reduced any income tax savings from transferring property into inter vivos irrevocable trusts.

If there are several beneficiaries and all of the income is paid out currently, whether a comprehensive trust or separate funds be employed would not affect the tax rates; each beneficiary would be separately taxed for the income that he received. Since accumulations are taxable to the trustee, however, a single so-called comprehensive trust would make accumulated income subject to higher surtaxes; if a separate trust is set up for each beneficiary, the higher brackets would be avoided because each accumulation would be individually taxed. Again, the personal exemption of $1,000 allowed to single individuals is also allowed to a trust, but it is only $1,000 irrespective of the number of beneficiaries. Separate trusts would therefore allow a greater total exemption. The savings in the normal tax on the additional five or six thousand dollars freed from taxation by the exemption are not of great magnitude, but if the total accumulation is of any size, these additional exemptions would otherwise be subject to a substantial surtax. The advantage of a comprehensive trust in the matter of offsetting losses and gains would not seem sufficient to outweigh these reasons for the establishment of separate trusts.

Whether the comprehensive or separate plan is adopted depends only on the intent of the settlor. That separate trusts were intended would seem decisively shown by the use of a separate instrument in providing for each beneficiary, even though the same trustee is named in each. But if a single instrument be used, and that unavoidably in

86 Taxation of irrevocable trusts as separate entities prevents the setting off of capital gains in one trust against the capital losses in another trust. A comprehensive trust would allow complete advantage in the offsetting of capital losses and capital gains.
87 In our suppositional case (see note 16, supra), if Mr. Brown gave his income-producing property, yielding $15,000 yearly, to trustees to accumulate the income any pay it to his three children on their reaching twenty-one, the income tax on one trust to accumulate for all three would be $1,160. If separate trusts were created, however, the total tax would be only $480—a saving to the beneficiaries of $680. If Mr. Smith gave income-producing property yielding $75,000 to trustees to accumulate until the children reached twenty-one, the income tax on a comprehensive trust would be $19,540, whereas if three separate trusts were created the tax would be $8,580. This would save the beneficiaries $10,960.
testamentary cases, a clear expression of the intent to create separate trusts is indispensable.

In the very recent case of *United States Trust Co. v. Commissioner*, a single trust was created by the original deed of trust which provided for the income to be accumulated for the first fifteen years of the trust, with the written consent of the primary beneficiaries, and added to the principal. Provision was made for the alteration of the trust, and the trust was amended four times. The sole question was whether these amendments created separate trusts. The important amendment was the first one to be executed and in part provided:

"The trust estate now held under said trust deed shall be divided into three separate and equal parts or shares (to which may be assigned undivided interests in the whole or any part of the said trust estate), which parts or shares shall severally be designated by our respective names, and each of us and our respective legal representatives shall have the same rights, interest and power in and over one of said three equal parts or shares and the income thereof which is given to us respectively by said indenture over one-third of said trust estate and the income thereof, except as may be otherwise specifically provided herein." 89

Prior to this amendment only one cash account had been maintained by the trustee, but after the amendment the single account was closed by transferring equal amounts of its balance to each of the three new accounts. Thereafter cash received and disbursed on account of the trust property was entered in these accounts, one-third in each.

The Supreme Court held that the amendments with their clear intent to establish separate trusts were effective to create such separate trusts despite the fact that the trust corpus had not been divided. The Court said:

"If the various securities had been divided physically, if new certificates of stock had been obtained for the several beneficiaries, and such certificates and specific bonds and cash had been set aside for each, there would be no room for argument that three separate trusts were not created. But it was not necessary to have such a physical division in order to carry out the clear intention of the parties. An undivided interest in property may constitute the corpus of a trust. . . . Where there is an intention to create sepa-

89 (U. S. 1936) 56 S. Ct. 329 at 330.
rate trusts, the fact that ‘the trusts’ are ‘kept in one fund’ does not necessarily defeat the intention and require the conclusion that there is but a single trust. . . .

“In the instant case, immediately following the first amendment, the trustee opened separate accounts for the three trusts and the single account previously kept was closed. Income received and amounts disbursed were divided and entered in the separate accounts. The property account of the single trust was closed and the items were transferred equally to separate accounts in the names of the beneficiaries, showing one-third of the assets of the old trust as representing the corpus of each of the three trusts. New principal was divided equally in the same way. If, at the outset, there had been three trust deeds, each creating a trust for the benefit of a distinct beneficiary in an undivided one-third of the property involved, no question would have arisen. We think the same result was achieved by the use of the power of amendment. . . .”

Language that even slightly looks toward a single trust will be fatal. In State Savings Loan and Trust Co. v. Commissioner, a trust was created by deed, the net income of which was to be paid “all or part” for the education and support of nine grandchildren. Any portion not annually distributed was to be accumulated. The words “the trust fund” and “trust estate” were used in the instrument. These words were held by the Circuit Court of Appeals for the Seventh Circuit to indicate an intention to create a single trust, although the state court in supervising the administration had held that nine trusts had been created.

Furthermore, the mere omission in the instrument of a single-trust

90 (U. S. 1936) 56 S. Ct. 329 at 332.
91 (C. C. A. 7th, 1933) 63 F. (2d) 482. Accord: Langford Investment Co. v. Commissioner, (C. C. A. 5th, 1935) 77 F. (2d) 468. In J. C. Wynne, 28 B. T. A. 125 (1933), affd. (C. C. A. 5th, 1935) 77 F. (2d) 473, the trust indenture provided that “Upon the arrival of each beneficiary at the age of twenty-one years, the trustees shall then turn over to such beneficiary his portion of the said estate and from that time such beneficiary shall own said property and be free to dispose of the same as he shall see fit.” (Italics supplied.) The Board held that the deed indicated that the “trustors did not intend to vest any definite share of the corpus in any one of the beneficiaries as of the date of the execution of the trust, but did intend ‘to create a single trust to be reformed and continued in the event of certain contingencies which are particularly specified.’” (Id. at 128.) See also McGinley v. Commissioner, (C. C. A. 9th, 1935) 80 F. (2d) 692; Charles B. Van Dusen, 33 B. T. A. 662 (1935); Houston Land Trust Co., 33 B. T. A. 73 (1935); Huntington Nat. Bank, Trustee, 32 B. T. A. 342 (1935).
sound is of itself insufficient. In *John J. Rauers*, the testator devised and bequeathed his estate in trust for the benefit of his wife and children. The trustees were directed to hold such estate undivided until the death of the widow and until the youngest child should attain the age of thirty years, whereupon the testator's estate should be equally divided among his children then in existence, upon the express condition, nevertheless, that the share coming to his daughters should be held by the executors in trust for the said daughters during their lifetime and then be distributed to their issue upon the death of the said daughters. The Board of Tax Appeals in reaching the decision in the case, said:

"Is there anything to show that the testator intended to direct in his will that three separate trusts be established, one for each daughter, at the time this division of the estate was to take place? We find nothing in the will which justifies us in reaching such a conclusion."

The Board accordingly held that only one trust had been created.

Indeed, it seems that the provision for separate trusts must be mandatory. In *Johnson v. United States*, the trust provided:

"I direct my trustees to hold and invest and reinvest all the remainder of such income and to hold and retain the same and all accumulations thereof in order that said trust fund may increase and keep the same intact until my said three children ... shall respectively arrive at the age of twenty-five years, dividing the said trust fund, however, into three equal parts, one of the said parts to be held for each of my said children, respectively, and in adding to such fund from ... income of my estate ... I direct that such additions shall be made equally to each of said three parts and as my said children shall respectively arrive at the age of twenty-five years the principal of such portion of said accumulated fund so held for such child shall be paid to such child or the lawful issue thereof."

The Court of Claims held that there was one comprehensive trust created because the words of separation were merely directory and not mandatory. It is difficult to see, however, why the provision in this case is not mandatory.

The appointment of separate trustees may involve disadvantages

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28 B. T. A. 516 (1933).
28 B. T. A. 516 at 519-520 (1933).
65 Ct. Cl. 285 at 289 (1928).
in administration. The recent Supreme Court cases indicate that separate trustees are not necessary in order to create separate trusts but that clear language alone is sufficient. Where administrative disadvantages are not substantial, however, the naming of separate trustees would be a wise precaution, as well as the use of separate instruments to create the separate trusts.

The separate trust device is, of course, equally available regardless of whether the settlor desires to give the beneficiaries vested or contingent interests in the accumulations. It is also immaterial that there be but a single life beneficiary and several remaindermen. If the income of a trust is to be paid to a life beneficiary and upon his death the trust income to be accumulated for the remaindermen with the rest of the corpus, it might seem necessary to create separate trusts for the life interest and the remainder. But obviously there is no tax advantage to the life beneficiary; in fact, such an arrangement would be disadvantageous in regard to offsetting capital losses and gains. Therefore in the situation where all of the income is paid currently to a single person for his life but after his death is to be accumulated for several beneficiaries for future distribution, a single trust should be created with separate trusts to arise upon the death of the life beneficiary.

A device to reduce income taxes where income is accumulated for several beneficiaries in irrevocable trusts is suggested by several cases in various federal circuit courts of appeals. It consists of placing the income-producing property in a single trust, the income to be paid over to separate subtrusts, one for each beneficiary, in which the accumulating will actually take place.

In Willcuts v. Ordway, the trustee, using the accumulated funds, purchased securities which he kept in separate safe-deposit boxes. Such segregation was held to be a properly credited distribution under Section 219 of the Revenue Act of 1921, substantially identical to Section 162(b) of the 1934 Act.

* DeVer H. Warner, 7 B. T. A. 1292 at 1301 (1927), affd. per curiam; (C. C. A. 2d, 1928) 26 F. (2d) 1023.
* In State Street Trust Co. v. White, Federal Tax Service (Prentice-Hall, 1934) par. 1002 (D. C. Mass. 1934), it was held that the will created a single trust for the life of the testatrix' son, with four separate trusts to arise upon his death from the corpus thereof.
* See note 86, supra.
The more recent decision of *Fidelity and Columbia Trust Co. v. Lucas* reached a like result. In that case the testator bequeathed property in trust for the benefit of his three children, share and share alike, to be used for the maintenance and education of such three children until each reached the age of twenty-one; from twenty-one to twenty-five each was to receive a sum not exceeding $10,000 annually, out of the income of the estate or their respective shares; and from twenty-five to thirty-five they were to receive in like manner not exceeding $15,000 annually; and when the eldest child became thirty the entire estate held in trust was to be divided into equal shares. In reference to the income that was not distributed the court said:

"we cannot escape the strong conviction that under the will the surplus income was to be received and held by the trustee for the equal benefit of the three children ... share and share alike, and that it was therefore the duty of the trustee to set up separate income accounts for each child and to annually credit these accounts with one-third of the net income. . . ." 108

This arrangement would have many advantages because, the corpus being in a single trust, losses and gains on corpus transactions could be offset, and from an administrative viewpoint the concentration of the assets in one trust would be highly desirable. The circuit court cases suggest a hierarchy of subtrusts in which the income of the major trust is paid out or credited through several subtrusts with each trust retaining only a small accumulation until the income of the numerous subtrusts would be taxable only in the lower surtax brackets.

Even though the authorities seem clear and precise on this point, however, it appears that if the hierarchy of subtrusts became complicated that the respective circuits would refuse to follow their own precedents. Many a taxpayer relying upon a circuit court case has found it to be a boomerang. The writer is inclined to believe that this result is likely if subtrusts are actually planned in a complicated manner. The number to be used, even relying on present authority, which is not too strong, would be to create one subtrust for each beneficiary.

Since Section 162(b), (c) of the Revenue Act of 1934 provides

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108 66 F. (2d) 116 at 119.

that the amount paid or credited to the beneficiaries is deductible from
the trustee's income tax return, it might seem a discretionary or manda-
tory provision that the trustee credit part of the accumulation to the
beneficiary would be a tax-saving device of less practical inconvenience
than subtrusts. The difficulty is, however, that if the accumulations are
actually for the purpose of withholding that income from the benefici-
ary, this purpose will be defeated. The amount credited must be avail-
able to the beneficiary or the Revenue Act will tax it to the trustee as an
accumulation despite the credit. ¹⁰⁸

III

Obstacles to Reduction

In addition to the doubtful validity of any method employed to
reduce income taxes, a number of legal stumbling blocks are encoun-
tered in utilizing trusts for that purpose.

One of the most important of these is Section 801 of the Revenue
Act of 1934 ¹⁰⁶ which provides that the term "corporation" includes
"association." Since a corporation is allowed to deduct only five per
cent of net income for charitable contributions, ¹⁰⁷ a trust that would
fall within the definition of an "association" would not have the usual
trust advantage in regard to such items; in fact, the fifteen per cent
deduction allowed to an individual would apparently be lost. ¹⁰⁸ Again,
improper accumulations are subject to a substantial surtax against the
corporation in addition to a surtax against the individuals who may
later receive them in the form of dividends. ¹⁰⁹ Hence if a trust that
provided for accumulation were taxed as an "association," not only
would the reduction of taxes not be achieved but an actual tax loss
might be entailed. If the trust provided for no accumulation, then there
would be no risk of double surtaxes. A trust taxable as an "associa-

(Supp. 1935).
¹⁰⁸ Revenue Act of 1934, § 23 (o), 48 Stat. L. 690, 26 U. S. C., § 23 (o). The
individual might try to assert the quasi-trust as his own charitable contribution. Since
the corporation is treated as a separate taxable entity, however, it seems that his efforts
should meet with little success.
tion,” however, would involve additional normal tax burden.\textsuperscript{110} It becomes extremely important, therefore, that the trust be a “pure trust” for revenue purposes.

Until the recent case of \textit{Morrissey v. Commissioner}\textsuperscript{111} in the United States Supreme Court, the plethora of authority upon this problem gave little light because of its hopeless state of confusion. The material facts of the \textit{Morrissey} case were that a trust was created in 1921 to purchase, encumber, sell, lease and operate real property; to construct and operate golf courses, club houses; to receive the rents; to make loans and investments; and generally to manage the trust estate as if the trustees were its absolute owners. Transferable certificates evidenced the beneficial ownership, but the beneficiaries’ sole power was to make recommendations which were at most advisory. After 1924 the activities of the trust were confined to the collection of principal and interest on contracts of purchase, the receipt of interest on bank balances, the execution of conveyances to purchasers, the receipt of dividends from an incorporated club, and the distribution of money to the holders of beneficial interests.

The Supreme Court held that for the years 1924 to 1926 the trust was not a “pure trust” but was taxable as an “association.” The distinctive feature of such a trust was “to enable the participants to carry on a business and divide the gains which accrue from their common undertaking, trusts that thus satisfy the primary conception of association and have the attributes to which we have referred, distinguish them from partnerships.” As to the attributes that made a trust analogous to a corporate organization the Court said:

“A corporation, as an entity, holds the title to the property embarked in the corporate undertaking. Trustees, as a continuing body with provision for succession, may afford a corresponding advantage during the existence of the trust. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The designa-

\textsuperscript{110} Comparative analysis of sections 102 of the Revenue Act of 1935 and 161 of the Revenue Act of 1934 make this apparent.

tion of trustees, who are charged with the conduct of an enterprise, who act "in much the same manner as directors," may provide a similar scheme, with corresponding effectiveness. Whether the trustees are named in the trust instrument with power to select successors, so as to constitute a self-perpetuating body, or are selected by, or with the advice of, those beneficially interested in the undertaking, centralization of management analogous to that of corporate activities may be achieved. An enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the interests of members of a corporation. And the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants. The trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking." 118

This case seems to give sanction to the recent Treasury Regulations 119 in holding that the only important test is whether the trust provides "a medium for the conduct of a business and sharing its gains." The tendency of many lawyers to give the trustees the widest possible powers must therefore be curbed if efforts to reduce taxes are to be successful. It therefore seems that a "pure trust" is now limited to only one purpose for its entire duration, namely, to "collecting the income and conserving the property" of the trust "against the day when it is to be distributed to the beneficiaries." 114

Furthermore, where the settlor desires to interpose a life insurance policy in the arrangement for his beneficiaries, Section 167(a)(3) 118 destroys the purpose of the grantor to reduce income taxes by providing that income "applied to the payment of premiums upon policies of insurance on the life of the grantor" shall be taxed to him.

Burnet v. Wells 116 upheld the constitutionality of the corresponding sections in the Revenue Acts of 1924 and 1926. This provision, however, does not apply to trusts to pay the premiums on life insurance policies of another, and hence if the financial situation of a husband or wife would permit one to create a trust to pay the premiums on the

112 56 S. Ct. 289 at 296.
114 56 S. Ct. 289 at 291.
other's life insurance policies, it would obviously not be covered by Section 167. Such an arrangement was upheld by the Board of Tax Appeals in *Lucy A. Blumenthal*,\(^{117}\) and the Commissioner has since acquiesced in the decision.\(^{118}\) But the creation of such a trust would involve gift taxes which would partially destroy the income tax saving.

Since the passage of the Revenue Act of 1932 taxing gifts\(^{119}\) and an increase in those gift tax rates by the Revenue Act of 1935,\(^{120}\) considerable attention must be given to the amount of the gift tax upon a transfer in trust before a conclusion can be reached that tax saving has been achieved.

Adequate and full consideration is now required for all transfers of property in trust unless there be a reservation of the power to revest the property in the donor;\(^{121}\) transfers for less than adequate and full consideration in money or money's worth are subject to the gift tax to the extent to which the transfer in trust is donative in character.\(^{122}\) Furthermore, the relinquishment or termination of the power to revest without adequate and full consideration in money or money's worth is a gift of such property at the time of the extinction of the power, unless the termination was the result of the donor's death.\(^{123}\)

The gift tax rates are progressive and attain fifty-two and one-half per cent under the Revenue Act of 1935.\(^{124}\) On the other hand, annual gifts of $5,000 to individual beneficiaries, other than future interests in property, are not subject to the gift tax,\(^{125}\) and a cumulative exemption of $40,000\(^{126}\) is allowed to each individual taxpayer. It therefore becomes an individual problem for each settlor whether payment of the gift tax on an irrevocable trust will be more advantageous than pay-

\(^{117}\) 30 B. T. A. 591 (1934), revd. on another issue in (U. S. 1935) 56 S. Ct. 305.


\(^{121}\) Revenue Act of 1932, § 501, 47 Stat. L. 245. See U. S. Treas. Reg. 79, Arts. 2, 3; even this exception was repealed by 48 Stat. 758 (1934).


\(^{123}\) See U. S. Treas. Reg. 79, Art. 3.


ment of ordinary income taxes. Where the settlor has already been subjected to considerable gift taxes, or where future gifts of any consequence are contemplated, the saving of income taxes will probably be insignificant by comparison. But where the settlor is not presented with the problem of past or future gifts of considerable size, then a reduction of income taxes through the use of trusts might be possible.

Outright dispositions in trust are obviously subject to the gift tax, but the settlor effects a considerable saving of taxes in the final analysis, however, for the reason that the property in trust will not be included in the settlor's estate for gross estate tax purposes, unless the gift is in contemplation of death. A comparison of the rates of the two taxes reveals an average saving of twenty-five per cent. Again, full advantage is taken of all exemptions under both the gift and estate tax unless the settlor leaves no estate—a very rare case. In testamentary trusts the gift tax has no application.

Finally, the cost of creating and administering a trust must be considered in determining whether taxes are actually reduced. In the case of inter vivos trusts a minimum tax economy of five per cent of the income of the trust will be necessary to offset the cost of the trustee's fees. If, as is usually the case, the settlor desires to manage the property and direct the investments of the trust, this can be most effectively accomplished by making himself trustee and thus eliminating any consideration of the trustee's fees. But where the settlor is not the trustee, this cost must be added to the gift tax before determining that an income tax saving can be accomplished.

In the case of testamentary trusts the trustee's fees become important only if the fee for the administration of the trust is retrogressive as to the amount of the trust income. Where that is the case, the additional trustee's fees in the administration of separate trusts rather than a single trust must be considered.