1985

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Recommended Citation
THE FUNDING OF CHILDREN’S EDUCATIONAL COSTS

by

Douglas A. Kahn*

The soaring expense of education has stimulated more and more parents to seek means of minimizing those costs. Since educational expenses typically are satisfied out of after-tax dollars,\(^1\) the principal means of reducing the parents’ costs is to minimize the tax liability incurred by the earnings that are employed in satisfying those costs. For example, where the marginal rate tax bracket of parent (P) is 50% and where the cost of sending child (C) to college for one year is $12,000, P will have to dedicate $24,000 of earnings to meeting C’s college costs—$12,000 of those earnings are taken by the income tax, and only the remaining $12,000 are available for payment of C’s college expenses. If P can redirect a portion of his passive income (that is, his income from investments) to someone in a lower marginal rate tax bracket and yet have the net proceeds after tax utilized to pay C’s college costs, it would require the dedication of a smaller amount of P’s passive earnings to provide a net after-tax figure of $12,000. For example, it would require only $15,000 of earnings that are taxed at an effective rate of 20% to provide an after-tax net of $12,000. A major question then is what means, if any, are available to reduce the tax burden imposed on earnings dedicated to children’s educational costs so that the amount of earnings required to meet those expenses will be reduced. This article will discuss the means that are currently available and the pitfalls that may be encountered. Finally, the article will examine portions of H.R. 3838 that would impact on the tax reduction arrangements that are currently utilized and will speculate on what means for cost reduction would be available if that

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* The author gratefully acknowledges the very helpful comments and suggestions that he received from Professor Larry D. Ward, who was kind enough to provide the author with a critique of an earlier draft of this manuscript.

\(^1\) In certain narrow circumstances, educational expenses are deductible. Where the education is undertaken to maintain or improve business skills or is required by the individual’s employer or is required by law or regulation as a condition to the retention of the individual’s employment or business status, the costs of that education are deductible by the individual as business expenses. See, Treas. Reg. § 1.162-5. A parent’s payment of the child’s educational expenses will rarely, if ever, qualify as a business expense deduction. If a dependent child is enrolled in a special school that treats or alleviates the effects of a mental or physical handicap, the parent’s expense of maintaining the child in that special school, including the expenses attributable to the school’s services in educating the child, are deductible as medical expenses if the primary purpose of placing the child in that school is to provide medical care for the child. If the primary purpose test is satisfied, i.e., if the educational function of the school is incidental to the providing of medical care, all of the expenses attributable to maintaining the child in that school, including tuition, meals and lodging, constitute medical expenses. Treas. Reg. § 1.213-1(e) (1) (v). Compare Lawrence D. Greisdorf, 54 T.C. 1684 (1970) (allowing a deduction for the cost of attendance of an emotionally disturbed child at a private school which specialized in treating children with such problems) with Paul H. Ripple, 54 T.C. 1442 (1970) (denying a deduction for the cost of a child’s attendance at a school that provided a remedial reading program for students with reading deficiencies because the court deemed the remedial reading program to be educational rather than medical care). Any such expenses that qualify as medical are aggregated with the payor’s other medical expenses and constitute an itemized deduction to the extent that the aggregate sum exceeds the floor amount established by § 213(a) of the Internal Revenue Code of 1954. Currently, this floor is an amount equal to five percent of the taxpayer’s adjusted gross income.
bill is enacted. H.R. 3838, titled as the Tax Reform Act of 1985, was passed by the House in December, 1985, and currently is pending in the Senate.

While a reduction of state income taxes is desirable, federal income tax reduction is the principal objective since many more dollars are at stake. This article will deal only with the federal tax system. It is noteworthy that a reduction in a parent's federally defined income usually will also reduce the amount of the parent's income for state income tax purposes.

A plan for reduction of educational costs should take federal transfer taxes into account. The method chosen for reducing income tax liability usually will involve making gifts. To the extent that it is convenient to do so, the transfer tax consequences of making such gifts should be minimized. This article will examine the estate and gift tax consequences of the income tax reduction arrangements described herein and will consider means of structuring the transactions so as to minimize those consequences.

In most cases where trusts or similar arrangements are utilized to reduce educational costs, there will be only one generation of beneficiaries that is a lower generation than that of the settlor so that no generation-skipping tax will be incurred. In some instances, however, there will be two or more generations of lower generation beneficiaries. In such cases, the planner must take the generation-skipping tax into account.

Because trusts play a major role in many of the arrangements that are utilized to reduce the tax burden on earnings that are dedicated to satisfying the costs of educating children, the author will briefly summarize the federal income tax treatment of estates and trusts with special emphasis on grantor trusts. Readers that are familiar with those tax rules can skip this part of the article. The author will not summarize the tax treatment of accumulation trusts—the so-called throwback rules—, but where a planning arrangement under discussion raises a throwback issue, that issue will be addressed.

I. INCOME TAXATION OF ESTATES, NONACCUMULATION TRUSTS, AND THEIR BENEFICIARIES

For income tax purposes, estates and trusts are treated as separate entities. Accordingly, they file annual income tax returns and pay income taxes on their net earnings. Estates and trusts are not taxed on income they distribute to the beneficiaries; rather, they are treated as mere conduits for passing such distributed income to the distributees. The income distributed to a beneficiary will be given the same characterization in the beneficiary's income tax return as it would have received in the return of the estate or trust had it not been so

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distributed. The above statement of the "conduit" principle is an oversimplified generalization that is useful to provide a context in which to examine some of the tax rules that pertain to estates and trusts. As the following discussion demonstrates, those rules are complex and technical.

**Taxable Income.**

The taxable income of an estate or trust is generally computed in the same manner as it is computed for an individual.\(^3\) The principal differences between the tax treatment of the income of an estate or trust and that of an individual are the income tax deduction allowed an estate or trust under §§ 651 or 661 for distributions made to beneficiaries and the unlimited deduction allowed under §642(c) for amounts paid (or in some circumstances permanently set aside) for a charitable purpose. With few exceptions, any distribution made from an estate or trust to a beneficiary—whether made from current or previously earned income or from principal—is treated as a distribution of current income to the extent of the estate's or trust's "distributable net income" (DNI). Under §643(c), the term "beneficiary" includes an heir, a legatee, and a devisee. The term "distributable net income" (DNI) is a creature of the tax law and is defined in §643. DNI serves to measure both the amount of a distribution to a beneficiary that constitutes income to him and the amount of such distribution that is deductible by the estate or trust. Before examining the meaning and function of DNI, first let us consider some other special aspects of trust and estate taxation.

**Personal Exemption.**

Estates and trusts are granted a personal exemption. The personal exemption of an estate is $600. The amount of a trust's personal exemption depends upon whether the trustee is required by the trust instrument to distribute all of the trust's income currently. If so, the trust has a $300 exemption; if not, it has only a $100 exemption. §642(b). The statutory reference to trust "income" required to be distributed currently applies to income as determined under state law for trust accounting purposes, as contrasted with "taxable income" determined under the income tax law. In many states, the trust accounting rules are established by the Revised Uniform Principal and Income Act. Typically, capital gains are excluded from income for trust accounting purposes.\(^4\) So, a trust which is required to distribute all of its trust accounting income for a taxable year and which accumulates capital gain income for that year will have a $300 personal exemption to deduct from its capital gain income.

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\(^3\) See, § 651(b). Unless indicated otherwise, all references herein to a "§" number shall refer to a section of the Internal Revenue Code of 1954 as amended at the date of this writing.

\(^4\) But see, section 12 of the Revised Uniform Principal and Income Act. See n. 16, infra.
**Deductions.**

By reason of §§ 1(e), 3(b) (3), and 63(d), an estate or trust has no zero-bracket amount. Thus, every dollar of income of an estate or trust, less its allowable deductions which, as noted above, include a personal exemption, is subject to tax at the rates set forth in § 1(e). With a few exceptions, an estate or trust is permitted the same deductions that are allowed to individuals. An example of an exception is that § 179(d) (4) prohibits an estate or trust from using the election to expense certain depreciable properties under § 179.

**Charitable Deduction.**

In lieu of the deduction allowed to an individual for charitable contributions (in a total amount not in excess of 30 percent or 50 percent of adjusted gross income), § 642(c) allows a deduction to an estate or trust for any amount, without limitation, that, pursuant to the will or other growing instrument, is, during the taxable year, paid for a charitable purpose or use.

Section 642(c) (4) provides that when an estate or trust is allowed a charitable deduction for long-term capital gains that were paid or permanently set aside for charitable purposes, the amount of such capital gains that is allowable as a charitable deduction must be adjusted by the 60 percent capital gains deduction allowed the estate or trust under § 1202. This prevents there being a duplication of deductions of such contributions.

If an estate or trust has both taxable and non-taxable income, a proportionate part of the non-taxable income must be allocated to the amount paid or set aside for charitable purposes and is not allowed as a deduction.5

Ex. Under the terms of a trust instrument, $30,000 of income must be distributed currently to A and the balance to X Charity. Last year, the trust earned $30,000 of taxable interest and $10,000 of interest on tax-exempt municipal bonds. The charitable deduction of $10,000 is allocated proportionately to the items of income of the trust, $7,500 to taxable interest, and $2,500 to tax-exempt interest. The makeup of A’s $30,000 of net interest income is $22,500 of taxable interest and $7,500 of tax-exempt interest.6

**Deduction for Depreciation and Depletion.**

Section 642(e) provides that the deductions for depreciation and depletion are allowable to an estate or trust only to the extent that they are not allowable to the beneficiaries. In general, such deductions are allowable to the beneficiaries in the same proportions that current income (i.e., trust accounting income) is allocable to them.7 If, pursuant to the governing instrument or local law, the trustee reduces trust accounting income by a reserve for depletion or deprecia-

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5 Treas. Reg. § 1.642(c)-2.
6 See, Treas. Reg. § 1.662(b)-2, Ex. (1).
7 §§ 167(b), 611(b).
tion, the depletion or depreciation deduction will be allocated to the trust to that extent, and any depletion or depreciation deduction in excess of the reserve will be allocated between the income beneficiaries and the trust.  

**Business Losses.**

Where an estate or trust incurs business losses, it is allowed a carryover of its net operating loss. In computing its net operating loss, no allowance is made for charitable deductions or for the deduction allowed (under §§ 651 or 661) for distributions made to beneficiaries.

**Distributable Net Income (DNI).**

If X made an outright gift of property to Y or if X died and bequeathed property to Y, the transfer would not cause Y to recognize any gross income. Of course, any income subsequently produced by the property while Y owns it will be taxed to Y. If, instead, X were to transfer income-producing property to a trust for the benefit of Y and if the transfer of such property constituted a gift or a bequest or an inheritance, neither the transfer to the trust nor the later distribution of the property from the trustee to Y should constitute gross income to Y or to the trustee. The purpose of § 102 is to exclude gifts and inheritances from gross income, and it should not matter whether the property is given to the donee or beneficiary immediately or whether it is parcelled out over a period of years through the medium of a trust. However, any income produced by the transferred property subsequent to the gift or bequest should be taxed either to the beneficiary to whom the income is distributed or to the trust (as a separate entity) if the income is accumulated. The beneficiaries of a trust or estate should be taxed only on their distributive share of the taxable income of the trust or estate, and a distribution to a beneficiary should be excluded from income by § 102 to the extent that it is not attributable to such taxable income. The difficulty, of course, is to determine the extent to which a distribution to a beneficiary is attributable to taxable income produced by the corpus of the trust or estate. The tracing of the source of trust or estate distributions becomes more complex where distributions are made to several beneficiaries, each of whom has a different type of beneficial interest. Since 1954, the income tax laws have used the concept of “distributable net income” as a device for determining whether a distribution to a beneficiary was attributable to the taxable income of the trust or estate.

For taxable years prior to the adoption of the DNI provision, several courts had held that to the extent that distributed amounts of trust principal and

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8 Treas. Reg. §§ 1.167(b)-1, 1.611-1(c) (4).
9 See, § 642(d) and Treas. Reg. § 1.642(d)-1.
10 § 102.
11 See, § 102(b).
non-taxable stock dividends were treated under state law for trust accounting purposes as income distributed to the beneficiaries, they were taxable as gross income of the beneficiaries even if the amount so distributed exceeded the gross income of the trust for the year of distribution.\(^1\) That result was inconsistent with the policy behind § 102 to exclude direct gifts and bequests from the gross income of the recipient. Accordingly, Congress eliminated that incongruity by limiting the amount taxable to a beneficiary of an estate or trust to the distributable net income (DNI) of the estate or trust and by defining "DNI" as the taxable income, with certain modifications, of the trust or estate. Thus, the function of DNI is to serve as a measuring device for allocating the taxable income earned on the property of a trust or estate among itself and its beneficiaries. The aggregate amount included in the taxable income of the beneficiaries and of the trust or estate will equal the taxable income earned on the property held in trust or by the estate.

Distributable net income (DNI) establishes the top limit on distributions by an estate or trust that may be treated as income to the beneficiaries.\(^2\) It also provides the basis for allocating various classes of income among the beneficiaries.\(^3\) A distribution that is treated as income to a beneficiary is not necessarily taxed to that beneficiary, since the tax consequences of receiving income depend upon the characterization of the distribution—for example, a distribution of interest on a corporate bond will be taxable income, but a distribution of interest from a state or municipal bond will usually be exempt from tax under § 103. Under §§ 652(c) and 662(c), if an estate or trust has a taxable year that is different from that of a beneficiary, the amount of income attributable to the beneficiary is based on the income of the estate or trust for its taxable year that ends within or with the beneficiary's taxable year. DNI also serves as a factor in determining the maximum amount of income tax deduction allowed to a trust or estate for distributions made to its beneficiaries.\(^4\)

"Distributable net income" (DNI) is defined in § 643 as the taxable income of the estate or trust for the taxable year with the following adjustments:

1. The deductions for income distributions and the personal exemption are eliminated.

2. Capital gains are excluded to the extent that they are allocated to corpus and are not (a) paid, credited, or required to be distributed to a beneficiary in the taxable year; or (b) paid, permanently set aside, or to be used for charitable purposes.\(^5\) Capital losses are excluded except

\(^{12}\) E.g., Johnston v. Helvering, 141 F.2d 208 (2d Cir. 1944), cert. denied, 323 U.S. 715 (1945); McCulloch v. Commissioner, 153 F.2d 345 (2d Cir. 1946).

\(^{13}\) §§ 651 and 661.

\(^{14}\) §§ 652(a), 662(a).

\(^{15}\) §§ 652(b), 662(b).

\(^{16}\) Where, under local law, an income beneficiary of a trust is entitled to receive a share of the trust's capital gain income because the trust's prior income from the asset that was sold had been underproductive [see, section 12 of the Revised Uniform Principal and Income Act], the income beneficiary's share of that capital gain is included in the trust's DNI as capital gain income that is required to be distributed. Rev. Rul. 85-116, 1985-31 I.R.B. 19.
to the extent that they are taken into account in determining capital gains that are paid, credited, or required to be distributed currently. The 60 percent long-term capital gain deduction is not taken into account.

3. In the case of "simple" trusts (defined below), extraordinary dividends and taxable stock dividends are excluded to the extent that the fiduciary allocates them in good faith to corpus and does not distribute them.

4. Tax-exempt interest, dividends excluded from gross income by §116, and, in the case of a foreign trust, foreign income, reduced by amounts that but for §265 would be deductible and which are allocable to such income, are included. A proportionate part of such income must be allocated to any allowable charitable deduction.

It will be seen from the definition of DNI that if capital gains are distributed currently, they are part of DNI and are taxable to the beneficiaries. In the taxable year in which a trust or estate is terminated, all of its income for that year (including its capital gain income) is required to be distributed to the beneficiaries, and thus capital gains recognized by a trust or estate in the taxable year of its termination are included in DNI. Except for gains recognized in the year of termination, capital gains typically are excluded from DNI and are not considered as paid, credited, or required to be distributed to a beneficiary unless they are (1) allocated to income under the governing instrument or local law by the fiduciary on its books or by notice to a beneficiary; or (2) allocated to corpus and actually distributed to beneficiaries during the taxable year; or (3) utilized, pursuant to the governing instrument or the practice followed by the fiduciary, in determining the amount that is distributed or required to be distributed.17

Separate Share Rule.

Section 663(c) provides that for the purpose of determining the amount of DNI of a trust that is allocable to a beneficiary, substantially separate shares of different beneficiaries are treated as separate trusts.18 The separate share rule applies only to trusts; it has no application to estates.

Characterization of Distributions.

Various classes of income retain the same character—such as dividends, long-term capital gain, and tax-exempt interest—in the hands of the beneficiaries that they had when received by the estate or trust.19 The estate or trust is thus treated as a conduit through which the income flows from its original source to the beneficiaries. This treatment requires an allocation of various

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17 Treas. Reg. § 1.643(a)-3(a).
19 §§ 652(b), 661(b), 662(b); Treas. Reg. §§ 1.652(b)-2, 1.662(b)-2.
classes of income ratably among beneficiaries according to the amount of DNI deemed received by each. As noted above, capital gains often will not be allocated to the beneficiaries.

**Distributions of Property in Kind.**

Prior to the adoption of the Tax Reform Act of 1984, an estate or trust’s distribution of property in kind to a beneficiary typically did not cause the estate or trust to recognize a gain or loss even though the distributed property was an appreciated or depreciated asset. In such cases, the beneficiary’s basis in the distributed property was equal to the property’s fair market value to the extent that the estate or trust’s DNI was allocated to the distribution.\(^20\)

However, where an estate or trust transfers appreciated property in satisfaction of a pecuniary bequest or gift or of a dollar claim against the entity, the entity recognizes a gain in the amount of such appreciation.\(^21\) An estate or trust’s distribution of a depreciated asset in such circumstances causes the entity to recognize a loss, but § 267 bars a trust from deducting a loss arising from a sale or exchange between a trust and one of its beneficiaries. Section 267 does not apply to transactions between an estate and one of its beneficiaries, and so an estate can deduct a loss it recognizes on making such a distribution. While a trust cannot deduct its recognition of a loss in such circumstances, under § 267(d), the beneficiary who received the distribution can exclude from income all or part of any gain that he might recognize on a subsequent disposition of the distributed asset. As noted above, under § 663(a), an estate or trust’s distributions in satisfaction of pecuniary bequests or gifts will not constitute a distribution out of the entity’s DNI.

The 1984 Act amended § 643 by adding subsection (d).\(^22\) The amendment left intact the treatment described above of an estate or trust’s distribution of appreciated or depreciated property in satisfaction of a dollar claim or of a pecuniary bequest or gift. The amendment also does not affect the tax treatment of distributions of charitable contributions.\(^23\)

As amended, § 643(d) provides that where an estate or a complex trust distributes property in kind to a beneficiary, the distributee’s basis in that asset is equal to the adjusted basis that the distributing entity had therein increased by any gain or decreased by any loss recognized by the entity on making that distribution. The amount distributed to the beneficiary, for purposes of determining under the DNI rules the amount of income recognized by the beneficiary

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\(^20\) Treas. Reg. § 1.661(a)-2(f).
\(^21\) Rev. Rul 82-4, 1982-1 C.B. 99; Rev. Rul. 83-75, 1983-1 C.B. 114. See, Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940). If appreciated property is distributed by a trust in a transaction that is treated as a sale or exchange and if the property is depreciable in the hands of the distributee, the gain recognized by the trust will be ordinary income. § 1239(a), (b) (2).
\(^22\) Due to an error in the 1984 Act, there are two subsections (d) to § 643. Presumably, one of those subsections will be relettered "(e)."
and the amount of deduction allowable to the entity, is the lesser of the fair
market value of the distributed property or its basis in the hands of the
distributee. This provision does not apply to distributions made by simple
trusts; it applies only to distributions made by estates and complex trusts. The
definitions of "simple" and "complex" trusts are discussed later in this piece.

A distributing estate or complex trust is granted an election under § 643(d) (3) to
opt out of the foregoing rules. If the entity elects, it will recognize gain or loss as
if it had sold the distributed asset to the distributee for its fair market value. In
that event, the amount that is deemed to have been distributed to the beneficiary
is equal to the fair market value of the distributed property.

**Simple Trusts.**

A "simple trust," sometimes called a "distributable trust," is one whose
governing instrument requires that all the trust's income be distributed cur-
rently and does not provide that any amount may be paid or permanently set
aside for charitable purposes. The taxation of a simple trust is governed by
§§ 651 and 652. A trust will not qualify as a simple trust in any year in which the
amounts distributed by the trust exceed the trust's income for that year. The
reference to "income" in this context means income for trust accounting
purposes rather than taxable income or distributable net income.

In general, the ordinary income of a simple trust (as contrasted to its capital
gains) is deductible by the trust and taxable to the beneficiaries whether actually
distributed or not. However, under §§ 651(b) and 652(a), the aggregate amount
of distributions deductible by the simple trust and taxable to the beneficiaries
cannot exceed the distributable net income (DNI) of the trust. The aggregate
amount taxable to the beneficiaries is limited to DNI which is apportioned
ratably among the beneficiaries according to the amount required to be dis-
tributed currently to each.

There is little significance to classifying a trust as a simple trust. With few
exceptions, a simple trust and its beneficiaries would be taxed in an identical
manner if the tax rules applicable to complex trusts §§ 661–664 were applied.

One difference in treatment of simple trusts is that, under § 643(a) (4),
extraordinary dividends and taxable stock dividends that a fiduciary of a simple
trust, acting in good faith, does not pay to a beneficiary on his determination
that, under local law or the governing instrument, such dividends are allocable
to corpus are excluded from DNI. Another difference is that the throwback
rules apply only to distributions from complex trusts. While the terms "simple
trust" and "complex trust" are not used in the Code, they are commonly
employed in tax parlance and they are used in the regulations.

Tax-exempt income is included in DNI (§ 643(a) (5)) solely for the purpose

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24 As previously noted, § 267 precludes a deduction to a trust that recognizes a loss on such a transaction, but
an estate is allowed to deduct a loss that it recognizes.
25 E.g., Treas. Reg. §§ 1.651(a)-1, -2, -3; 1.651(b)-1; 1.652(a)-1; 1.661(a)-1.
of allocating various classes of income among beneficiaries. No distributions
deduction is allowed to an estate or trust for such income, and it retains its
color of tax-exempt income in the hands of the beneficiaries.

_Estates and Complex Trusts._

Trusts other than simple trusts are sometimes referred to as "complex
trusts." These trusts include: (1) those that provide for, or permit, the accumu-
lation of income; (2) those that distribute any corpus in the taxable year in
question; or (3) those that provide that amounts are to be paid, permanently set
aside, or used for charitable purposes. A decedent's estate in process of
administration is taxed in the same way as a complex trust. The rules relating to
complex trusts and estates are found in §§ 661 and 664 (subpart C of subchapter
J). If any income of an estate or complex trust is required to be distributed
currently, such income is treated in the same way as in the case of a simple trust;
whether or not distributed, it is taxed currently to the beneficiaries and is
deductible by the estate or trust. While an estate is properly in the process of
administration, none of its income is usually considered income required to be
distributed currently. Amounts other than required income distributions are
deductible by an estate or trust and taxable to beneficiaries only if they are
distributed during the taxable year.

_Distributions Deemed to Be Distributions of Income._

Any distribution, whether from current income, prior years' income, or
principal, is treated as a distribution of current income, except (under § 663(a)
(1)) for an amount paid or credited as a gift or bequest of a specific sum of
money or specific property that, under the terms of the government instrument,
(1) is paid or credited all at once or in not more than three installments, and (2) is
not payable solely from income. However, in one case, a partial distribution of
the corpus of an estate to a residuary legatee in advance of final settlement was
not treated as a distribution to the legatee for tax purposes because local law
provided that such partial distributions were subject to recall by the estate if
needed for such purposes as the payment of taxes or debts.27

Ex. A's will bequeathed all of his personal belongings and household effects
to B. Pursuant to that bequest, in Year One the executor distributed A's jewelry
(valued at $8,000 at the time of A's death and at the time of distribution by the
estate) to B. The estate had DNI of $10,000 in Year One, and no other estate
distributions were made in that year. B recognized no income as a consequence
due to the exclusion of specific bequests.28 If A had made no separate bequest of his personal belongings but instead had be-
queathed his entire estate to B in the residuary clause of his will, the distribution

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26 See, Treas. Reg. § 1.661(a)-1.
27 Bohan v. United States, 456 F.2d 851 (8th Cir. 1972).
28 See, Treas. Reg. § 1.663(a)-1(c).
to B would have caused B to recognize $8,000 of gross income, the lesser of the estate’s basis or the fair market value of the jewelry that was distributed to B. For this purpose, it makes no difference that the distributed property was part of the corpus of A’s estate.

Deduction for Estate or Trust.

§ 661(a) allows as a deduction for complex trusts and estates “(1) any amount of income for such taxable year required to be distributed currently . . . , and (2) any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income of the estate or trust.” A deduction is not allowed for the distribution of other amounts (i.e., amounts other than required income distributions) unless “properly paid or credited or required to be distributed.” Where trust distributions made under a poorly drafted trust instrument were determined to be improper because no distributions were permitted to be made at the time of distribution to the distributees in question, the trust was not allowed a deduction. 29

No deduction is allowed for the distribution of any item of DNI that was not included in the gross income of the estate or trust. 30

Tier System.

As in the case of simple trusts, the aggregate of the amounts deductible by an estate or complex trust and taxable to beneficiaries is limited to the DNI of the estate or trust. If the aggregate amount of income required to be distributed currently to beneficiaries (including amounts required to be distributed currently that may be paid out of either income or corpus to the extent that they are actually paid out of income for the taxable year) exceed DNI, the DNI is apportioned ratably among those beneficiaries according to the amount of income required to be distributed to them. For this purpose, DNI is computed without the charitable deduction, so that if the required distributions of income to beneficiaries exceed DNI without taking into account the charitable deduction, those beneficiaries will receive no benefit from the charitable deduction. The charitable deduction allowed to a trust or estate is not passed through to “first-tier” beneficiaries.

If both required income distributions (including deemed distributions) and other distributions are made, and if the aggregate of such distribution exceeds the entity’s DNI, an order of priority among beneficiaries, or “tier system,” is established and (1) the DNI is allocated first to the beneficiaries of required income distributions, who are placed in the “first tier”; and (2) any balance of DNI is allocated ratably and taxed to the beneficiaries of the other distributed

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29 American National Bank & Trust Co. v. United States, 46 AFTR2d ¶ 80-6007 (6th Cir. 1980).
30 § 661(c).
amounts, who are placed in the "second tier." The allocation of the remaining DNI to a tier-two distributee is made proportionately to that distributee's share of the total tier-two distributions that were made by the entity that year.

In determining DNI for the purpose of computing the amount of gross income recognized by a second-tier beneficiary, the charitable deductions allowed the trust or estate are taken into account. If required income distributions (i.e., first-tier distributions) do not exceed DNI, computed by taking the deduction for charitable distributions, the amount taxable to second-tier beneficiaries is limited to the balance of DNI as so computed. Thus, second-tier beneficiaries receive the benefit of the charitable deduction. To characterize the income of the beneficiaries, a proportionate part of each income item comprising the income of the estate or trust must be allocated to the charitable contribution.\footnote{The following illustrations demonstrate the operation of the tier system. In the interest of simplification, these illustrations will not take into account: depreciation deductions, the small exclusion allowed by \$ 116 for the receipt of a dividend from a domestic corporation, and the "throwback rule" (\$ 665-669). In all of these illustrations, the trust and its beneficiaries report on a calendar year basis and use the cash method.

Ex. (1) A is the sole income beneficiary of a trust created by S. Under the terms of the trust, all of the trust's income is to be distributed currently to A. In Year One, the trust had $20,000 income from rental property; $10,000 in long-term capital gains, which under local law are allocated to corpus rather than to income; and $2,000 in trustee fees, all of which is chargeable against corpus under the trust instrument. The DNI of the trust is $18,000. The trustee distributed all of the trust income ($20,000) to A. A. will include in his gross income for Year One $18,000, which is characterized as rental income. The taxable income of the trust for that year is $3,700 which is computed as follows:

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\begin{align*}
20,000 & \quad - \text{rental income} \\
10,000 & \quad - \text{long-term capital gain} \\
(6,000) & \quad - \text{\$ 1202 deduction} \\
(2,000) & \quad - \text{trustee fee deductible under \$ 212} \\
(300) & \quad - \text{personal exemption} \\
(18,000) & \quad - \text{deduction for distribution to A} \\
6,000 & \quad - \text{income tax} \\
\end{align*}
\]

Ex. (2) B is the sole income beneficiary of a trust created by D. Under the terms of the trust, all of the trust income is to be distributed currently to B. In Year One, the trust received income from rental property in the amount of $20,000 and tax-free interest from municipal bonds in the amount of $5,000, and it paid trustee fees (chargeable to corpus under the trust instrument) in the amount of $2,000. The amount required to be distributed to B is $25,000, the
total income of the trust. The DNI of the trust is $23,000 which is determined as follows.

\[
\begin{array}{ll}
\text{rental income} & \text{tax-exempt interest} \\
$20,000 & 5,000 \\
(1,600) - \text{trustee fee} & (400) - \text{trustee fee} \\
$18,000 - \text{net rent} & $4,600 - \text{net interest}
\end{array}
\]

A portion of the trustee's fee must be allocated to the tax-exempt interest, and this amount is nondeductible because of § 265. The portion of the fee to be disallowed is equal to the portion of the trust's income that is represented by the tax-exempt interest. Of the trust's income that is represented by the tax-exempt interest. Of the trust's $25,000 of income, $5,000 or 20% is tax exempt interest. So, $400 of the trustee's fee is nondeductible. The remaining $1600 of the trustee's fee can be allocated to any of the trust's income that the trustee selects. In this illustration, the trustee should allocate the $1600 balance of the fee to the rental income since that is the only taxable income that the trust received.

The $25,000 of trust income that is distributable to B is treated as income to B only to the extent of the trust's DNI ($23,000). B's income from the trust is characterized in B's hands in the same manner that it was characterized in the hands of the trust. B therefore includes $18,400 of rental income in his gross income. B also has $4,600 of tax-exempt interest, but that interest is excluded from his gross income by § 103. Thus, of the $23,000 of DNI that is allocated to B, he will include only $18,400 in his gross income.

The trust is granted a deduction for the amount distributable to B that does not exceed the trust's DNI. The deduction is further limited by the proviso that no deduction is permitted for an item included in DNI that was not included in the trust's gross income. The amount of the deduction therefore cannot include the $4,600 of tax-exempt interest (net of the interest's share of trustee fees). The taxable income of the trust for Year One is ($300)—$20,000 minus $1,600 minus $18,400 minus $300 = ($300).

Ex. (3) A created a trust for the benefit of certain persons. In Year One, the trust had income from rental property of $44,000 and had trustees fees of $4,000, which under the trust instrument is chargeable to corpus. The trust's income for trust accounting purposes is $44,000, and the DNI of the trust is $40,000. Consider the amount included in gross income of the beneficiaries in the following alternative circumstances.

(a) All of the trust income is required to be distributed currently to B and C and is to be distributed between them equally. B and C each will include $20,000 in his gross income.

(b) Same facts as in (a) except that the income is to be distributed between B and C in a ratio of 2 to 1 respectively. B will include $26,667 in his gross income and C will include $13,333 in his gross income.

(c) Same facts as in (a) except that under the trust instrument the trustee is
given discretion to distribute corpus of the trust to D. The trustee exercised that
discretion in Year One by distributing $10,000 to D from the corpus of the trust.
D is a tier-two beneficiary. The trust’s DNI is allocated first to B and C, the
tier-one beneficiaries, and only the balance of DNI, if any, that is remaining is
allocated to D.\textsuperscript{32} Since all $40,000 of the trust’s DNI is exhausted because of
the tier-one distributions to B and C, no DNI is allocated to D who, therefore,
includes none of the $10,000 that he received from the trust in his gross income.
B and C each includes $20,000 in his gross income.

(d) The trust instrument requires distributions to B and C of $20,000 per year
and $10,000 per year, respectively. The trustee is authorized, in his discretion,
to make distributions of principal to D and to E. In Year One, the trustee
exercised his discretion by giving $20,000 to D and $10,000 to E. Thirty
thousand dollars of the trust’s DNI is allocated to the tier-one beneficiaries. B
includes $20,000 in his gross income, and C includes $10,000 in his. The
remaining $10,000 of the trust’s DNI is allocated pro rata to the discretionary
distributions made to D and E. D will include $6,667 in his gross income, and E
will include $3,333 in his gross income.

(e) The trust instrument requires that distribution be made to B and C of
$20,000 per year and $10,000 per year, respectively. The trustee has discretion
to distribute additional amounts to B and C if he sees fit. The trustee also has
discretion to distribute amounts from the trust to D and E. In Year One, in
addition to the required distributions to B and C, the trustee distributed $10,000
to B, $20,000 to D, and $10,000 to E. The $20,000 that is required to be
distributed to B is a tier-one distribution, and the $10,000 discretionary
distribution that the trustee made to B is a tier-two distribution. So, B includes
$20,000 in gross income from the tier-one distribution, and he includes $2,500
in his gross income because of the tier-two distribution. The amount that each
beneficiary includes in his gross income is: B-$22,500, C-$10,000, D-$5,000,
E-$2,500.

Ex. (4) B and C were equal beneficiaries of a trust created by D. The income
from the trust is to be allocated equally between B and C; however, under the
trust instrument, the trustee has discretion to accumulate the income of either
beneficiary who is under the age of twenty-five. Each beneficiary shall receive
all income accumulated on his behalf plus his share of the trust corpus upon
attaining age twenty-five. The trustee had discretion to pay a beneficiary’s
share of current income to the beneficiary prior to his twenty-fifth birthday, and
the trustee also has authority to distribute corpus from a beneficiary’s share of
the trust to that beneficiary. In Year One, the trust had gross income of $42,000
and had trustee fees chargeable to income of $2,000. The DNI of the trust,
therefore, was $40,000. In Year One, the trustee distributed $20,000 of income
to B and also distributed to B an additional $20,000 from corpus. The trustee
elected to accumulate the $20,000 income allocated to C and added it to C’s

\textsuperscript{32} \textsection 662(a).
share of the corpus. In the absence of a separate share rule (§ 663(c)), B would have $40,000 included in his gross income, and the trust would have no taxable income. Because of the separate share rule, B includes only $20,000 in his gross income, and the trust has taxable income of $19,900 after deducting its $100 personal exemption.

Ex. (5) X created a trust for the benefit of B, C and D. The trust instrument requires the trustee, each year, to distribute $40,000 of trust income to B and C, to be divided equally between them. The trustee is authorized, in his discretion, to distribute additional amounts of trust income and principal to D. In Year One, the trust has rental income of $40,000, and it receives interest of $10,000 from state bonds. The interest is tax-exempt. The trust’s only expense is a $2,500 trustee fee, which is payable out of trust income according to the trust instrument. The trustee distributes $20,000 to B and a like amount to C. The trustee exercises his discretion to distribute an amount to D by distributing $30,000 to D. The DNI of the trust is $47,500, which consists of $38,000 of rental income and $9,500 of tax-exempt interest. One-fifth of the trustee fees ($500) is required to be allocated to the tax-exempt interest which comprises one-fifth of the trust’s income, and that is the reason that the tax-exempt interest is reduced to $9,500.

The DNI is allocated first to the tier-one distributions that were made to B and C. So, $20,000 of DNI is allocated to B and $20,000 is allocated to C. The remaining $7,500 of DNI is allocated to the $30,000 tier-two distribution that was made to D. The DNI that is allocated to each beneficiary is characterized the same, and in the same proportions, as it is characterized in the hands of the trust. So, of the $20,000 of DNI that is allocated to B, $16,000 (80%) constitutes rental income and $4,000 constitutes interest from a state bond that is excluded from gross income by § 103. B then includes $16,000 in his gross income. C includes the same amount. Of the $30,000 that D received, only $7,500 is treated as a distribution of DNI, and only $6,000 of that amount (80%) is included in D’s gross income. The remaining $1,500 of DNI constitutes tax-exempt interest.

The consequence of including tax-exempt interest in DNI is to shift taxable income from tier-one to tier-two distributions. It does not increase the aggregate amount that is included in the gross incomes of all the beneficiaries. In this example, without regard to its personal exemption, the trust had taxable income of $38,000 after deducting the portion of the trustee fee that is not allocated to the tax-exempt interest. B and C together included $32,000 in their gross incomes, and D included $6,000 in his gross income. The aggregate amount included in the beneficiaries’ gross income equals the trust’s taxable income.

Since the estate of a decedent is a separate tax entity and since the throwback rules does not apply to estates, the estate can be used for income-splitting purposes by distributing a portion of the estate’s income to the beneficiaries and accumulating a portion of its income to be taxed to the estate itself. To prevent the administration of the estate from being unduly prolonged so as to continue
this income-splitting practice, Treas. Reg. § 1.641(b)-3 treats an estate as terminated when the duties of administration either have been completed or should have been completed. In some circumstances, however, estates have been maintained for a number of years. For example, if the executor elects to defer a portion of the estate tax and pay it in installments under § 6166, the estate may be able to survive for tax purposes until the entire estate tax is paid.³³ Under § 6166, the final installment payment of the estate tax can be deferred for more than 14 years after the decedent’s death.

Multiple Trusts.

The use of multiple trusts as an income-splitting device has been a source of concern and litigation for the government for many years. One attack on such trusts is the treatment of a trust’s accumulations of income that are provided by the throwback rules. A more recent thrust was made by Congress in the Tax Reform Act of 1984 when it added § 654(e) to the Internal Revenue Code. This new subsection requires that two or more trusts be treated as one trust if (i) the trusts have substantially the same grantor or grantors and substantially the same beneficiary or beneficiaries, and (ii) tax avoidance is a principal purpose of the trusts. Spouses are treated as one person. This provision was adopted in response to a Tax Court decision which invalidated Treas. Reg. § 1.641(a)-O(c). ³⁴

II. GRANTOR AND MALLINCKRODT TRUSTS

A. Grantor Trusts

The principle here involved is merely an application of a familiar common law doctrine of general income taxation—namely, the anticipatory assignment of income doctrine. Indeed, the origin of the grantor trust rules is the Supreme Court’s decision in Helvering v. Clifford ³⁵ applying the anticipatory assignment doctrine to tax the grantor of a short-term trust on the income earned by the trust’s assets. Because of its origin, a grantor trust is sometimes referred to as a “Clifford Trust.” Confusingly, a short-term trust that was designed to avoid the grantor trust rules is also sometimes referred to as a “Clifford Trust.” The grantor trust rules were codified and expanded by statutory and regulatory provisions, and so the common law doctrine of anticipatory assignment of income has been absorbed by subpart E of subchapter J of chapter I of the 1954 Code.

Subpart E contains nine sections (§§ 671–679), of which the first seven (§§ 671–677) comprise the rules dealing with domestic grantor trusts. Section 671 provides that subpart E is the exclusive test for determining whether

³⁵ 309 U.S. 331 (1940).
income from assets previously transferred in trust will be taxed to the grantor. Nevertheless, even where subpart E does not operate, the anticipatory assignment of income doctrine can cause income to be taxed to the grantor. For example, the assignment to an irrevocable trust of the right to wages to be earned by the grantor at a future date will not insulate the grantor from income taxation on those wages. Similarly, the grantor’s right to a business expense deduction for the rent paid to lease property from a trust created by the grantor where the property is used in his trade or business is determined by non-statutory factors.

According to § 671, if the grantor is treated by subpart E as the owner of any portion of the trust, then the income, deductions, and credits of the trust that are attributable to that portion of the trust will be treated as income, deductions, and credits of the grantor. The provision for the allocation of income to the grantor refers to income as determined for tax purposes, as contrasted with a trust accounting determination of income.

Reserved Income Interest.

If the trust instrument requires the trustee to make current distributions to the grantor of all or a portion of the trust’s income, then even in the absence of any special provisions the ordinary trust tax rules would require the grantor to report his share of the trust’s income under the principle of allocating DNI. Special rules do apply in such circumstances, however. Section 677 treats a grantor as the owner of a portion of a trust the income from which, without the consent of an adverse party, is or (in the discretion of a nonadverse party) may be: (1) distributed to the grantor or to his spouse; (2) held for future distribution to the grantor or to his spouse; or (3) applied to the payment of premiums on insurance on the life of the grantor or his spouse (unless the insurance proceeds are payable to a qualified charity). Accordingly, if the trust’s income or a portion thereof is required to be distributed currently to the grantor, he will be treated as the owner of the trust’s assets, or of a portion thereof, and will be required to report the trust’s income, deductions, and credits, or a portion thereof, as his own. If only trust accounting income is to be distributed to the grantor and if capital gains are not included in trust accounting income, a provision permitting or requiring the distribution of trust income to the grantor will not cause him to be taxed on the trust’s capital gains; nor will he be permitted to deduct the trust’s capital losses.

40 Treas. Reg. §§ 1.671-3(b), 1.677(a)-1(g), Ex. (1).
If the trust’s income is required to be distributed currently to the grantor, there are circumstances in which § 677 will cause the grantor to be taxed differently than would be the case under the formal rules allocating DNI among the beneficiaries, of whom the grantor is one. An obvious example is where the trust’s deductible expenses for the year exceed its gross income. A grantor of a grantor trust could utilize the excess deductions in his return for that year, but a non-grantor beneficiary could not do so unless the trust had been terminated in that year. Another example is the difference in the time at which the grantor will recognize the income. The characterization of the grantor as the owner of the trust’s assets can also affect the treatment of the grantor in other tax areas.

The doctrine of reciprocal trusts can apply to cause a person to be treated as the grantor of a trust that was nominally created by another, and so the constructive "grantor" may then be treated as the owner of all or a portion of such trust.

Reversionary Interest.

Under § 673, if a grantor retains a reversionary interest in any portion of either the corpus or the income of a trust, he will be treated as the owner of that portion of the trust if his interest "will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust." There is one exception to this ten-year rule. § 673(c) provides that if the grantor has a reversionary interest in a trust that is not to take effect until the death of the income beneficiary or beneficiaries of the trust, he will not be taxed on the trust’s income merely because of his reversionary interest. This exception applies even when the life expectancy of the income beneficiary is less than ten years. Where a grantor is not treated as the owner of a trust under § 673, he may be treated as the owner because of some other provision.

Ex. (1) G transferred property to a newly created trust, the income from which is payable to named beneficiaries for 8 years, after which period the corpus reverts to G. Since G’s reversionary interest will take effect in possession and enjoyment within 10 years of the transfer, G is treated as the owner of the trust corpus, and all income of the trust (including both ordinary income and capital gains) is taxed to G. Similarly, all deductions of the trust are attributed to G. If the income from the trust were payable to the named beneficiaries for a period of 11 years, G’s retention of a reversionary interest will not cause any of the ordinary income earned by the trust in that 11-year period to be taxed to G. However, the trust’s capital gains and losses will be

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41 See, § 642(h).
42 The specifics of the treatment accorded to the grantor as the owner of the trust’s assets and the method of reporting his tax items are detailed in Treas. Reg. §§ 1.671-3, -4.
43 See, e.g., Rev. Rul. 81-98, 1981-1 C.B. 40 (a grantor’s transfer of an installment obligation to a grantor trust does not constitute a disposition thereof); § 1361(c) (2) (A) (ii); Treas. Reg. § 20.2042-1(c) (6).
44 Krause v. Commissioner, 57 T.C. 890, 899-901 (1972), aff'd, 497 F.2d 1109 (6th Cir. 1974).
attributed to G under § 677 if under local law capital gains are excluded from trust accounting income.

Ex. (2) G transferred property to a newly created trust, the income from which is payable to named beneficiaries for 11 years. At the end of the 11 year period, the income is payable among G and the named beneficiaries in such manner as the trustee (a bank) shall determine in its discretion. Upon G’s death, the corpus of the trust is to be distributed equally among the named beneficiaries. Since the only income that may be paid to G is ordinary income earned after the expiration of an 11-year period, neither § 673 nor § 677 will cause G to be taxed on the trust’s income during the first 11 years of the trust’s existence. See the last sentence of § 677(a). After the expiration of the 11-year period, however, G will be taxed on all of the trust’s subsequent income (other than its capital gains) under § 677(a).

Ex. (3) The same facts as those in Ex (2) except that: during the trust’s initial 11-year period, the trustee is permitted by the trust instrument to accumulate trust income; and after the 11-year period has expired, the trust’s accumulated income can be distributed by the trustee among G and the named beneficiaries in such manner as the trustee determines in its absolute discretion.

Although G cannot receive any trust income for a period of more than 10 years, income earned by the trust during the 10-year period can be held for future distribution to G. Therefore, under § 677(a), G is treated as the owner of the trust from the first day the property was transferred to the trustee. All of the trust’s income (other than its capital gains) is taxable to G in the taxable year that the income is earned by the trust.45

Ex. (4) G transferred property to a newly created trust, the income from which is payable to S and D equally for 7 years; at the end of the 7-year period, the income is payable to G for 4 years. After those 11 years have expired, the trust terminates and the trust corpus is distributed to S and D equally. G’s secondary income interest constitutes a reversionary interest in the trust’s income that takes effect within 10 years of the date the transfer to the trustee was made. Under § 673, G is taxed on the trust’s ordinary income for the entire 11-year term of the trust. If capital gains are excluded from trust accounting income, G will not be taxed on the trust’s capital gains; nor will he be permitted to deduct its capital losses.46

Ex. (5) G transferred property to a newly created trust, the income from which is payable for life to G’s mother, M, who was then 99 years old; the corpus is to be returned to G upon M’s demise. G is not taxed on the trust’s ordinary income, even though M’s life expectancy is less than ten years. The § 673(c) exception applies because G’s reversionary interest will not take effect in possession or enjoyment until the death of the income beneficiary. However, if local law follows the normal rule that capital gains are excluded from trust accounting income, the trust’s capital gains are to be distributed to G after M’s

45 Treas. Reg. § 1.677(a)-1(f); Krause v. Commissioner, 57 T.C. 890, aff’d, 497 F.2d 1109 (6th Cir. 1974).
46 Treas. Reg. § 1.671-3(b) (1).
death. G therefore is taxed (in the year realized) on the trust's capital gains under § 677(a), and the trust's capital losses will also be allocated to G.

Ex. (6) The same facts as in Ex (5) except that the term of the trust is for the life of M for 9 years, whichever period is shorter. In this case, G would be taxed on all of the trust's income.47 However, if the term of the trust were for the life of M or for 11 years, whichever is shorter, then G would not be taxed on the trust's ordinary income. G will be taxed on the trust's capital gains in either case if capital gains are excluded from the determination of trust accounting income.

If there is a postponement of the date specified for the grantor's acquisition of the right to possession or enjoyment of the reversionary interest, the postponement is treated as a new transfer in trust commencing on the date the postponement is effected. However, the grantor will not be taxed on the income from any year in which he would not have been taxed in the absence of the postponement.

Ex. (1) G placed property in trust for his son, A, for a term of 12 years, at the expiration of which there is a reversion to G. The income from the trust is payable currently to A. Capital gains do not constitute income for trust accounting purposes. Nine years after the trust was created, G extended the term of the trust for an additional 6 years. G is considered to have made a new transfer in trust for a 9-year term—i.e., 3 years remaining on the original transfer plus the 6-year extension. While G will be taxed on the trust's income in the last 6 years of its term, he will pay no tax on the ordinary income for the first 3 years following the extension since he would not have been taxed on that income if there had been no extension.48 It should be emphasized that the effect of a reversionary interest is determined according to the date of transfer of the property in question irrespective of the length of time a trust to which the property was transferred may have existed prior to the transfer.

Ex. (2) The same facts as those in Ex. (1) except that after 9 years, G extended the term of the trust for an additional 8 years (instead of the 6-year extension). G is considered to have made a new transfer for an 11-year term (the 3 years remaining on the original term plus the 8-year extension). Since that is greater than 10 years, G is not taxed on the trust's ordinary income. G will be taxed on the trust's capital gains for the entire term of the trust (including the extended term).

Power to Revoke.

If the grantor or some nonadverse party or both have the power to revest in the grantor title to any portion of a trust, the grantor is treated as the owner of such portion.49 However, when such a power can affect the beneficial enjoyment of the income of the trust only after the expiration of at least ten years from the date of transfer or only after the death of the income beneficiary, the grantor

47 See, Treas. Reg. § 1.673(a)-1(b).
48 See, Treas. Reg. § 1.673(d)-1.
49 § 676(a).
will not be taxed on the trust’s income until the period has expired. After the period has expired, the grantor will be taxed on subsequent income unless the power is relinquished. The terms “adverse party” and “nonadverse party” are defined in § 672 and are discussed later in this chapter.

Ex. (1) G transferred property to a trust under which the income is payable currently to his son, B, for 20 years. After 20 years, the trust corpus is to be distributed to B. G reserved the power to revoke the trust after 11 years have expired. G is not taxed on trust income (both ordinary income and capital gains) beginning with the twelfth year unless prior to that time G relinquishes the power to revoke. If capital gains are excluded from trust accounting income, G is taxed on capital gains earned during the 11-year period.

Ex. (2) The same facts as those in Ex. (1) except that G reserved the power to revoke the trust after seven years have expired. G is taxed on the trust income (both ordinary income and capital gains) from the date of transfer unless and until he relinquishes his power to revoke.

Ex. (3) The facts are the same as those in Ex. (2) except that G does not possess a power to revoke, but the trustee, the Friendly National Bank, possesses a power to revoke the trust and return the corpus to G after seven years have expired. Since the bank is a nonadverse party, the income from the trust will be taxed to G from the date of the transfer.

Power to Affect Beneficial Enjoyment.

Section 674(a) provides that the grantor is to be treated as the owner of any portion of a trust over which he or a nonadverse party or both have the power to affect the beneficial enjoyment of either the corpus or the income from such portion without the consent of an adverse party. The statute then creates a number of explicit exceptions to this general rule of taxability, the applicability of which depends upon the status of the person or persons who possess the power to affect beneficial enjoyment. Section 674(b) exempts certain enumerated powers irrespective of who holds them, including the grantor himself. Section 674(c) exempts certain other powers if held by independent trustees. Under § 674(d), anyone other than the grantor or a spouse living with the grantor may be given the power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries if the trust instrument restricts the exercise of such power to conditions that constitute a reasonably definite standard.

The definitions promulgated in § 672 are crucial to determinations under § 674. An adverse party is defined in § 672 as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.” A donee of a general power of appointment possesses a beneficial interest in the trust; but the financial interest of a trustee, as such, is not sufficient to make him an

\[30\] § 676(b).
adverse party. Remainder interests are adverse to the exercise of any power over the corpus of the trust but are not adverse to the exercise of a power affecting only the income interest preceding the remainder. The question of whether a person qualifies as an adverse party is essentially a question of fact and "must be determined by considering in each case the particular interest created by the trust and the relative size of that interest." A nonadverse party is simply defined by § 672(b) as any person who is not an adverse party.

A beneficiary is generally an adverse party as to the exercise of a power if the exercise will adversely affect his interest, but if his right to share in the income or corpus of a trust is limited to only a part thereof, the regulations provide that he may be an adverse party only as to that part.

Section 674(b) specifies that the general rule of § 674(a) will not apply to certain types of powers, no matter by whom such powers are held. These permissible powers are:

1. a power to apply income to the support of a dependent to the extent that the grantor would be excused from tax under § 677(b) for possessing that power;
2. a power to affect the beneficial enjoyment only after a ten-year period or after the death of the income beneficiary;
3. a power exercisable only by the grantor’s will, other than a power in the grantor to appoint by will the income of the trust where the income is either (a) accumulated for such disposition by the grantor, or (b) may be so accumulated by the grantor or by a nonadverse party or by both;
4. a power to allocate income or corpus among charitable beneficiaries;
5. a power to distribute corpus to a beneficiary or beneficiaries provided that either (a) the power is limited by a reasonably definite standard established in the trust instrument, or (b) the corpus may be distributed only to current income beneficiaries and any such distribution must be chargeable to the recipient beneficiary’s share of the trust corpus from which his income is payable—i.e., such current beneficiary’s share of trust income must be treated as if it constituted a separate trust;
6. a power to withhold income temporarily, provided that the accumulated income must ultimately be payable either (a) to the beneficiary from whom distribution was withheld, or to his estate, or to his appointees (pursuant to a broad power of appointment defined in the statute), or to the takers in default of such broad power; or (b) to the beneficiary from whom distribution was withheld, or is such beneficiary fails to survive a date of distribution that could reasonably have

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52 Paxton v. Commissioner, 57 T.C. 627, 631 (1972), aff’d, 520 F.2d 923 (9th Cir.), cert. denied, 423 U.S. 1016 (1975).
53 See, Treas. Reg. § 1.672(a)-1(b).
been expected to occur within the beneficiary’s lifetime: to designated persons, other than the grantor or his estate, whose shares have been irrevocably specified in the trust instrument, or to the beneficiary’s appointees or takers in default; or (c) on termination of the trust, or on distribution of corpus plus accumulated income, to the current income beneficiaries of the trust in shares that have been irrevocably designated in the trust instrument;

7. a power to withhold income during the disability of a current income beneficiary or prior to a current income beneficiary’s twenty-first birthday; and

8. a power to allocate receipts and disbursements between corpus and income, even if expressed in broad language.

The exceptions provided for powers to distribute corpus and to accumulate income are not applicable if any person has the power to add to the beneficiaries or to a class of beneficiaries, except for powers to add after-born or after-adopted children.

Ex. (1) G declared herself trustee of a trust for the benefit of her ten-year old son, S. The trust is to terminate on the twenty-first birthday of S or upon S’s earlier demise; the trust assets, including any accumulated income, are then to be distributed to S if he is then living, or if not, to X. G, as trustee, is empowered to accumulate trust income. G is not taxed on the income from the trust, since G’s power to accumulate is exercisable only during the period when S, the income beneficiary, is under the age of 21. 54

Ex. (2) G declared herself trustee of a trust for the benefit of her twenty-one-year-old son, S, who has no disability. The trust is to terminate after the expiration of a twenty-one-year period or after S’s death, whichever occurs earlier. In her capacity as trustee, G is empowered to accumulate trust income in such amounts as she determines. Upon termination, the trust assets, including accumulated income, are to be distributed to S if then living; if S is not then living, then to such person as S may appoint (exclusive of S himself, S’s estate, S’s creditors, and the creditors of S’s estate), and in default of appointment to X. The income from the trust is not taxed to G. 55 If the objects of S’s power of appointment were limited to S’s children, § 674 (b) (6) still might apply because the twenty-one-year period of the trust is a period a twenty-one-year-old might reasonably be expected to survive. 56

Ex. (3) G created a trust for the benefit of his daughter, D, naming himself and the Friendly National Bank as co-trustees. The trust is to terminate on D’s death. The income from the trust is payable to D during her life; however, the trustees are authorized to accumulate all or any part of the income. Upon D’s death, the corpus and accumulated income of the trust are to be distributed

54 § 674(b) (7).
55 § 674(b) (6).
56 See, Treas. Reg. § 1.674(b)-1(b) (6) (i) (b).
among D’s living issue, per stripes, or if none, to D’s estate. In this situation, G is taxed on the trust’s ordinary income because of the retained power to accumulate. On D’s death, the accumulated income need not necessarily be paid to D’s estate because it might be distributed to her issue. The fact that the trust shares of D’s issue are designated in the trust instrument will not excuse the grantor from the tax since the date of final distribution is not a date D could reasonably have been expected to survive. A distribution to D’s issue is not equivalent to a distribution to her estate. The fact that G’s power is held jointly with an independent trustee does not prevent grantor trust characterization and treatment.

Ex. (4) G creates a 12-year trust for the benefit of A, B, and C. The income from the trust is distributed monthly among the three beneficiaries in such shares as the trustees shall determine. The trustees have no power to accumulate income. G and the Friendly National Bank are cotrustees. Upon termination of the trust, the corpus is to be returned to G or to G’s estate. G is taxed on the income from the trust. There is no provision permitting a grantor to possess the power to sprinkle income among several beneficiaries. However, if the bank were the sole trustee and could not be removed by G, the bank’s possession of the power to sprinkle income would not cause G to be taxed on the trust’s ordinary income. The exception provided by § 674(c) would apply even if the bank and G’s wife, W, were cotrustees; but G is not permitted to act as a cotrustee if § 674(c) is to operate. In any event, G’s reversionary interest in the corpus of the trust will cause him to be taxed under § 677(a) on the trust’s capital gains.

Ex. (5) G transferred property to a trust. The trust instrument provides for payment of the income to G’s two adult sons in equal shares for ten years, after which the corpus is to be distributed among G’s grandchildren in equal shares. G reserved the power to pay over to each son up to one half of the corpus during the ten-year period, but any such payment shall proportionally reduce subsequent income payments made to the son receiving the corpus distribution. Since the power that G retained qualifies under the exception in § 674(b) (5) (B), G is not taxed as the owner of the trust. It should be noted also that a grantor’s power to invade corpus on behalf of a sole current income beneficiary of a trust will not cause the grantor to be taxed since any distribution of corpus to the sole income beneficiary must perforce reduce the beneficiary’s share of trust income proportionately.

Under § 674(c), certain enumerated powers may be held by an independent trustee or by trustees, none of whom is the grantor and at least one-half of whom are independent. The enumerated powers that may be so held are the power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries and the power to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries. This

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57 See, Treas. Reg. § 1.674(b)-1(b) (5) (iii), Ex. (3).
exception is not applicable if any person can add beneficiaries other than to provide for after-born or after-adopted children.

Ex. (6) The facts are the same as those in Ex. (3) except that the sole trustee of the trust is the Friendly National Bank (an independent trustee). In this case, G is not taxed on the trust’s income because under § 674(c) an independent trustee is permitted to accumulate trust income without causing adverse tax consequences to the grantor.

Ex. (7) creates a trust for the benefit of her three children. The term of the trust is 15 years, and upon termination, the corpus is to be returned to G. The income from the trust is to be distributed currently among the beneficiaries in such proportions as the trustee or trustees shall determine. Regardless of the treatment of the trust’s ordinary income, the trust’s capital gains will be taxed to G under § 677(a) because of her retained reversionary interest in the corpus. The taxation of the trust’s ordinary income will depend upon who is serving as trustee: (1) If G is a trustee, regardless of whether she is the sole trustee or merely a cotrustee, she will be taxed on the trust’s ordinary income under § 674(a). (2) If the sole trustee is an independent party, G will not be taxed on the trust’s ordinary income. (3) If G’s husband and an independent party are cotrustees, then G is not taxed on the trust’s ordinary income.

Ex. (8) G created a trust for a term of 12 years. The income from the trust is distributable to G’s 5-year-old daughter, D, but the trustee can accumulate income in its discretion. The Friendly National Bank (an independent party) is the sole trustee. If D dies before the expiration of the 12-year term, the trust corpus (including accumulated income) is payable to X upon D’s death. However, if D is living at the expiration of the trust’s term, the trust corpus (including accumulated income) reverts to G’s wife, W. The trustee’s power to accumulate income does not cause G to be taxed under § 674. The power is exempted by § 674(c), and a power to accumulate income during minority is also permitted by § 674(b) (7). Nevertheless, G is taxed on both the ordinary income and the capital gains of the trust because of § 677(a); the trust’s capital gains and ordinary income may be accumulated for possible future distribution to the grantor’s spouse, W, if D survives the 12-year period.

Ex. (9) H and W have four children—A, B, C, and D. H created a trust (Trust 1) for the benefit of A and B, funding it with assets having a value of $50,000. W created a trust (Trust 2) for C and D, funding it with assets having a value of $50,000. H named the Friendly National Bank and W as cotrustees of Trust 1; W named the Secure National Bank and H as cotrustees of Trust 2. The trustees of each trust are to distribute income currently between the two beneficiaries in such proportions as the trustees shall determine in their discretion. After 20 years, the corpus of each trust is to be distributed equally between the two income beneficiaries. The Trust 1, nominally created by H, may be deemed to have been created by W under the reciprocal trust doctrine. If so, it will cause the ordinary income of Trust 1 to be taxed to W under § 674. W’s status as both the grantor of Trust 1 and as a cotrustee thereof will preclude the application of
§ 674(c) to permit sprinkling powers to be held by the trustees. Similarly, the
ordinary income of Trust 2 may be taxed to H as a grantor trust. It is not
necessary to the application of the reciprocal trust doctrine that one trust be
created in consideration of the creation of the other. 58

Section 674(d) provides that if none of the trustees is the grantor or a spouse
living with the grantor, a power to distribute, apportion, or accumulate income
to or for a beneficiary or beneficiaries or to, for or within a class of beneficiaries
will not cause the grantor to be treated as owner of the corpus if the power is
limited by a reasonably definite external standard that is set forth in the trust
instrument. This exception is not applicable if any person can add beneficiaries
other than to provide for after-born or after-adopted children.

Even if a trust fits into the exceptions of § 674(c) or § 674(d), if the grantor
has the power to remove, substitute, or add trustees, this may prevent the trust
from qualifying under these exceptions, unless his power is limited so that it
does not alter the conditions of the exception. For example, Treas. Reg.
§ 1.674(d)-2(a) states that if a grantor can remove an independent trustee only if
he replaces the trustee with another independent trustee, this power does not
prevent the trust from qualifying under § 674(c).

Obligations of Support.

Under § 662, trust distributions made to satisfy a legal obligation of a
nongrantor beneficiary of a trust are treated as distributions to the beneficiary. 59
The reference to a beneficiary’s legal obligation includes only unconditional
obligations. A child’s obligation (if any) to support his parent is a conditional
obligation—and thus not covered by § 662—because it arises only if the parent
lacks sufficient funds to support himself. Distribution in fulfillment of this
obligation—as when the parent’s earnings are, in fact, insufficient—are
therefore not taxed as income to the beneficiary. 60 Where trust assets are used to
satisfy a beneficiary’s legal debts, the beneficiary is regarded as the distributee
of those payments, and the amount included in the beneficiary’s gross income is
determined according to the usual rules for allocating the trust’s distributable
net income (DNI).

When it comes to the grantor of a trust, income that is or may in the discretion
of the grantor or a nonadverse party or both used to satisfy legal obligations
of the grantor or of his spouse is taxed to the grantor. 61 If, however, the legal
obligation is an obligation of support, § 677(b) provides a special rule. Section
677(b) expressly precludes the taxation of a grantor on trust income that in the
discretion of the trustee, including the grantor (as trustee or cotrustee) or
someone other than the grantor, may be distributed or applied to maintain or
pay for the support of a beneficiary whom the grantor or his spouse is obligated

59 Treas. Reg. § 1.662(a)-4.
60 Treas. Reg. § 1.662(a)-4.
61 Treas. Reg. § 1.677(a)-1(d).
to support or maintain except to the extent that such income is so applied or distributed.\textsuperscript{62} Trust income of the current taxable year must be used to satisfy an actual legal obligation of support as determined under local law before income will be taxed to the grantor under § 677(b).\textsuperscript{63} Section 677(b) does not apply to income that may be distributed to or applied to maintain or pay for the support of the grantor’s spouse.

Current income of the trust that is actually distributed or applied to support or maintain a beneficiary whom the grantor or the grantor’s spouse is legally obligated to support is taxed to the grantor.\textsuperscript{64} Neither the statute nor the regulations define the term \textit{legally obligated} to support as it is used in § 677(b). Possibly, the narrow construction employed in Treas. Reg. § 1.662(a)-4 which limits a \textit{legal obligation} to an unconditional obligation is equally applicable to § 677(b), but that is unsettled.

The tax consequences of establishing a trust the income from which will be used to defray the cost of educating a child in college or a university or in a private secondary school often turns on the question of whether the child’s parents are legally obligated to provide such an education for their child. The presence or absence of such a legal obligation is determined by local law. The extent to which the laws of the several states impose a legal obligation on a parent to provide college and private school education for his child is of vital importance in planning for the minimization of such costs, and this issue is discussed at length in the next section of this article.

Section 677(b) deals only with the \textit{current income} of a trust that either is or may be used to satisfy a legal obligation of support of the grantor or of his spouse. When \textit{corpus or previously accumulated income} of a trust is used to support or maintain a beneficiary whom the grantor is legally obligated to support, the grantor is treated as the beneficiary of that distributed amount and is taxed according to the usual rules for inclusion of trust distributions in a distributee’s gross income.\textsuperscript{65}

Ex. (1) G created a trust for the benefit of his son, A. The Friendly National Bank was named the trustee. The trust is to terminate after 15 years have expired or earlier if A dies. Upon termination, the trust estate is distributed to A, if living, or to G’s sister, R, if A is not then living. The trust instrument authorizes the trustee to distribute or use such amounts of trust income for the health, education, and support of A as the trustee deems necessary. A is a five-year-old minor, and G is obligated to support him. During the tax year, no amounts were actually used for this purpose. There is no tax on G since § 677(b) provides that the grantor is only taxed to the extent that funds are actually used for fulfilling his obligation of support. The result would be the same if G were the sole trustee; but in that event, care should be taken to avoid § 674(a). Under

\textsuperscript{62} Treas. Reg. § 1.677(b)-1(a).
\textsuperscript{64} Treas. Reg. § 1.677(b)-1(a).
\textsuperscript{65} §§ 677(b), 662(a); Treas. Reg. § 1.677(b)-1(b).
the terms of the trust instrument stated above, there is no problem with § 674(a) in this case, and G could serve as the trustee. From a planning viewpoint, however, it is preferable in the interest of caution to have someone other than the grantor serve as trustee if the arrangement is feasible.

Ex. (2) The facts are the same as those in Ex. (1) except A is 20 years old and the independent trustee (the sole trustee) used income from the trust to pay A's tuition at the University of North Carolina. The question of whether A's college tuition falls within G's obligation of support is determined by local law, which is discussed later in this article. However, even if local law does not require G to pay for A's college education, under the reasoning of a district court judge's decision in *Morrill, Jr. v. United States*, G might be held taxable on the ground that G was obligated to pay A's tuition under an implied contract between G and the university in which G impliedly agreed to pay his son's tuition. The thrust of the *Morrill* case can be avoided with a little advance planning—i.e., the university could agree to seek payment only from A and the trust, and it could exonerate G from liability. In that event, the question of whether the trust's income is taxed to G will depend upon whether such expenses constitute an obligation of support for G under local law.

**Administrative Powers.**

If the grantor of a trust can exercise any of the administrative powers specified in § 675 without the approval or consent of an adverse party (see § 672 for the definition of *adverse party*) he is treated as the owner of all or a portion of the corpus of the trust from the date of its inception. The powers exercisable by the grantor or a nonadverse party that are prohibited by § 675 are: (1) a power that enables the grantor (or a nonadverse party) to purchase, exchange, or otherwise deal with or dispose of the corpus or income of the trust for less than adequate consideration in money or money's worth; (2) a power that allows the grantor to borrow trust corpus or income without adequate interest or security, except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security; and (3) a power of administration exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. Powers of administration are powers such as the power to vote stock of a corporation in which the grantor or the trust has a significant voting interest; the power to control investment of the trust funds; and the power to reacquire the trust corpus by substituting other property of an equivalent value. If the grantor has actually borrowed trust funds and has not completely repaid the loan before the beginning of a taxable year, unless the loan was made by a trustee other than the grantor and other than a related or subordinate party subservient to the grantor and unless the loan provides for adequate interest and

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security, the grantor will be taxed as the owner of all or a portion of the trust.\textsuperscript{67}

A power exercisable by a person as trustee is presumed to be a power exercisable in a fiduciary capacity, i.e. primarily in the interest of the beneficiary. This can be rebutted only by clear and convincing proof that the power is not so exercisable.\textsuperscript{68}

To avoid difficulties with § 675, a trust instrument should specifically deny to the grantor and to all other persons the powers described in § 675 that would cause the grantor to be treated as the owner of the corpus.

\textit{Two Year Rule.}

Subject to certain exceptions, § 644 provides that the sale of an asset by a trustee within two years after the donor transferred the asset in trust will cause any gain attributable to appreciation prior to the transfer to be taxed as though it were includable in the tax return of the donor. The tax is payable by the trust, but the characterization of the gain and the tax bracket of the rate schedule are determined as if the donor had sold it. This rule does not apply if the sale takes place after the donor’s death. While this rule is not a grantor trust rule, it is related to that doctrine.

\textbf{B. Mallinckrodt Trusts}

In \textit{Mallinckrodt v. Nunan},\textsuperscript{69} the Service successfully applied the theory of the Clifford case to situations where a person other than the grantor has such powers over trust income as to make that person the virtual owner of the trust. In the 1954 Code, the Mallinckrodt principle was codified into § 678. If a person other than the grantor has the power \textit{exercisable solely by himself} to vest the corpus or the income therefrom in himself—or having released or modified such a power, retains such powers as would cause the grantor to be treated as the owner under §§ 671 through 677—such person is treated as the owner of the trust, or of that portion of the trust to which the power in question relates. There are two important exceptions to the Mallinckrodt principle as codified. Under § 678(b), it does not apply with respect to a power over \textit{income} where the grantor is treated as the owner of the trust under §§ 671 through 677. It also does not apply to a power that enables such a person—in his capacity as trustee or cotrustee—merely to apply the income of the trust to the support or maintenance of a person to whom the holder of the power is obligated to support or maintain, except to the extent that such income is actually so applied.\textsuperscript{70}

Ex. (1) G established a trust for 9 years, income payable to his son, with a reversion in G. A is made trustee and has a power to appoint income to himself.

\textsuperscript{67} § 675(3). The portion of the trust that the grantor is deemed to own was determined in \textit{Benson v. Commissioner}, 76 T.C. 1040 (1981).
\textsuperscript{68} See, Treas. Reg. § 1.675-1(b) (4).
\textsuperscript{69} 146 F.2d 1 (8th Cir. 1945).
\textsuperscript{70} § 678(c).
G is taxed on the trust’s income under § 673. Even though A’s power is one that otherwise would have caused him to be taxed on the trust’s ordinary income under § 678, he is not taxed because the grantor trust provisions have priority over § 678’s application to powers over trust income. If the term of the trust had been 11 years, or if G had retained no reversionary interest in the trust, then the trust would not have been a grantor trust and A would have been taxed on the trust’s ordinary income.

Ex. (2) The same facts as those in Ex. (1) except that instead of a power over trust income, the trustee, A, has the unrestricted power to appoint all or part of the trust’s corpus to himself at any time. It appears that A will be taxed on at least part and likely all of the trust’s income. A’s power to appoint corpus causes him to be taxed on the trust’s ordinary income (as well as on its capital gains) since an appointment of corpus will affect the trust’s income earned thereon. While it might appear that part of the trust’s income will be taxed to G because of his reversionary interest, it is likely that G will not be taxed on any of the trust’s income (and therefore that A will be taxed on all of it) since A’s unrestricted power of appointment prevents there being a reasonable prospect that G’s reversionary interest will ever take effect in possession or enjoyment.

Ex. (3) G created a trust for the benefit of his children; the trust does not constitute a grantor trust. G named the Friendly National Bank as the sole trustee. However, G gave his brother, B, the power to appoint trust income for the support and maintenance of B’s minor children. In year One, no such appointment is made by B. B is taxed on the trust’s ordinary income because the exception provided by § 678(c) applies only where the power in question is held by a person in his capacity as a trustee.

Ex. (4) The same facts as those in Ex. (3) except that B can appoint trust income for his minor children only if his wife, W, joins with him in exercising that power. Section 678(a) (1) applies only to powers exercisable by a person “solely by himself.” It therefore appears that jointly held powers are not covered by § 678. If W is not the mother of B’s minor children (i.e., W is B’s second wife), it is likely that § 678 will not apply. Of course, B will be taxed under § 662 on any trust income actually appointed to B’s children to the extent used to satisfy B’s support obligation.

If W is the mother of B’s children and so has some obligation to support them (even if only a secondary obligation), one might question whether the exclusion of jointly exercisable powers from § 678 is applicable. A literal reading of § 678 makes that statute inapplicable, but the literal language may be inconsistent with the spirit of the legislation and therefore might not be followed. The most likely result is that the requirement of a joint exercise of B’s power is sufficient.

71 See, Treas. Reg. § 1.671.3(b) (3).
72 Treas. Reg. § 1.678(a)-1(b).
73 See, Treas. Reg. § 1.678(a)-1.
75 Treas Reg. §§ 1.662(a)-4, 1.678(a)-1(b).
to prevent either B or W from being taxed on the trust’s income under § 678.

Ex. (5) The same facts as those in Ex. (3) except that the bank, as trustee, rather than B, has the power to appoint income for the support and maintenance of B’s children. Section 678 does not apply. In the taxable year, the bank used trust income to pay expenses of the children for which B was legally obligated. B is treated as the beneficiary of those payments, and the amount included in his gross income is determined under § 662 in accordance with the usual rules for inclusion of distributions in the gross income of a distributee of trust property.76

Ex. (6) H died, leaving property in trust for the benefit of his children and grandchildren. The Friendly National Bank was named the trustee. W, H’s wife, was given a non-cumulative power over the trust’s assets to appoint $5,000 to herself in each calendar year. In the calendar year, 1980, W did not exercise her power of appointment. The value of the trust’s assets at all times in 1980 was $200,000.

W’s power to appoint to herself is subject to § 678, and W is treated as the owner of that portion of the trust that $5,000 represents.77 In this case, $5,000 represents $2\frac{1}{2}$ percent of the value of the trust’s assets. So, W will be taxed on $2\frac{1}{2}$ percent of the trust’s income, and she is entitled to $2\frac{1}{2}$ percent of the trust’s deductions and credits. If, as is more realistic, the value of the trust’s assets fluctuated during the calendar year, it is not settled how W’s portion of the trust is to be measured. The most likely solution is to use the value of the trust’s assets at the end of the year when W’s power lapsed.

Disclaimers.

A holder of a Mallinckrodt power who would otherwise be taxed under § 678(a) can avoid that result by disclaiming the power within a reasonable time after the holder first becomes aware of its existence.78 Note that § 678(d) uses a “reasonable time” standard, rather than the fixed nine month period used for “qualified disclaimers” under § 2518 and that the fact that a disclaimer is qualified under § 2518 is irrelevant for income tax purposes, as that section applies only with respect to estate, gift, and generation-skipping transfer taxes.

Crummey powers.

A typical Crummey power, enabling a beneficiary to withdraw the lesser of the annual additions to the trust or a fixed sum (sometimes the annual gift tax exclusion, other times a “5 or 5” power) is a Mallinckrodt power, and the beneficiary is taxed as the owner of the portion of the trust that is subject to the power.79 The income tax consequences of holding a Crummey power are discussed in Part IV of this article.

76 Treas. Reg. § 1.678(c)-1(c).
78 § 678 (d).
III. COLLEGE AND PRIVATE SCHOOL EDUCATIONAL COSTS AS A PARENT'S LEGAL OBLIGATION OF SUPPORT

As previously noted, where the income from a trust may be used to satisfy or discharge the settlor's obligation to support someone, the income will be taxed to the settlor only to the extent that it is actually used to satisfy that obligation.80 Where a parent establishes a trust the income from which will be utilized to pay the costs of educating the settlor's child in a college or university, there can be no income tax reduction from that arrangement if the parent is legally obligated to provide such an educational experience to his children since the income used for that purpose would be taxable to the parent. The question of the extent to which a parent is required to provide for his children's college education and the extent to which such an obligation extends beyond the child's attaining the age of majority is crucial. The boundary of a parent's obligation to support his child is determined by the law of the state in which the parent is domiciled.81 The author will first discuss the current status of state law on that issue and will then discuss several federal court decisions concerning the taxation of trust income that is used to pay for the advanced educational costs of children.

Initially, the common law rule was that a parent is not obligated to provide college or other advanced educational experiences to his children.82 As time passed, college education became commonplace, and many states responded by including college in a parent's support obligation in certain limited circumstances.83 Where a state has so expanded a parent's obligation, typically it has done so through the common law procedure of judicial determinations, but some states have statutory provisions that define a parent's obligation of support to include educational expenses. There is no uniformity in the treatment of educational expenses, and so a planner must examine the law of the state of a parent's domicile in each case. Since state laws fall into one of several broad categories, some observations of the different approaches that have been adopted are useful.

Where a child's parents are not divorced or separated, there appears to be no state which imposes an obligation on the parents to provide a child with a college or advanced education. Nor is such an obligation imposed on the estate of a deceased parent.84 Virtually all of the state court cases that address this

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80 § 677 (b).
83 See e.g., Esteb v. Esteb, 138 Wash. 174, 244 Pac. 264 (1926). Esteb is one of the earliest cases to include college within a divorced parent's obligation of support.
issue deal with divorced or separated parents. Where a child is a member of an intact family (as contrasted to a family broken by divorce or separation), the states leave the decision of whether to provide the child with a college or advanced education to the parents, who are responsible for the upbringing of their children. The courts are loathe to interfere with normal parental discretion. Once the parents separate, the non-custodial parent may feel less of a commitment to the welfare of his children and may transfer at least part of his loyalty to a new family which he may acquire. The children of a broken family are vulnerable to niggardly treatment and therefore need the protection of the state to require the non-custodial parent to provide the type of support for the children that they likely would have received had the marriage remained intact. The objective in divorce cases is to protect the children of a broken marriage from suffering any injury that reasonably can be avoided. The extent, if any, to which a court will include college or advanced schooling within that protected area varies from state to state.

In several cases, state courts have stated or indicated that, absent a contractual agreement, a parent of an intact family is not required to provide a college education for his children. For example, Iowa Code Annotated, section 598.1(2) includes college education in the support to which a child of divorced parents is entitled. This support obligation terminates when the child attains the age of 23. In its Vrban decision, the Iowa Supreme Court upheld the constitutionality of that provision against an attack that it was invalid because it applied only to divorced and not to married parents. The court reasoned that that distinction is reasonable because a non-custodial parent is more likely not to wish to support his child than is a custodial parent. In a divided en banc decision, an Oregon intermediate appellate court held that a divorced father has no obligation to pay for his daughter’s attendance at a community college where the daughter was legally in his custody even though she lived with her maternal grandparents. The Oregon court held that the state statute that imposed that responsibility on a divorced parent applied only to the non-custodial parent. In Grishaver v. Grishaver, after the wife had paid their child’s college expenses, she sued her husband for legal separation and for reimbursement of those expenses. The New York court held that college expenses cannot be considered “necessaries for which reimbursement may be recovered.” The court denied the wife’s claim for reimbursement. Grishaver is in accord with an earlier decision in which the New York court stated that a child’s college education is not a “necessary” for which a third party can recover from a

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86 See, Kujawinski v. Kujawinski, op cit., n. 85, 76 N.E.2d at pp. 1389-1391.
87 In re Marriage of Vrban, 293 N.W.2d 198 (Iowa, 1980). See also, Kujawinski v. Kujawinski, op cit., n.85.
88 For a discussion of the constitutionality of treating non-custodial parents differently from the treatment accorded to parents of an intact family, see Smith, Educational Support Obligations, 36 Rutgers L. Rev. 588 (1984).
89 In the Matter of the Marriage of Kathleen May Thomas, 70 Or. App. 317, 689 P.2d 348 (Or. App. 1984) (en banc).
parent, but a husband in a divorce action can be required to pay such expenses.  

As to a divorced or separated non-custodial parent, most (and perhaps all) states permit a divorce or family court to require that parent to pay the college expenses of a child if circumstances warrant imposing that obligation. In New York, for example, a divorced husband is not obligated to pay for his child’s private school or college education unless he contractually undertook that liability or unless special or unusual circumstances exist. The factors that are utilized to determine whether special or unusual circumstances exist include: (1) the educational background of the parents, (2) the environment in which the child grew up, (3) the child’s academic ability, (4) the financial ability of the non-custodial parent to provide the funds to defray the college expenses. Pennsylvania has adopted a similar rule that, absent an agreement, a divorced parent is liable for college expenses only if certain circumstances exist—such as where the child has demonstrated the ability to succeed in college and the sacrifice to the non-custodial parent for providing the funds is not too great. The Pennsylvania courts have stated on two occasions that: “The duty of a parent to provide college education for a child is not as exacting a requirement as the duty to provide food, clothing and shelter for a child of tender years unable to support himself.” In Cochran, for example, a Pennsylvania court reversed a lower court’s order for the divorced father to pay his daughter’s college fees where the father was already paying a substantial amount for his children’s support; the court stated that the lower court had “abused its discretion” in ordering the father to pay those expenses.

Thus, even a divorced parent’s obligation to pay college expenses is conditional. As we will see, many states do not impose an obligation of support after the child attains the age of majority. Some states, by statute or by judicial decision, have extended the obligation to cover an emancipated child subject to certain conditions. This extension is sometimes restricted to preclude a court from requiring the payment of educational expenses after the child attains a specified age, but some states permit the court to require a parent to pay educational expenses without regard to the child’s age.

In many states, in the absence of an agreement, a parent has no obligation to support a child after the child attains the age of majority. For example, this rule...
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is followed in the states of: Virginia, North Carolina and Alabama. Since many states have reduced the age of majority to 18, the divorced parent’s obligation in those states will terminate when the child attains that age unless a statutory provision or judicial construction extends the duration of the parent’s obligation beyond the date on which the child attains his majority. A number of states have adopted such extensions. New York, for example, extends the parent’s support obligation until the child attains age 21. As noted below, New York will require a parent to provide advanced education to a child who has passed his 21st birthday where circumstances warrant doing so. Iowa has extended the cut-off age to the child’s attaining his 23rd birthday. A few states—for example, Mississippi, California, New Hampshire, Illinois and New Jersey—do not impose any age limitation on a parent’s obligation to provide his child a college or post-graduate education. One rationale for this position is that a child who is attending college or post-graduate school is still dependent on his parent and so is not emancipated for that purpose even though the child may be emancipated for other purposes. This approach is sometimes referred to as the “deferred emancipation concept.” A number of states permit a court to require a parent to support a child who has attained his majority if special circumstances warrant imposing that obligation, and the need of a child for a college education typically is treated as a special circumstance if the imposition of the support obligation does not cause too great a sacrifice on the part of the parent.

The rule in Michigan has taken an interesting turn. Michigan Compiled Laws, section 552.17(a) permits a divorce court to order support for a minor child until the child is 18 years of age and beyond age 18 “in case of exceptional circumstances.” The Michigan courts have determined that where the parent is obligated to provide for the child’s college expenses, that constitutes an “exceptional circumstance” that permits the court to order such payments to be made after the child’s 18th birthday, but the courts have held that no award of support for an educational purpose after the child’s majority is justified.

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97 E.g., See, Smith, Educational Support Obligations, 36 Rutgers L. Rev. 588, 618-620 (1984) for a list of states that restrict the obligation to children who have not attained age 18.
99 Iowa Code Annotated, section 598.1(2).
102 E.g., Bierman v. Bierman, 683 S.W.2d 241 (Ark. App. 1985); Lord v. Lord, 96 Misc. 2d 434, 409 N.Y.S.2d 46 (Sup.Ct. 1978); Ulmer v. Sommerville, op cit. n. 93. In South Carolina, A Family Court may order support running past a child’s majority if “exceptional circumstances” warrant it. The need for a college education is treated as an exceptional circumstance which empowers the court to order the parent to pay for his child’s educational expenses after the child has been emancipated by attaining his majority. Kerr v. Kerr, 293 S.E.2d 704 (S.C. 1982).
support can be made for the period following the child's 21st birthday. The landmark decision that precluded a court from making an award for support after the child attained 21 is the 1956 decision of the Michigan Supreme Court in Johnson v. Johnson. In Johnson, the court said: "The trial court only had authority to grant support until arrival at majority—majority being 21 years old." At the time that Johnson was decided, the age of majority in Michigan was 21 years. But that was changed by The Age of Majority Act of 1971 which makes age 18 the age at which a person becomes an adult. The question of whether the change of the age of majority reduced the period during which a Michigan court can order a parent to pay college expenses has not been definitively resolved. If the Age of Majority Act did effect a reduction of the court's power, it would render a nullity the reference in the statute to "exceptional circumstances." In dictum, the Michigan Supreme Court stated in a footnote in a 1975 decision that the Age of Majority Act does not affect the court's power to order the payment of college expenses until the child's 21st birthday.

In those states which do not impose an obligation on a divorced parent to pay his child's college expenses or which terminate any such obligation when the child attains a specified age, the courts nevertheless will enforce a separation agreement in which the non-custodial parent undertakes to be liable for college or post-graduate education. If the agreement is incorporated in the parties' divorce decree, the divorce court typically can enforce the parent's obligation by a contempt order even though the court would have been precluded from entering an order imposing such an obligation in the absence of an agreement.

In summary, most states impose an obligation on a divorced parent to provide a college education for his children to some extent. Except for that minority of states that establish no cut-off age for college support, in the absence of an agreement, a parent's obligation will terminate upon the child's attaining a specified age—in some states, the cut-off age is 18, and in some it is as high as 23. The normal age for entering college is 18 or 19 years of age. Thus, even for divorced parents, they often will not be liable for some (or even all) of their children's college expenses unless there is an agreement in which they undertook that obligation. Moreover, where state law permits a divorce court to require a parent to pay college expenses, the decision to do so will be in the discretion of state courts. If no such obligation is imposed by a divorce

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105 78 N.W.2d at p. 220.
court, it would appear that the parent is not liable for such expenses insofar as the tax law is concerned.

Where state law does impose liability for college expenses on a parent, is the parent required to provide the child with an expensive private school education as contrasted to a state college or university? Decisions in New York and New Jersey suggest that the parent is not so obligated.\(^{109}\) An Illinois court held that a court in that state could require the parent to provide private college education if appropriate, but that case relied on the terms of an Illinois statute.\(^{110}\)

There is little reason to believe that a custodial parent who is neither divorced nor separated from his spouse has a legal obligation to provide college or advanced education for his child. The reasons for imposing a broad support requirement on a non-custodial parent do not apply to a parent in a family which has not broken apart. Several courts have noted that distinction and have indicated that the latter parent has no obligation for college expenses.

There have been several federal court decisions that addressed this issue and did so in the context of determining whether a grantor was taxed on trust income that was used to pay educational expenses of a child of the grantor. The earliest of these cases was *Mairs v. Reynolds*,\(^{111}\) a 1941 decision of the Eighth Circuit. In *Mairs*, a parent of an intact family was held to be taxable on trust income that was used to pay the educational expense of the parent’s children at college and at private secondary schools. The parent was the grantor of the trust. The court held that the trust income had been used to satisfy the parent’s legal obligation of support. The decision in *Mairs* was made many years before it was established that the determination of whether an item constitutes a legal obligation of support depends upon state law. While the court’s opinion made reference to Minnesota law (the domicile of the parent), it is unclear from the opinion whether the court sought to apply Minnesota law or whether it was creating a federal standard based on what it deemed to be the general law. Since there was no clear common law decision or statute in Minnesota that imposed such a liability on a parent of an intact family, it seems more likely that the Eighth Circuit in *Mairs* was applying a federal standard.\(^{112}\) For that reason, the case has been criticized as incorrectly decided,\(^{113}\) and appears to have had little influence on subsequent federal court decisions.\(^{114}\)

*Morrill v. United States*,\(^{115}\) dealt with the taxation of trust income that was used to pay the educational costs of the grantor’s four minor children. During the tax years in question, the children attended three private colleges and two

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\(^{111}\) 120 F.2d 875 (8th Cir. 1941).


\(^{113}\) Ibid.

\(^{114}\) See e.g., Wyche v. United States, 36 A.F.T.R.2d 75-5816 (Ct. Cl. Trial Div. 1974).

\(^{115}\) 228 F. Supp. 734 (D. Me. 1964).
private secondary schools. The grantor, who was the father of the children, had expressly assumed responsibility for the payment of expenses at two of the colleges. Each of the other schools sent the grantor a bill for the children's expenses. The grantor paid part of the children's expenses, but the tuition and room charges were paid by the trustee from trust income. The district court did not reach the question of whether the grantor was legally obligated under Maine law to pay for his children's college and private school education. Instead, the court held that the grantor's assumption of responsibility for the payment of expenses at two of the colleges made the trust's payment of tuition and room expenses at those schools a discharge of an express contractual obligation of the grantor and so was taxable to him. As to the other three schools, the court held that they provided services to the grantor's children in the expectation that he would pay the expenses since he was the children's parent and natural guardian and since there was no evidence that the schools agreed to look only to the trusts for payment. The court noted that the bills were sent to the grantor—never to the trustee. Accordingly, the court held that the trustee's payment of room and tuition expenses for those three schools was a discharge of an implied obligation of the grantor and so was taxable to him.

In *Brooke v. United States*, the taxpayer had deeded realty to his minor children as a gift and then had been appointed as their guardian. The taxpayer, acting as guardian for the children, collected the rents and used them to pay for the children's private school tuition, musical instruments, and various lessons. The funds also were used to purchase an automobile for the eldest child and to pay travel expenses to New Mexico for an asthmatic child. The Ninth Circuit held that a court administered guardianship is subject to § 677 just as if it were a trust. The district court and the Ninth Circuit held that under Montana law the items which the taxpayer paid were not items which he was legally obligated to provide. The taxpayer was not taxable on the income from the realty.

In *Wyche v. United States*, trust income was used to pay for tuition at a private secondary school and for music and dancing lessons for the grantor's minor children. The private school in question had a policy not to enter into contractual arrangements with parents (or others). Instead, all tuition and other charges were payable in advance of the student's attendance at the school. No bills were sent to the grantor or to the trust or to anyone. The court held that, under South Carolina law, the grantor was not obligated to pay those expenses. The court further held that *Morrill* was inapposite because there was no express or implied contract obligating the grantor to pay those expenses. The grantor was not taxed on the trust's income.

The Tax Court's 1984 memorandum decision in *Frederick C. Braun, Jr.* is the most recent federal court decision in this area. In that case, the taxpayers, a husband and wife who reside in New Jersey, jointly created two trusts for their

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116 468 F.2d 1155 (9th Cir. 1972).
six children. Theirs was an intact family. The husband, Dr. Braun, was a physician who practiced medicine as a shareholder and employee of a professional corporation, herinafter sometimes referred to as "Westfield." One of Westfield's offices was located in a designated portion of the taxpayer's residence. The corpus of each of the two trusts that taxpayers created for their children is described in the trust instruments as a one-half interest in the portion of taxpayers' residence that was utilized as an office by Westfield. The taxpayers made no formal conveyance or lease of that property to the trusts. The taxpayers filed no gift tax returns for the purported transfer of the property in trust. On their individual income tax returns, they claimed depreciation and expense deductions for the space utilized by Westfield, and those claims were inconsistent with their assertion that the property had been transferred to the trusts.

The income from the two trusts was payable to the beneficiaries (the children of the taxpayers). After a little more than 10 years, the trust corpus reverted to the taxpayers, and any undistributed income was to be distributed to the children. Each of the trusts had the same three trustees—the two taxpayers and a friend of the family who did not constitute an adverse party.

The trusts entered into written leases of one-year terms with Westfield who paid the trusts rent for the use of the property that was located in taxpayers' residence. The trust instruments did not state how the trusts' income was to be allocated among the six beneficiaries. In fact, during the years in question, the trusts' income was used for the benefit of only four of the six children. The income was used to pay tuition and room and board at college and at a private high school for those four children.

The Commissioner contended that the trusts' income was taxable to the taxpayers. The Commissioner asserted four separate grounds for so holding. One of the grounds was that the transaction constituted an anticipatory assignment of income. The court did not reach that question since it held for the Commissioner on two other grounds. The court also chose not to pass on a Morrill issue.

The court construed the trust instruments and extrinsic evidence as establishing that the trustees had the power to sprinkle trust income among the beneficiaries of each trust. Since, in the years in question, the taxpayers were trustees, they had the power in conjunction with a non-adverse party to affect the beneficial enjoyment of the trust's income. The court held that the taxpayers were taxable on the trusts' income under § 674.

The court also determined that, under New Jersey law, the taxpayers were obligated to provide a college education for their children since they had adequate means to do so. The court held that New Jersey law imposed this requirement on parents of intact families as well as on parents of broken families. The two New Jersey cases on which the Tax Court based that conclusion are discussed below. Rejecting a contrary statement in New Jersey state court decision, the Tax Court held that the current view of the New Jersey
courts is to apply that same obligation to the expenses incurred in sending a
child to a private secondary school. The Tax Court cited no authorities for this
latter view; instead, the court opined that any other result would be anomalous.

Accordingly, the court held that the trust income that was used to pay college
and private school expenses was taxable to the taxpayers under § 677(b). The
significance of this holding is somewhat weakened by the fact that it is merely
an alternative holding; all of the trusts' income was held to be taxable to the
taxpayers under § 674. In fact, some of the income from one of the trusts was
not distributed in two of the years in question, and since that income could not
be taxed under § 677(b), it was taxed to the taxpayers only under § 674. Thus,
§ 674 caught all of the income earned by both trusts; § 677 caught most, but not
all, of that income. It is difficult to understand why the Tax Court chose to adopt
an alternative holding, which did not cover all of the income in dispute,
especially since the New Jersey cases on which the court relied for its § 677
holding do not support the court's determination.

The Tax Court relied on two New Jersey cases for its determination that
parents of a family that is intact may be liable under New Jersey law to provide a
college education for emancipated children. The court cited the New Jersey
Supreme Court decision of Newburgh v. Arrigo \(^{119}\) for the proposition that in
proper circumstances a parent may be required to provide higher education for a
child who is over the age of 18. As noted previously in this article, it is clear that
the New Jersey courts may order a non-custodial parent to provide higher
education for a child who has attained the age of majority. There is no reason to
quarrel with the Tax Court's assertion that such is the doctrine in New Jersey. It
is quite another matter, however, to claim that New Jersey applies that
obligation to parents where the family is intact. While the Tax Court did not cite
Newburgh v. Arrigo for the latter assertion, it may be useful to point out some of
the facts of that case in order to demonstrate that the case would not support that
assertion in any event. The Newburgh case dealt with a trial court's allocation
of funds collected under a wrongful death claim. Eighty percent of the funds
were awarded to the decedent's widow. The remaining 20% was awarded to an
adult child of the decedent by a prior marriage. The issue to which the Tax
Court's citation refers is the extent to which the adult son by a prior marriage
was entitled to share in the wrongful death proceeds. The purpose of the New
Jersey Wrongful Death Act is to provide for those who were dependent on the
decedent at the time of his death. The New Jersey Supreme Court held that the
majority of the child did not preclude his receiving support from the decedent.
To share in the wrongful death proceeds, however, the child must meet "his
burden of proving the likelihood and amount of [the decedent's] contribution to
his college or law school education." The court remanded to the trial court for a
reconsideration of the parties' distributive shares in light of several relevant
facts including the fact that the child inherited two-thirds of the decedent's

\(^{119}\) 88 N.J. 529, 443 A.2d 1031 (1982).
estate under the laws of intestacy.

For its assertion that New Jersey’s support rule is not limited to divorced parents, the Tax Court cited the decision of the New Jersey Superior Court in *Sakovits v. Sakovits*. In *Sakovits*, the court denied a divorced mother’s claim against her ex-husband for contribution to the cost of their emancipated son’s college education. The Superior Court pointed out that the obligation of a non-custodial parent to provide for his child’s education can survive the child’s majority if certain conditions are satisfied. The court’s threshold test for imposing such an obligation is whether the parents likely would have provided that education for the child had there not been a separation and divorce. The Tax Court cited page 1095 of 429 A.2d as the part of the Superior Court’s opinion that justified the Tax Court’s assertion that the obligation to provide higher education for a child applies to a parent of an intact family. On that page, the Superior Court noted its concern in accepting the threshold question described above that it was “requiring divorced parents to contribute the college education of their children when, had the parents remained together, they could not be required to do so.” The Superior Court recognized that by imposing a greater obligation on divorced parents than on married parents, constitutional questions are raised. The court’s response to this problem was not to extend the doctrine to married parents. Rather, the court pointed out that an affirmative answer to the threshold question is not sufficient to impose an obligation on the non-custodial parent; other factors must also be present. The court listed a number of such other factors. This list is given in the context of describing the test for imposing liability on a non-custodial parent. Several of the tests expressly refer to the non-custodial parent: for example,

2. The ability of the noncustodial parent to pay the cost, and its relation to the type of schooling sought;
5. The child’s relationship to the noncustodial, paying parent.

In sum, the *Braun* decision is not supported by the New Jersey cases and is of doubtful validity.

**IV. PLANNING FOR COST REDUCTION**

The principal means of reducing educational costs is to reduce the tax burden on earnings devoted to that purpose. Typically, this is accomplished by making some type of transfer of income-producing property. While, in most cases, the property transferred will be stocks, securities, or real estate, other types of

121 The threshold question which the Superior Court adopted is taken from an earlier decision from which the court quotes as follows (429 A.2d at p. 1094): “Had there not been a separation and divorce would the parties, while living together, have sent their daughter to law school and financed that schooling?”
122 429 A.2d at p. 1095.
property can be especially useful to donate. The anticipatory assignment of income doctrine may preclude the successful transfer of certain types of property, but, if proper care is taken, many such transfers can be designed to avoid that doctrine. For example, if the parent has authored a book and is willing to part with all (or an undivided share) of his interest therein or with all (or an undivided share) of his right to exploit the book in a specific medium, he can shift the tax burden on all or a portion of the income from the exploitation of that book to the donee. To be successful, the donor must not retain any residual interest in the book—no matter how small it may be. An assignment of an author's royalty interest in a publication contract will not be sufficient to cause the income earned from that contract to be taxed to the donee. The author retains a residuary interest in the book if the publisher fails to fulfill the terms of the publication agreement, and the author may retain other residual rights in the book that are not assigned to the publisher under the terms of their contract. To be successful, the author must assign away all of his interests in the book—not merely his royalty interest. The failure of the author to divest himself of a residuary or residual interest, no matter how small the value, will cause the assignment of his royalty interest to be characterized as an anticipatory assignment of income.

There are a number of means available to transfer an interest in income-producing property to a child. (1) The parent can transfer the property outright to the child. (2) The parent can apply funds for the benefit of the child. (3) The parent can transfer property to a custodian for the child pursuant to the Uniform Gift to Minors Act. (4) The parent can transfer property in trust for the benefit of the child for a period of time and have the corpus of the trust revert to the parent when that period expires. (5) The parent can transfer property in trust and retain no reversionary interest therein. This fifth category of gifts can be subdivided into transfers where the remainder interest in the trust after the expiration of the child's income interest passes to: (a) the child who was the income beneficiary, (b) the spouse of the grantor (a so-called "spousal remainder trust"), or (c) some other person or persons. (6) The grantor transfers property in trust or to a trust equivalent under which the child has an annuity interest for a specified period after which the remainder passes to a qualified charity.

Let us now examine the tax consequences of making each of those disparate types of transfers except for the charitable remainder trust. In doing so, unless otherwise indicated, the author will assume that the donated property is not of a type that raises anticipatory assignment of income questions.

125 See, Strauss v. Commissioner, 168 F.2d 441 (2d Cir. 1948), cert. denied, 335 U.S. 858, rehearing denied, 335 U.S. 888 (1948). Perhaps, the author could retain the right to exploit the copyrighted work in another medium (for example, the movie rights), but even that retention may be sufficient to trigger the anticipatory assignment doctrine.
Direct Transfer to a Child.

The parent can transfer property outright to a child who can then use the property and the income therefrom to pay educational expenses. If the child is a minor, the gift can be made to the child or to a guardian of the child’s property.

In order to obtain significant income tax savings, the direct gifts typically will have to be made some time prior to the child’s use of the funds to pay educational expenses.\(^1\) The savings arise from the lower tax rates imposed on the income from the donated funds that will be taxed to the child rather than to the donor. The longer the period of time that the funds can be invested by the child, the greater the amount of income that can be produced and, consequently, the greater the potential for income tax reduction. However, gifts of certain types of property interests that constitute the right to income from a particular item can be made shortly before the child enters college or even thereafter. For example, a gift of a copyright interest in a book or of a patent falls within this category.\(^2\)

In those states that establish the age of majority at 18 years, the child will attain his majority shortly before or about the time that he enters college. A direct gift program for the college education of such children often will commence when the child is still a minor. Of course, in those states where the age of majority is 21, the donor usually will commence the gift program during the child’s minority. If the gift program is intended to provide for the costs of private secondary school education of the child, it almost certainly will be made during the child’s minority. Let us then examine the tax consequences of making direct gifts to a minor child whose funds will be managed by a guardian.

Where property in kind is given directly to a minor, the donee cannot readily dispose of the property during his minority since a buyer would be vulnerable to the minor’s disavowal of the sale upon attaining his majority and most potential buyers will not purchase under those conditions. This blot on the market appeal of the donated property makes it difficult, or even impossible, for the minor donee to shift to new investments or to consume the principal of the donated property. Even if the gift is made in cash, it usually will be desirable to invest the cash and then to have the capacity to sell and reinvest. Therefore, for gifts of significant amounts, a guardian should be appointed to manage the funds. Once a guardian for a minor child is appointed, gifts to that child can be made directly to the guardian.

The appointment of a guardian can be a cumbersome and costly procedure. The guardian is entitled to a fee, but that cost can sometimes be avoided if a relative serves as the child’s guardian. In addition, the guardian will have to account to the minor (and sometimes to a court) for his handling of the minor’s

\(^{126}\) Of course, direct or outright gifts can be made for non-tax saving purposes or for the purpose of minimizing taxes other than the income tax. One tax purpose for making gifts, for example, is to reduce death tax costs on the grantor’s demise. The reduction of educational costs, however, primarily rests on income tax savings, and so it is the income tax on which this article is focused.

\(^{127}\) See, op. cit., ns. 124 and 125, and the text thereto.
funds, and the preparation of such accounts can be burdensome. A guardianship is less flexible than a trust arrangement since the terms of the trust can be defined by the grantor in the trust instrument. For example, the types of investments that a guardian is permitted to make are more restricted than those that a trustee can be authorized to make by the trust instrument. These "costs" must be taken into account in determining whether to make direct gifts to a minor rather than to utilize a trust or custodial arrangement.

Let us now consider income tax consequences. The income produced by donated property, including capital gain income, ordinarily will be treated as income of the donee, as owner of the property, and taxed accordingly. Even gain recognized on the sale of the donated property that is attributable to appreciation in the hands of the donor typically will be treated as the donee's income. Only in unusual circumstances, such as where the sale or exchange of the donated property was all but consummated by the donor prior to making the gift, will such income be treated as that of the donor because of one of several common law doctrines—e.g., the anticipatory assignment of income doctrine or the Court Holding doctrine. Income from donated property that was accrued but not recognized in the hands of a cash method donor will be taxed to the donor when collected by the donee. The gift of an installment obligation may cause the donor to be taxed under § 453B.

If income from donated property is used to satisfy a support obligation of a parent, a question will arise as to whether the parent is taxed on that income. In general, a child's funds cannot lawfully be used to satisfy a parent's obligation of support if the parent has the means of meeting that obligation. If the child's funds are used to satisfy a parent's legal obligation of support, the child will have a cause of action for the amount wrongfully appropriated by the parent to discharge his own obligation. This cause of action will not expire before the child attains his majority. The amount so used should be taxed to the parent in the year that the funds were applied for his benefit even though the parent may be obligated to reimburse the child since that obligation cannot be said to have arisen out of mutual consent of the parent and the child. The parent should be

128 See, §1015.
129 For example, where a shareholder makes a gift of corporate stock after the corporation has adopted a plan of liquidation but before the liquidation is effected, the majority of circuit courts that have passed on the issue have held that the resulting gain is taxed to the donor as an anticipatory assignment of income. Compare, Jones v. United States, 531 F.2d 1343 (6th Cir. 1976); Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973); Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972) with Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971). The Court Holding doctrine is named after the landmark decision of the Supreme Court in Commissioner v. Court Holding Co., 324 U.S. 331 (1945). For an application of that doctrine to a donor's gift of stock which the donor had previously contracted to sell, see Salvatore v. Commissioner, 434 F.2d 600 (2d Cir., 1970). In W.R. Royster, P-H Memo T.C. Par. 85, 258, gain from the sale of assets previously given to adult children was taxed to the donor on Court Holding and similar doctrines.
132 See, James v. United States, 366 U.S. 213 (1961), in which the Supreme Court held that embezzled funds are income to the embezzler in the year that the theft takes place even though the embezzler is legally obligated to return the stolen funds to the victim. The Court distinguished loans from wrongfully appropriated property on the basis that a loan requires the consensual recognition of the borrower and lender that the borrower is obligated to repay the loan. A wrongful taking does not include the consent of the person whose property was appropriated.
taxed on such income, regardless of whether he is the donor of the property which produced it, provided that he either participated in or acquiesced with the decision to use the funds for the parent’s benefit.\(^{133}\)

In *Brooke v. United States*,\(^ {134}\) the Ninth Circuit held that at least some of the statutory grantor trust rules (specifically, § 677) apply also to guardianships which the court said are to be treated as trusts for certain purposes. In *Brooke*, the court held that the parent of minor children was not legally obligated to provide them with private school education, musical lessons and other lessons and benefits for which the income from guardianship funds had been employed. Therefore, the donor in *Brooke* was not taxable on that income. The Ninth Circuit’s decision implies that had the guardian used the income from the guardianship funds to satisfy the donor’s legal obligation of support, the income that was so employed would be taxable to the donor under § 677(b).

Instead of relying on the grantor trust rules, the Commissioner might seek to include in a parent’s income all guardianship funds, both income and principal, that are used to satisfy a support obligation of the parent for which state law prohibits the use of the child’s funds. This approach rests on the parent’s wrongful appropriation of the child’s funds rather than on grantor trust or general anticipatory assignment of income rules. The case for applying this approach is strongest when the parent is serving as the child’s guardian since the parent would then be applying the guardianship funds for his own benefit. The result should be the same, however, where someone other than the parent serves as guardian and uses the funds to satisfy the parent’s obligations of support since the parent typically will be cognizant of the guardian’s use of the funds and very likely was the instigator of that use. The parent is obligated to return the funds to the minor, and, in light of his probable complicity in the application of those funds for his own benefit, his failure to return the funds constitutes a wrongful appropriation.

To date, the Commissioner has not sought to tax such use of the income or principal of guardianship funds on a wrongful appropriation theory, but, instead, has sought to tax a person only on the income that was used to satisfy that person’s legal obligation. For example, in Rev. Rul. 56-484, 1956-2 Cum. Bull. 23, the Commissioner determined that the income from custodial funds that were used to satisfy a person’s legal obligation to support a minor is taxable to that person under § 61 regardless of the relationship of the donor or of the custodian to the minor donee. Although, conceptually, it is sound to tax the principal of the donated funds as well, it may be that the Commissioner has refrained from doing so because he deems that result to be too harsh, or it may be that the Commissioner deems the resulting complications (described below) that would occur when the donee attains majority to be administratively inconvenient. It is possible that none of the instances in which this issue arose


\(^{134}\) 468 F.2d 1155 (9th Cir. 1972).
involved the use of guardianship funds in excess of guardianship income so that the Commissioner did not have to face the question of whether the principal could also be taxed to the parent.

If guardianship funds (income or principal) are taxed to a parent under a wrongful appropriation approach, what tax consequences occur when the minor child attains his majority? Upon attaining majority, the child has a reasonable period of time to require the parent to repay the wrongfully appropriated funds. If the parent does return the funds to the child, either voluntarily or in response to the child's demand, the parent should be allowed a deduction for that repayment.\textsuperscript{135} If, on attaining his majority, the child knows of his right to demand the return of the funds but declines to do so, and if the parent does not voluntarily return the funds, the transaction should be treated as if the parent did return the funds to the adult child who, in turn, made a gift to the parent of those funds. In such event, the parent would qualify for an income tax deduction equal to the amount of the misappropriated funds, and the adult child might be subject to gift tax consequences.

If, on attaining his majority, the child does not request repayment because of the child's ignorance either of the wrongful appropriation or of his right to demand repayment, the child should not be deemed to have made a gift to the parent, and there should be no constructive repayment by the parent. In that event, the child's attaining his majority will not cause any additional income tax consequences to the parent—the parent will receive no deduction and, having been taxed once on the wrongful appropriation, will not be taxed a second time when the child's right to repayment expires. Of course, the child will not incur gift tax consequences. Since, in most cases, the child will not know of the wrongful appropriation, the expiration of the child's right to repayment will not cause any tax consequences. Tax complexity arises only in the unusual circumstances where repayment is made or where the child knowingly refrains from exercising his right to repayment.

If the minor child should die prior to attaining his majority, the child's claim for reimbursement will pass to his estate. The same tax consequences, described above, that attend the child's attaining his majority also apply on the child's demise.

If guardianship income is taxed to a parent under § 677, rather than under a wrongful appropriation approach, the parent's repayment of that amount to the child likely will not entitle the parent to a deduction unless the parent is legally obligated to repay the amount. In other words, regardless of the theory on which the guardianship income is taxed to the parent, it is only where the use of the income constitutes a wrongful appropriation of those funds that the parent can receive a deduction for returning them.

Regardless of whether the Commissioner relies on § 677 or on a wrongful

\textsuperscript{135} In James v. United States, op. cit., n. 132, the Supreme Court noted that an embezzler who was taxed on the taking of embezzled funds will be granted a deduction when he repays that amount to the victim. The same rule should apply to wrongfully appropriated funds.
appropriation approach, guardianship income (or principal) can be taxed to the parent only where that income (or principal) is used to satisfy an obligation of the parent for which the child's funds cannot lawfully be employed.\textsuperscript{136} The extent to which a parent is obligated to provide private secondary school, college and post-graduate education is discussed in Part III of this article. The degree of a parent's responsibility to provide various items of support for his children is not the same for each such item, and college education is relatively low in that hierarchy. The Pennsylvania Superior Court, which has taken an expansive view of a parent's obligation to pay for college expenses, has stated: "The duty of a parent to provide college education for a child is not as exacting a requirement as the duty to provide food, clothing and shelter for a child of tender years unable to support himself."\textsuperscript{137} It is likely that if a child (especially an adult child) has adequate funds to pay for his own college education, the parent will not be required to pay for those expenses and can require the child to use his own funds or can employ a minor child's guardianship funds. For example, a Pennsylvania Superior Court held that in determining whether a parent has an obligation to provide a college education for his child, the funds belonging to the child (including custodial funds which are not required to be distributed to the child) are taken into account.\textsuperscript{138} Similarly, an Arkansas court has held that if an adult child is able to support himself, the parent is not liable for the child's college expenses.\textsuperscript{139}

If the parents of a minor child are separated or divorced, the parents may have executed a separation agreement that requires one of the parents to pay the child's college (and perhaps post-graduate) expenses. If a parent agreed to provide for such expenses, irrespective of whether the agreement was incorporated into the divorce decree, that parent will be taxed on guardianship income that is used to satisfy his contractual obligation. In light of the high divorce rate, it is likely that many fathers are contractually obligated to provide advanced education for the children of their broken marriage. During such children's minority, it may not be possible to obtain income tax reduction for the earnings employed in paying their educational expenses unless the agreement or divorce decree can first be modified with the wife's consent.

Once such a child becomes an adult and the guardianship is terminated, the adult child's use of his income to pay educational expenses will not cause the parent to incur income tax liability. Even if the parent continues to be contractually liable for such expenses, the child's payments are voluntary and should be excluded from the parent's income under § 102 as gifts. However, for gift tax purposes, such payments by the adult child may constitute a gift to

\textsuperscript{136} Cf., Ref. Rul. 56-484, 1956-2 C.B. 23. Of course, income will be taxed to the donor where the anticipatory assignment of income or a similar doctrine is applicable. See, op cit., n. 129 and the text thereto.
\textsuperscript{138} Sutliff v. Sutliff, op cit., n. 131.
the contractually obligated parent if that contractual obligation is not terminated upon the child's attaining adulthood or at some other specified age. Where the parent remains liable, the gift tax problem might be solved by having the adult child, as third-party beneficiary of the separation agreement, release the parent of that obligation. If the agreement was incorporated into a divorce decree, it may be necessary to have the court modify its order. On the other hand, the release itself will constitute a gift the value of which is difficult to determine.

A parent can also incur a contractual obligation to pay his child's educational expenses as a consequence of an express or implied contract with the school that his child attends. It is remotely possible for this obligation to be joint with the child himself unless, under local support law, the parent is exclusively liable for such payments. Even if the child is jointly liable to the school for such payments, the parent's contractual assumption of that obligation may run to the child so that, between the parent and the child, the parent alone is liable. In other words, the parent is not merely a guarantor of the child's debt but rather is the primary obligor. If the child is jointly liable for the educational expenses, that is, if the child is a co-obligor with the parent, the use of guardianship funds to pay those expenses should not be taxed to the parent.

Thus, under current law, the income from guardianship property that is used to pay for college expenses of the donor's adult or minor child probably will not be taxable to the donor unless the donor is contractually obligated to make such payments or is under a court order to do so.

Note that no income tax savings are obtained by a parent's direct payment of his child's educational or other expenses. Savings can occur only as to income produced by donated property after the transfer to the child has been effected.

If the income from property that was donated to a child is not taxed to the parent, the income will be taxed to the child. For this purpose, a guardianship is not a trust, and guardianship income is treated as the income of the child whom the guardian represents. The child can deduct his personal exemption from his income.\footnote{\textsection 151(b).} Even where the child's income exceeds the personal exemption amount, the parent is also entitled to a dependency exemption for the child if the child qualifies as a dependent and if the child either is under the age of 19 or is a full-time student.\footnote{\textsection 151(e) (1) (B).} However, under \textsection 152(a) and (e) (1), if, in a taxable year, a child's funds, including guardianship funds, are used to provide a greater amount of his support than is provided by his parents, the child will not be a dependent of either parent who will therefore be denied a dependency exemption for that year.

Where a child who qualifies his parent for a dependency exemption has passive income, such as interest and dividend income, the child's passive income cannot be reduced by the child's zero bracket amount that would otherwise be available.\footnote{\textsection 63(e).} This rule is implemented by adding to the child's

\footnotesize{\textsection 151(b). For the year 1985, the amount of the exemption is $1040. Rev. Proc. 84-79, 1984-2 C.B. 755.}
\footnotesize{\textsection 151(e) (1) (B).}
\footnotesize{\textsection 63(e).}
taxable income an amount equal to the difference between the child’s zero bracket amount and the greater of the child’s itemized deductions and the child’s earned income.\textsuperscript{143} If the child’s itemized deductions or earned income equals or exceeds his zero bracket amount, no amount will be added to the child’s taxable income. If the child does not qualify as someone’s dependency exemption, there is no restriction on the child’s use of his zero bracket amount.

Thus, the passive income of a dependent child who is a full-time student is reduced by the child’s personal exemption even though the child continues to qualify his parent for a dependency exemption. But, in such cases, the child’s passive income in excess of his personal exemption will be taxed at the child’s graduated rates without the availability of the zero bracket amount. The income-splitting benefit to the donor in such cases lies in the child’s lower marginal tax rates. The child can utilize his zero bracket amount for any earned income that he recognizes.

Transfer taxes do not pose a significant obstacle to making direct gifts. Only uncompensated transfers that are not made in satisfaction of a legal obligation raise transfer tax issues. Even as to such transfers, the gift and estate tax consequences often are not onerous. Unless the parent transfers a future interest to the child, the gift will qualify for the gift tax annual exclusion under § 2503(b). Under that exclusion, a parent can give each of his children (or any other donee) as much as $10,000 a year without incurring any gift tax consequence. Indeed, each year that the donor’s spouse consents under § 2513 to treat the gifts made by either of them during that year as made one-half by each, the parent can give up to $20,000 to each child without incurring any gift tax consequences. In addition, gift tax law also excludes a donor’s direct payment of a donee’s tuition and medical care expenses.\textsuperscript{144} This latter exclusion will not apply to a donor’s direct gift to his child even if that gift is used by the child to pay tuition or medical expenses. To qualify, the donor must pay the expense directly, but, as already noted, there is no income tax saving in making such payments directly.

Any amounts given to a child in excess of the gift tax annual exclusion will have transfer tax consequences, but will not necessarily cause the donor to incur any tax liability. The transfer tax law provides a unified credit that effectively excludes a specified amount of gift and death transfers from estate and gift tax liability.\textsuperscript{145} This unified credit is equivalent to an exemption of a dollar amount.\textsuperscript{146} For gifts made and decedent’s dying in the year 1986, the exemption equivalent of the credit that applies to that year is $500,000. For the year

\textsuperscript{144} § 2503(e).
\textsuperscript{145} §§ 2010 and 2505.
\textsuperscript{146} There is no difference between a universally shared credit and a dollar exemption. The tax rate schedule can be set to provide an identical tax consequence regardless of whether a credit or exemption is employed. For example, for the year 1986, if there were no unified credit and if the tax rate schedule that currently exists were changed so that the first $500,000 of taxable gifts and estate tax base were subjected to a zero tax and if the current marginal tax rates for amounts in excess of $500,000 were retained, the tax liability under that structure would be identical to the liability imposed by the current rate schedule which employs a $155,800 unified credit.
1987 and thereafter, the exemption equivalent is scheduled to be $600,000.\textsuperscript{147} So, it is possible to make a substantial amount of gifts in excess of the annual exclusion without incurring a gift tax liability.

Where a gift is made outright to a child, no part of the gift will be included in the donor’s gross estate for estate tax purposes even if the donor should die within three years of making the gift.\textsuperscript{148} That does not mean, however, that direct gifts will have no estate tax consequences. Any gift to a child in excess of the gift tax annual exclusion that is provided by \$ 2503(b) will constitute an “adjusted taxable gift,” which is defined in \$ 2001(b). The total of a donor’s adjusted taxable gifts over his lifetime are added to his taxable estate and thereby can cause an increase in the rate of estate tax imposed on his gross estate after his death.\textsuperscript{149} Also, to the extent that a gift which exceeds the annual exclusion is insulated from gift tax liability because of the unified credit, the inclusion of that amount of the gift in the donor’s estate tax base on his death will result in the gift’s having exhausted the amount of unified credit that was utilized when the gift was made. Thus, even where no gift tax liability is incurred on gifts in excess of the annual exclusion, such gifts can cause the donor’s estate to incur a greater estate tax liability.

Under current law, regardless of the number of generations between the donor and the donee, there will be no generation-skipping consequences to making a direct gift.\textsuperscript{150} In sum, the advantages of making a direct gift to a minor child are: (1) income earned subsequently on the transferred property typically will be taxed to the child at a lower marginal rate of tax, (2) in many cases, the donee’s realization of any appreciation of the donated property will be taxed to the donee even though the appreciation occurred in the hands of the donor, (3) the gift qualifies for the annual exclusion and to that extent causes neither estate nor gift tax consequences, (4) any appreciation of the donated property that occurs after the gift is made will not cause estate or gift tax consequences to the donor. The disadvantages are: (1) the donor must part with control over the donated property, (2) the property will be held by the child or his guardian, (3) a

\textsuperscript{147} Ibid.
\textsuperscript{148} \$ 2035(d). However, gifts made within three years of the donor’s death will be included in the donor’s gross estate for certain purposes other than the determination of estate tax liability. For example, such gifts are treated as part of the donor’s gross estate for the purpose of applying \$ 303(b) to determine whether the redemption of corporate stock that was included in a decedent’s gross estate can be redeemed under that Code section so as to escape dividend treatment. \$ 2035(d) (3) (A). Also, note that any gift tax paid on a gift made within three years of a decedent’s death will be included in the decedent’s gross estate under \$ 2035(c). In most cases, no gift tax will be payable on a direct gift to a child, and so no amount will be includible in the donor’s gross estate under \$ 2035(c).

\textsuperscript{149} The estate tax is determined by applying the estate tax rates to the sum of the decedent’s taxable estate and the adjusted taxable gifts (exclusive of gifts that are included in decedent’s gross estate under the estate tax law) that the decedent made after the year 1976. The resulting figure is then reduced by the amount of gift tax that would have been payable on the gifts that were made by the decedent after 1976 if the rate schedule that is applicable at the decedent’s death were applied to such gifts. \$ 2001(b). Note that the rate schedules for estate and gift taxes are identical. \$\$ 2001(c) and 2502(a). The effect of this formula is to push the decedent’s taxable estate into higher brackets of the estate tax rate schedule.

\textsuperscript{150} \$\$ 2601 and 2611.
guardianship is a cumbersome arrangement, (4) if the donated property is appreciated, the donor forfeits the prospect of having the basis of that property stepped-up under § 1014 at the donor’s death if it is still appreciated at that time, (5) even after applying gift-splitting with the donor’s spouse, the gift may cause estate and gift tax consequences to the extent that the amount deemed given by each spouse exceeds the gift tax annual exclusion, (6) guardianship income will be taxed to the parent to the extent that it is used to satisfy a contractual obligation of the parent or his obligation of support.

**Custodianship.**

Instead of making a direct gift to a minor child or to his guardian, a donor can utilize the Uniform Gift to Minors Act. The purpose of this Act is to provide a simple and inexpensive means of making a direct gift to a minor child without incurring the expense and administrative burden that accompanies a guardianship. In effect, the Act provides a less formal type of guardianship than otherwise is available.\(^{151}\) Section 2 of the Act permits an adult to make a gift of certain types of properties to a custodian on behalf of a minor. The gift to the custodian is made simply by using the special words required by the statute—i.e., by properly titling the deed or contract of gift or by properly designating the title of the bank account in which donated funds are deposited. The proper language for effecting a gift under the Act is set forth in section 2 of the Act. The list of properties which can be given to a custodian is broad but there are types of property for which a custodianship is not currently available. For example, real estate cannot be transferred to a custodian unless the legislature of the state in question modified its version of the Uniform Act so as to permit the transfer of realty. While virtually all of the states have adopted some form of the Uniform Act, many of the states have made their own modifications, which include, *inter alia,* changes in the types of property that can be transferred, the mode of making the transfer, the date on which final distribution to the minor must be made, and the identity of the persons who can serve as custodian.

Section 4(b) of the Uniform Act permits the custodian to pay over to the minor or expend for the minor’s benefit so much of the custodial property as the custodian deems advisable for the support, maintenance, education and benefit of the minor without regard to the duty of the custodian or of any other person to support the minor. The Act requires that the remaining custodial property be turned over to the minor when he attains the age of 21 or be turned over to the minor’s estate if he should die before attaining that age.\(^{152}\) Many states have modified that provision by reducing the age at which all remaining custodial property is to be conveyed to the minor. The most common modification is to

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\(^{151}\) See, Joseph Anastasio, 67 T.C. 814, 817-818, affd 573 F.2d 1287 (2d Cir. 1977). See also, sections 3 and 4 of the Revised Uniform Gift to Minors Act.

\(^{152}\) Section 4(d) of the Revised Uniform Gift to Minors Act. A number of states have retained as the date of mandatory final distribution the date on which the minor attains the age of 21 — e.g., Pennsylvania and Georgia. 20 Pa. C.S.A § 5305(d); 31 Code of Georgia, 44-5-115(a).
require distribution when the minor attains the age of 18.\footnote{E.g., Ann. Laws of Mass., c. 201A, § 4(d); 17B Cons. Laws of New York, EPTL § 7-4.4(d).} The reader should consult the statutory provision adopted in the state in which the gift is made. Several states have adopted an interesting variation of the Uniform Act which permits the donor to delay the date on which the final distribution of custodial property must be made to the minor. In Virginia, for example, the donor is permitted, at the time of making the gift, to establish the age of 21 as the date for the final distribution of the remaining custodial funds, and California permits the donor to establish any age, up to and including the minor’s 25th birthday, that the donor chooses; in both Virginia and California, if the donor fails to make that election, the custodial property is to be distributed when the minor becomes 18 years of age.\footnote{California Uniform Transfers to Minors Act, California Probate Code §§ 3920, 3920.5; 5A Code of Virginia, § 31-27(e). The age of majority in Virginia is 18 years. 1 Code of Virginia, § 1-13.42.} After the transfer is completed, the income tax treatment of income subsequently earned on that property is the same as the treatment of direct gifts to a minor child.\footnote{See, Rev. Rul. 59-357, 1959-2 C.B. 212. The income tax treatment of income earned on property that was directly given to a minor is discussed in the text to notes 129 to 138.} Thus, income from custodial property that is used to satisfy a person’s legal obligation will be taxed to that person under § 61, and income can be taxed to the donor to the extent that the anticipatory assignment of income or related doctrines are applicable. Apart from those exceptions, such income will be taxed to the minor donee, who is treated as the owner of the property.\footnote{See, op. cit., ns. 129, 130.} As previously noted, there are grounds for treating the corpus of guardianship funds that are used to satisfy a legal obligation of a person as income to that person because it constitutes a wrongful appropriation of the funds. That treatment is not available for custodianship funds since section 4(b) of the revised Uniform Gift to Minors Act authorizes the use of custodianship funds for the support of the minor without regard to the obligation of the custodian or of any other person to support the minor. Consequently, only custodianship income that is used to satisfy a parent’s support obligation can be taxed to that parent.

Capital gain income from the sale of property that was donated to a custodian typically will be taxed to the minor donee even though the donated property was an appreciated asset at the time that the gift was made.\footnote{§ 1015(a). See the test to n. 129.} Since a custodianship is not a trust, § 644 will not apply, and none of the gain from property that is sold within two years after the transfer to the custodian was made will be taxed at the donor’s marginal rate under that Code provision.

Custodial property is not deemed to be held in trust. Rather, it is treated as property held by a guardian for the minor donee, and the income earned on the custodial property is taxed directly to the minor.\footnote{See, Joseph Anastasio, 67 T.C. 814, 817-818, aff’d 573 F.2d 1287 (2d Cir. 1977).} The income from custodianship property is passive income. As explained in the discussion of direct gifts, a minor donee can utilize his personal exemption as an income tax deduction
against his passive income, but the extent to which he can utilize his zero 
bracket amount is restricted. 159 This restriction applies only if the minor donee 
qualifies as a dependency exemption for some person.

The donated property will constitute a completed gift even if the donor serves 
as the custodian of the property. 160 For gift tax purposes, the donated property 
qualifies as a gift of a present interest for which an annual exclusion is 
permitted. 161 So, a parent can make gifts to a custodian of up to $10,000 per 
year for each of his children without causing any gift tax consequences (or any 
estate tax consequences if the donor does not serve as custodian). If the parent's 
spouse consents to split-gift treatment under §2513, the parent can give up to 
$20,000 per year to each child. The gift tax exclusion for direct payment of 
medical and tuition expenses does not apply to custodial gifts which are used by 
the custodian for that purpose because such payments are not made directly by 
the donor to the medical or educational institutions.

Any gifts made in excess of the allowable annual exclusion will cause gift tax 
consequences, but because of the unified credit, the donor is not likely to incur a 
gift tax liability. 162 The excess of gifts over the annual exclusion will constitute 
adjusted taxable gifts which may cause an increase in the estate tax rates that are 
applied to the donor's gross estate when he dies. 163 The donated property will 
be excluded from the donor's gross estate for estate tax purposes unless the 
donor serves as custodian of the gift for the minor donee. 164 If the donor is also 
the custodian and if the donor dies before the donee attains the age at which the 
custodial property must be distributed to the donee, the value of the custodial 
property remaining in the donor's custody at the time of his death will be 
included in the donor's gross estate under § 2038. 165 Such properties will be 
valued for estate tax purposes at the date of the donor's death or at the alternate 
valuation date if the donor's executor elects the alternate date under § 2032. In 
addition, any discretionary distributions of custodial property that the donor-
custodian made to the donee within three years of the donor's death will be 
included in the donor's gross estate under § 2035(d) (2) as a release of an 
interest to which § 2038 would otherwise have applied. If the donee attained his

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159 See the text to notes 140 to 143.
160 Rev. Rul. 59–357, 1959–2 C.B. 212. If the donor is the custodian of the donated property, he retains the 
power to make distributions of that property to the minor donee. Since the minor donee has the vested ownership 
of the custodial property, the donor's power over the custodial property constitutes only a power to affect the time 
of the donee's possession or enjoyment, and the retention of such powers does not render the gift incomplete. 
161 Rev. Rul. 59–357, 1959–2 C.B. 212. The gift is not treated as a future interest for gift tax purposes because 
it satisfies the requirements of § 2503(c). Where state law has reduced the age at which the custodial property is 
required to be distributed to the minor donee to 18 years, the gift to a custodian will nevertheless qualify for the 
162 § 2505. See, notes 145 to 147 and the text thereto.
165 The donor's power as custodian to affect the donee's time of enjoyment causes the property that is subject to 
that power to be included in the donor's gross estate under § 2038. Rev. Rul. 57–366, 1957–2 C.B. 618; Rev. 
majority before the donor died, none of the donated property, including
discretionary distributions of custodial property that the donor made to the
donee within three years of the donor’s death, is included in the donor’s gross
estate. Section 2035(d) (2) applies only to a release of an interest in property
that would have been included in the decedent’s gross estate if the decedent had
retained that interest.

A custodianship is treated as a generation-skipping trust equivalent under §
2611(d).166 If the minor donee is the child of the donor, there will be no
generation-skipping tax. If the minor donee is more than one generation
removed from the donor, there can be generation-skipping tax consequences in
certain circumstances.167 In general, these consequences can arise only if the
custodian is of a generation that is younger than the donor’s and older than the
minor beneficiary’s or if the custodial funds are actually used to discharge a
legal obligation of support of someone who is of a generation between that of
the donor’s and the minor donee’s.168

The advantages of custodial gifts are that: they are simple and inexpensive to
make; the gifts qualify for the gift tax annual exclusion; unless used to satisfy
another person’s legal obligation, the income earned on the donated property
(including gains from the sale of that property) will be taxed to the minor donee,
presumably at lower marginal rates than that of the donor; unless the donor
serves as custodian, the donated property (including any subsequent appreci-
aton thereof) is excluded from the donor’s gross estate for estate tax purposes.
Where a parent has no contractual or judicially imposed obligation to pay the
college or advanced educational expenses of his child and where the income
from custodial property is used to pay such expenses, the income probably will
not be taxed to the parent because even if the parent’s support obligation
requires him to pay such expenses, he likely will not be required to do so where
the child has adequate funds of his own, including the child’s custodial funds.
Moreover, the custodial property is required to be distributed to the minor
donee when he reaches a specified age (typically, no greater than 21), and so a
considerable portion of the college and post-graduate expenses will be incurred
after the custodianship has been terminated.

The disadvantages of custodial gifts are: the terms of the custodianship are
fixed by statute and so lack flexibility; the custodial property must be dis-
tributed to the minor child at an early age (as early as age 18 years in many
states), and if large sums are involved, that may not be desirable; the donor
must part with control over the disposition of the donated property; if the
donated property is appreciated, the donor forfeits the prospect of having the
basis of the property stepped-up under § 1014 at the donor’s death; the donor
cannot serve as custodian if he wishes to exclude the donated property from his
gross estate in the event that he should die before the custodianship is termi-

167 Prop. Reg. § 26.2613-4(d), (e), Ex. (3).
168 Ibid.
nated (but the donor’s spouse can serve as custodian without causing estate consequences to the donor or to the spouse). If the parent is contractually obligated to pay the child’s educational expenses (because of a separation agreement with his spouse or because of an understanding with the child’s school), or if a divorce court has ordered the parent to provide for the child’s education, the use of custodianship income to pay those expenses will cause the parent to be taxed on that income.

In general, a custodianship is useful for making gifts of such size that more flexible rules and a later date of mandatory distribution are not needed. For large gifts, the donor may prefer to use a trust arrangement.

Reversionary Trusts.

A reversionary or short-term trust is an irrevocable trust the income from which is to be paid or accumulated for designated persons for a specified period of time at the expiration of which the trust corpus reverts to the grantor or to his estate. The current income beneficiary of the trust may be one person or several persons whose income interests may either be established by fixed percentages or by ascertainable standards or pursuant to a power of the trustee to sprinkle the income among the beneficiaries according to his discretion. The term of the trust can be established as a term of years (typically, for more than 10 years in order to avoid grantor trust characterization) or it can be terminated on the occurrence of some contingency such as the death of the income beneficiary. Where trusts are established for the education of minor children, the term will usually be set as a period of years.

A major purpose of the short-term or reversionary trust is to reduce the tax burden imposed on the income from the donated property by having it taxed as lower marginal rates than would be applied if the income taxed to the donor. The trust, therefore, must be designed so as to avoid the grantor trust treatment that is established by §§ 671-677. To the extent that it is convenient to do so, the trust also should be designed to avoid the Mallinckrodt rule which treats a third party as the owner of all or part of the trust under § 678. The grantor and Mallinckrodt trust rules are described in Part II of this article.

Since the origin of the statutory grantor trust rules is the Supreme Court’s decision in *Helvering v. Clifford*, a short-term trust that does not constitute a grantor trust is sometimes referred to as a “Clifford trust.” That terminology is confusing because a short-term trust that is treated as a grantor trust also is sometimes referred to as a “Clifford trust.” For that reason, the author does not use that terminology.

If a reversionary trust is designed so as to avoid grantor trust treatment, under § 662, the grantor nevertheless will be taxed on the trust income that is actually used to satisfy his legal obligation of support or his contractual obligation. In

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169 309 U.S. 331 (1940).
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such cases, the grantor is treated as a distributee of the trust who is taxed pursuant to the normal DNI allocation rules. As previously discussed, where a parent has a non-contractual legal obligation to pay for his child's college and post-graduate education, typically, he will not be required to do so to the extent that the child has funds of his own that are available for that purpose. The child's income interest in the short-term trust constitutes a property interest that is available for payment of college and post-graduate expenses. It is likely then that the income from the trust that is used to defray such expenses will not constitute payments of items for which the grantor was primarily liable, and so the grantor should not be taxed on that income.

However, if the grantor enters into a contract, express or implied, under which he undertakes the primary responsibility for the payment of his child's educational expenses, the trust income used to pay those expenses would be satisfying a legal obligation of the grantor and would be taxed to him.

Indeed, where the grantor creates a contractual obligation for the payment of such expenses, a case can be made for taxing him on trust income that can be used to pay those items even if not so employed since the obligation then is not merely one of support but also is a contractual liability of the grantor which exists independently of the grantor's obligation. Another possible ground for taxing the grantor on the trust's income is the possibility that the power of the trustee to use trust income to satisfy a legal obligation of the grantor might constitute a reversionary interest in the trust's income which may reasonably be expected to take effect in possession or enjoyment within 10 years of the trust's creation and therefore would cause the grantor to be taxed on the trust's income under § 673. To date, however, the Commissioner has not contended that the mere availability of trust income to pay educational expenses for which the grantor is contractually liable is sufficient to cause the grantor to be taxed thereon. Arguably, the exclusion from the grantor's income that is provided by § 677(b) for income that may be but is not used to satisfy a support obligation of the grantor applies equally to support obligations for which the grantor is also contractually obligated as well as those for which the sole source of the grantor's obligation is a local law's requirement of providing support. It is possible, then, that where trust income is permitted to be used by the trustee to

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171 Morrill v. United States, 228 F. Supp. 734 (D. Me. 1964). The Morrill decision is discussed in Part III of this article.
172 Where trust income may be distributed to the grantor, the income will be taxed to the grantor under § 677(a). A distribution which satisfies a legal obligation of the grantor is equivalent to a distribution to the grantor. Cf., Treas. Reg. § 1.662(a)-4. Therefore, income which may be used to satisfy a grantor's legal obligation is equivalent to income that may be distributed to the grantor and so is taxable to him under § 677(a). Treas. Reg. § 1.677(b)-1(d). The exception in § 677(b) that taxes the grantor only on income that is actually expended in satisfying the grantor's obligation of support applies exclusively to obligations of support and to no other types of liabilities of the grantor. Treas. Reg. § 1.677(b)-1(d). If the grantor is obligated under local law to pay for his child's college expenses as an item of support and if the grantor is also contractually obligated to make that payment, it is possible that § 677(b) would apply to that expense item, but that issue has not been passed upon.
pay a child’s college expenses for which the grantor is contractually obligated, but which income is not so employed, the grantor might wish to seek the protection of § 677(b) by contending that the child’s college expenses are an obligation of support under local law. That could lead to a reversal of the normal litigating positions of the Commissioner and the taxpayer where the existence of a support obligation is in question.

Even if the contractual obligation of a parent to pay for his child’s educational expenses is not within the letter of § 677(b), it is within the spirit of that exculpatory provision, and perhaps that is the reason that the Commissioner has not yet raised this issue. In any event, where a reversionary trust is to be employed, the grantor could seek an express contractual agreement with the educational institutions at which his children attend exculpating him from any obligation to pay his children’s expenses. It would be preferable to exclude the grantor from even a secondary liability to pay those educational expenses that are not paid by the trust. The safest approach is to have the trust pay the child’s tuition and similar expenses in advance so that the grantor can have no contractual obligation for those expenses.

If the parent is contractually obligated to pay his child’s educational expenses as a consequence of an express provision in a separation agreement, trust income that is used to pay such expenses will be taxed to the parent. Once the child attains adulthood, perhaps the child (as a third party beneficiary) can release the parent from this obligation and perhaps the former spouse would consent to that release in light of the parent’s creation of the trust. If the separation agreement was incorporated into a divorce decree, it will be necessary to apply to the divorce court to modify its decree. This problem might be avoided if it is anticipated at the time that a separation agreement is being negotiated. If, at that time, the parent were to establish an adequate trust to provide for the children’s education, it might be feasible to omit from the separation agreement any reference to college or advanced education. In that event, no contractual obligation will be imposed on the parent.

Virtually all capital gains recognized by a reversionary trust will be taxed to the grantor under § 677(a). Capital gains typically are not included in trust accounting income, and so such gains will revert to the grantor when the trust terminates. Since the capital gain income is held for future distribution to the grantor, it is taxed to him when earned by the trust. The trust’s capital losses will be treated as incurred by the grantor and may be deducted by him.

For the years prior to the year in which the child’s income interest expires, the grantor will have to pay the tax on the trust’s capital gains with his own funds. If the trust instrument were to instruct the trustee to utilize the trust’s capital gains to pay the capital gain tax incurred by the grantor or to reimburse the grantor for the payment of that tax, that would constitute a reversionary interest in the corpus of the trust that could take effect within the obligatory

ten-year period. The grantor, therefore, would be treated as the owner of at least a portion (and perhaps all) of the trust, and he would be taxed on that portion (or all) of the trust's income. Since the amount of capital gain that the trust will recognize during its term cannot be ascertained at the time of the grantor's contribution of property to the trust, the grantor's proscribed reversionary interest may be deemed to encompass virtually all of the trust's corpus. While the value of the grantor's reversionary interest in the trust must be less than 100% of the value of the trust's assets, the fact that the value of that interest cannot be ascertained may cause the grantor to be treated as the owner of all of the trust's assets.

If the trust instrument merely authorized, but did not require, the trustee to use capital gain income to pay the capital gain tax or to reimburse the grantor, and if the trustee did in fact pay virtually all of such taxes, the Commissioner likely would contend that there was an understanding that the trust's capital gain income would be so employed and, consequently, that the tax treatment of such a provision would be the same as that applied where the trustee was instructed to pay such taxes. Even if the ten-year reversionary interest restriction of § 673 were deemed inapplicable, the trustee's power to pay such taxes would constitute a power to revoke under § 676 unless the trustee is an adverse party. The question of what portion of the trust is subject to the trustee's power of revocation turns on the same considerations that were discussed in connection with the determination of the portion of the trust that the grantor would be deemed to own under § 673 if the trustee were instructed to pay such taxes.

If the trustee does not exercise his power to use capital gain income to pay the capital gain tax thereon, § 676 would nevertheless cause the grantor to be treated as the owner of part of the trust unless the trustee is an adverse party. Also, in such a case, the Commissioner might contend that because of the trustee's power, the grantor's reversion "may reasonably be expected to take effect" within 10 years in contravention of § 673.

If the trustee were instructed to pay the capital gains tax out of the trust's ordinary income, that would provide the grantor with a reversion in the income interest which takes effect within the proscribed ten-year period in contravention of § 673(a). Section 677 also would apply. If the trustee were merely authorized to use ordinary income for that purpose, the grantor would be taxed under § 677(a) on any income that could be so used, since the income would be available to satisfy a legal obligation of the grantor.

Since the grantor will be taxed on gains realized from the sale of trust assets, § 644 will not apply. Section 644 taxes certain gains from trust assets that are sold or exchanged within two years of the grantor's contribution at the grantor's marginal rate.

A grantor can avoid being taxed on a trust's capital gains by defining trust accounting income in the trust instrument as including capital gains which then would be distributable to the income beneficiaries. The disadvantage of that arrangement is that it will increase the gift tax value of the grantor's gift to the
beneficiary. Indeed, the gift tax value may possibly be increased to equal the entire value of the property transferred to the trust since it may not then be feasible to value the grantor’s reversionary interest. This latter consequence is especially likely if the trust’s capital losses are charged against the principal of the trust.

Where a trust accumulates income which is later distributed to a beneficiary, the distribution may invoke the throwback rules that are set forth in Subpart D of Subchapter J. The throwback rules generally do not apply to distributions to a beneficiary of income that was accumulated prior to the distributee’s 21st birthday. If the grantor retains no interest in the trust’s current income during the term of the trust and if he has no power, either alone or in conjunction with non-adverse parties, to alter the beneficial interests of the income beneficiaries, there will be a completed gift of the value of an income interest in the transferred property for the term of the trust. The value of the income interest is determined according to tables set forth in Treas. Reg. § 25.2512-5(f). These tables are based on interest at 10 percent per year, compounded annually. For example, the gift tax value of an income interest in a trust with a ten-year term is $61,445.70 of the value of the property that is transferred to the trust. If a grantor transferred property having a value of $100,000 to a 10-year reversionary trust, the value of the gift of the income interest in that property is $61,445.70.

If the income of the trust is required to be distributed no less frequently than annually to the sole beneficiary of the trust or if the income is to be distributed no less frequently than annually among named beneficiaries according to established percentages that cannot be altered, the value of the income interest of each such beneficiary will qualify for the gift tax annual exclusion.

As noted previously, the annual exclusion is $10,000 per donee, and if the donor’s spouse consents to split-gift treatment under § 2513, up to $20,000 per donee can be excluded each year for which such consent is given. Qualification for the annual exclusion becomes especially important if the donor contemplates making additional gifts to the trust in succeeding years. The annual exclusion’s importance is magnified by virtue of the fact that to the extent that gifts are excluded under that provision, they do not constitute adjusted taxable gifts which are included in the donor’s estate tax base on his death. Note that if the grantor wishes to add additional amounts to the trust from time to time, the ten-year reversionary interest restriction for each such additional gift is measured from the date that that gift is transferred to the trust.

When trusts are established for minor beneficiaries, it frequently will not be desirable to require that the trust’s income be distributed currently. There are

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174 See, Rev. Rul. 77-99, 1977-1 C.B. 295 where the Commissioner determined that a gift to a trust in which capital gains were treated as income and capital losses were treated as principal constituted a gift of the entire value of the transferred property for gift tax purposes. See also, Robinette v. Helvering, 318 U.S. 184 (1943).
175 § 665(b).
177 § 2001(b). See, op. cit., n. 149.
several reasons why that is so: the minor’s disability would require the appointment of a guardian to hold the distributed income; the grantor may wish to have the income accumulated for some future expense such as college and advanced educational costs; the accumulation of part of the trust’s income provides income-splitting between the beneficiary and the trust. Consequently, many trusts for minors permit the trustee to accumulate income during the term of the trust.

Several methods are available to qualify the income interests in gifts to such trusts for the annual exclusion. One method is to structure the trust so that it satisfies the requirements of § 2503(c). For example, a short-term trust can be created for the benefit of a single minor beneficiary. The trustee can be authorized to distribute or accumulate the trust’s income until the beneficiary attains the age of 21. On the beneficiary’s 21st birthday, the trust instrument requires the trustee to distribute all of the accumulated income to the beneficiary, and thereafter, for the remainder of the trust’s term, income is to be distributed currently to the beneficiary. If the beneficiary should die prior to his 21st birthday, any income accumulated at that time is to be distributed to the beneficiary’s estate. The value of the beneficiary’s right to receive income until age 21 or until his earlier death will qualify for the annual exclusion. The value of the beneficiary’s right to income that will be earned after his 21st birthday will not qualify for the annual exclusion.

Another method available for qualifying gifts to a discretionary distribution trust for the benefit of a minor for an annual exclusion is to create a so-called “Crummey trust.” The name of this type of trust is taken from the principal decision that established the doctrine — Crummey v. Commissioner. Where a beneficiary has the power to withdraw income or corpus from a trust, the beneficiary is deemed to have the present right to the use, possession and enjoyment of that income or corpus. The Crummey doctrine holds that where the donee of such a power is a minor the power provides the minor with a present interest in the trust even though the minor lacks the capacity to exercise the power and no guardian has been appointed for the minor. The Commissioner has conceded that a Crummey power is sufficient to qualify for the annual exclusion provided that the donee is notified of his power and is given a reasonable period of time in which to exercise it.

In a Crummey trust, the minor beneficiary typically is empowered to withdraw any amount contributed to the trust within a specified time (e.g., 30 days) after receiving notification of the contribution to the trust. The amount that can be withdrawn usually is subjected to a ceiling so that no more than a specified amount can be withdrawn in any one year. This arrangement will

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179 Estate of Levine v. Commissioner, 526 F.2d 717 (2d Cir. 1975).
180 397 F.2d 82 (9th Cir., 1968).
qualify for the annual exclusion the amount that is contributed to the trust to the extent of the beneficiary’s power of withdrawal. Of course, the entire amount of contribution that the beneficiary can withdraw (not merely the income therefrom) will constitute a gift to the beneficiary, but that amount may be excluded from gift tax consequences by the annual exclusion. The grantor typically will receive no exclusion for the gift of the income interest in the excess of contributed property over the amount that the beneficiary can withdraw.

Unlike the § 2503(c) trust, a Crummey trust can provide a trustee with the power to sprinkle income among several beneficiaries provided that a Crummey power is given to one or more of the beneficiaries to withdraw a specified amount of contributed property. By giving each of the current beneficiaries the power to withdraw a specified percentage of contributions (subject to a dollar ceiling), the amount of gifts that will be excluded can be greatly expanded. It is contemplated that the powers of withdrawal will be permitted to lapse since the minor beneficiaries lack the capacity to exercise those powers.

The advantages of the Crummey trust are obvious, and that form of gifting has become increasingly popular. However, there are drawbacks which should be taken into account. When a beneficiary fails to exercise a power of withdrawal, the resulting lapse of that power can cause adverse tax consequences. The beneficiary’s power of withdrawal constitutes a general power of appointment for estate and gift tax purposes. Under § 2514(e), a lapsed power is treated as a release of the power to the extent that the amount which could be appointed exceeds the greater of $5,000 or 5% of the value of the property out of which the power can be satisfied. To the extent that the amount of the lapsed power is treated as a release of a general power, it can cause both gift and estate tax consequences.

The beneficiary will have made a gift to the grantor of the remainder interest in the amount that was deemed released since the grantor will receive that property pursuant to his reversionary interest.\(^\text{183}\) This will be a gift of a future interest and will not qualify for an annual exclusion. If there are other income beneficiaries of the trust, whose income interests are fixed and not subject to the trustee’s discretion, the donee of the lapsed power will also be treated as having made a gift to them of their portion of the income interest in the released power. If the trust is a sprinkling or spray trust in which the several beneficiaries, including the donee of the Crummey power, are permissible distributees, it is possible, that the gift to the other beneficiaries will be incomplete until such

time as the income from the donated amount is actually distributed to them.\textsuperscript{184}

If the other income beneficiaries also had Crummey powers that lapsed at the same time, it might appear that the transfers from each beneficiary could be offset by the amounts received in turn from the others, but none of the releases of the powers was made in consideration of the others, and so it is possible that there will be mutual gifts by each beneficiary rather than an offset. This is especially likely in the case of a discretionary trust since, at the time of the release, it is not possible to determine which of the permissible distributees will receive the future income from the released interest.

The donee’s gift to the grantor of a remainder interest in the property that was subject to the released power will subject the donee to estate tax consequences under §§ 2041(a)(2), (b)(2), and 2036 or 2038 if the donee dies before the trust terminates. To the extent that the donee retained a non-discretionary income interest in the property that was deemed transferred by the release of his power, such property is included in the donee’s gross estate.\textsuperscript{185} The amount so included is a percentage of the value of the trust estate at the donee’s death, which percentage is determined at the time that the release occurred.\textsuperscript{186} To the extent that the gift made by the donee is not included in the donee’s gross estate, the amount of the gift that does not qualify for an annual exclusion will constitute an adjusted taxable gift which can increase the donee’s estate tax rate.\textsuperscript{187} If the donee possessed a power of withdrawal at the time of his death, the amount which he was empowered to appoint at that time will be included in his gross estate.

Since lapses will occur each year, the computation of estate and gift tax

\textsuperscript{184} Rev. Rul. 76–103, 1976–1 C.B. 293. Outwin v. Commissioner, 76 T.C. 153 (1981), Acq. Under Outwin and the revenue ruling, a grantor’s transfer of property to a trust of which the grantor is a discretionary distributee is incomplete if local law permits the prior and subsequent creditors of the grantor to reach the trust’s assets to satisfy claims that they hold against the grantor. The Tax Court and the Commissioner reasoned that the grantor’s power to borrow money and thereby relegate trust assets to the claims of his creditors rendered the gift incomplete. But, what if state law permits a creditor to reach the assets of a discretionary trust only to the extent that the grantor is insolvent. See, 2 A. Scott, The Law of Trusts, section 147 (3d ed. 1967). In such cases the grantor has the power to spend himself into insolvency and thereby prevent the beneficiaries of the trust from receiving trust assets. But, the state of insolvency has substantial independent significance, and the capacity to spend oneself into insolvency hardly qualifies as a naked power to defeat the beneficiaries interests in the trust. See, Estate of Smead v. Commissioner, 78 T.C. 43 (1982); Rev. Rul. 72–307, 1972–1 C.B. 307; Rev. Rul. 75–415, 1975–2 C.B. 374.

\textsuperscript{185} Treas. Reg. § 20.2041–3(d)(3). Fish v. United States, 432 F. 2d 1278 (9th Cir., 1970). In the case of a sprinkling trust in which the donee of the power is a permissible distributee, it is possible that the donee will be treated as having retained an income interest in the entirety of the released power, op. cit., n. 184. Even if the applicable local law permits the creditors of a grantor to reach property transferred to a discretionary trust, it is possible that the local law may not permit the creditors of a donee of a lapsed power to reach any part of the trust’s corpus or income because of the donee’s interest as a discretionary distributee. The donee’s retained income interest (if any) in a discretionary trust is retained for a period that does not, in fact, end prior to his death (§ 2036(a)) if he dies before the trust terminates. Note that Rev. Rul. 76–103, op. cit., n. 184 relied on § 2038 to include trust corpus in a grantor’s gross estate, but the same reasoning would permit § 2036 to apply to a deemed transfer of property caused by a donee’s release of a Crummey power in a sprinkling trust provided that state law permits the donee’s creditors to reach the income earned by the property that was deemed to have been transferred.

\textsuperscript{186} Treas. Reg. § 20.2041–3(d)(4).

\textsuperscript{187} See, op. cit., n. 149.
consequences can present administrative difficulties. To avoid administrative costs as well as tax costs, a donee’s Crummev power of withdrawal may be restricted to $5,000 per year or to a “5 and 5” power — i.e., a power to withdraw up to the greater of $5,000 or 5% of the value of the corpus out of which the power can be satisfied. By this means, the lapse will not constitute a release of a power which causes estate and gift tax consequences; but if the donee dies during the term of the trust, the amount which he had the power to withdraw at the time of his death will be included in his gross estate. The adoption of a “5 and 5” limitation restricts the dollar amount that can be contributed annually by the grantor under the umbrella of the annual exclusion. If the $5,000 or “5 and 5” limitation is adopted, problems will arise if the donee of the power is the beneficiary of more than one trust. The Commissioner maintains that the beneficiary’s interest in several trusts must be accumulated in applying the “5 and 5” exclusion.188

Even if the estate and gift tax problems of the Crummev power are avoided, there are also income tax problems. A minor beneficiary’s power to withdraw income or corpus from a trust will cause the minor to be taxed under § 678 as an owner of part of the trust even though the minor lacks the capacity to exercise the power.189 The minor will be deemed to be the owner of that portion of the trust which the amount that he has the right to withdraw represents.190 Where a minor releases a § 678 power in such manner that if he were the grantor of a transfer he would be taxed on the income therefrom under the grantor trust rules, the minor will be treated as the owner of the portion of the trust that the amount of the released power represents.191 The lapse of a Crummev power will constitute a release of that power, and since there is no “5 and 5” exclusion in § 678, the entire amount of the lapse constitutes a release. Since the income from the released power either will or may be distributed to the minor, he will be taxed on the income from the portion of the trust which he is deemed to own by virtue of § 678(a) (2).

If the income from such a trust becomes taxable to the grantor under the grantor trust rules (e.g., if the trust’s income is used to satisfy a legal obligation of the grantor), there is a question as to how the trust’s income should be divided between the grantor and the minor whose Crummev power lapsed. Section 678(b) establishes a priority for the grantor trust rules where the § 678 power is over the trust’s income. But, that provision does not apply to a beneficiary’s power over the trust corpus. The proper allocation between the grantor and the minor beneficiary in such cases is unresolved.

Instead of granting the minor beneficiary a power over trust corpus, he can be given a power to withdraw trust income, which power will lapse within a specified number of days after the close of the year. Since the beneficiary will

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191 § 678(a) (2).
have the right to all of the trust’s income, the value of the beneficiary’s income interest for the term of the trust will qualify for an annual exclusion. The minor will be taxed on the trust’s income unless the trust is a grantor trust. If the power is permitted to lapse, the amount in excess of $5,000 or of 5% of the amount of the trust’s income will not cause gift and estate tax consequences if the minor is the only income beneficiary so that the income will eventually be distributed to him or to his estate. If the minor is not the only income beneficiary, there could be estate and gift tax consequences. In that regard, the 5% exclusion for lapses refers to 5% of the assets out of which the power could have been satisfied, and since the power could be satisfied only out of trust income, the exclusion is based on 5% of income instead of corpus. For that reason, in most cases, only the $5,000 exclusion will prove useful.

Another means of qualifying the beneficiaries’ interests for an annual exclusion is to provide in the trust instrument that all trust income be distributed currently among the beneficiaries in predetermined shares. There are several ways to distribute trust income to a minor beneficiary. If state law permits, the trust instrument can permit the trustee to distribute a minor’s share of trust income to a custodian for the minor. Not all states permit custodial contributions to be made in that manner. Instead, the minor’s share of income can be paid to a guardian of the minor. Finally, a § 2503(c) or Crummey trust could be established for each minor beneficiary, and each minor’s share of the primary trust’s income can be paid to the § 2503(c) or Crummey trust that was created for him. A distribution to a § 2503(c) trust permits the distributed income to be accumulated in the second trust until the minor becomes 21. Income paid to a Crummey trust can be accumulated for an even longer period. Using a Crummey trust as a distributee creates less of an administrative burden than would the insertion of Crummey powers in the short-term trust since there is only one beneficiary of the distributee trust and so no allocation of the income from lapses of the minor’s § 678 Mallinckrodt power is needed. Moreover, capital gains recognized from the sale of investments made by the minor’s separate trust will not be taxed to the grantor since he has no reversionary interest in that trust. However, the reader should be leery of making a second trust the beneficiary of the trust to which the grantor transferred the trust corpus because there is a risk that the Commissioner will contend that the gifts to the first trust do not qualify for an annual exclusion — i.e., the Commissioner may refuse to look at the terms of the distributee trust in determining whether the primary trust complies with the requirements for qualifying for an annual exclusion. It would seem that the income interest in a gift to the first trust should qualify for an annual exclusion in such cases, but there is a risk that it will not.

The grantor will not obtain significant estate tax reduction from making gifts to a short-term trust. If the grantor dies after the trust has terminated, the trust corpus will have reverted to him and be included in his gross estate unless he

192 Fish v. United States, op. cit., n. 185.
made another gift of that property before his demise. The income earned by the trust's assets will have been distributed to the beneficiaries and so is removed from the grantor's gross estate. Any adjusted taxable gifts caused by his transfers to the trust may increase his estate tax rates. The adjusted taxable gifts will be included in the grantor's estate tax computation even if he dies during the term of the trust so that his reversionary interest in the trust would be included in his gross estate under § 2033. If the grantor dies during the term of the trust and the entire trust corpus is included in his gross estate because of some retained power, then the adjusted taxable gifts will be excluded from his estate tax computation, but that would be of small comfort.

If the beneficiaries of the short-term trust are the children of the grantor, there should be no generation-skipping tax consequences. If any of the beneficiaries are two or more generations removed from the grantor, it is possible for a generation-skipping transfer to occur, but it will not frequently arise.

The principal advantage of the short-term trust is that it provides income splitting without requiring the grantor to part permanently with his property. Also, since only an income interest is donated, the gift tax costs are smaller than those associated with a direct gift, especially if the transfers to the short-term trust qualify for an annual exclusion. The trust serves as a taxable entity that provides additional income splitting between the trust and the beneficiary, and so long as the beneficiary is under the age of 21, accumulated income will not be subjected to throwback treatment when distributed to the beneficiary. The trust is a more flexible vehicle than are guardianships and custodianships. The trust can be tailored to serve the specific goals of the grantor and the needs of the beneficiaries.

The maximum gift tax benefits from the short-term trust arise when the actual rate of return on investments is higher than the rate employed in the Treasury's gift tax tables for valuing income interests. Conversely, the short-term trust is disadvantaged by the gift tax tables if the actual return on investments is lower than the rate that is used in the tables. Currently, the tables are based on a 10% return compounded annually.

The major disadvantages are that the grantor must part with the transferred property for at least 10 years and that he will be taxed on capital gains recognized during the trust's term. This type of arrangement does not provide meaningful estate tax savings, and other devices must be used for that purpose.

**Funding.**

The optimum method of funding a short-term trust is to contribute property that produces a high rate of return. Several funding methods warrant a brief discussion.

One method that has been used is the "trust leaseback" approach. The grantor transfers to the short-term trust property, typically real estate, that the grantor uses in his business. The grantor then leases the property from the trustee at a fair rental. The grantor claims a deduction for the rent payments, and
(if all goes well) the rental income will be taxed to the trust or to the minor beneficiary at a lower tax rate than the grantor's marginal bracket. This arrangement is not for the faint of heart. There is substantial risk that it will not succeed in providing the tax benefits which are promised. If attempted, the following conditions must be satisfied for there to be any prospect of success. The trust must have only independent trustees. There must be a written lease providing a fair rental for a reasonable period. There must be a bona fide business reason for leasing the property. Even if all of those conditions are satisfied, two circuit courts (the Fourth and Fifth Circuits) have repudiated such arrangements and imposed an additional standard that is difficult to meet. Those courts felt that when viewed as a whole, including the creation of the trust, the transaction lacks economic reality. Three other circuit courts (the Second, Eighth and Ninth Circuits) and the Tax Court have approved such arrangements. Those courts hold that there need not be a business purpose for creating the trust; it is sufficient that there be a business purpose for the leaseback from the trust provided that the minimum conditions described above are satisfied.

Some commentators have recommended a plan under which the grantor establishes a short-term trust, borrows money from a bank, contributes the proceeds of the loan to the trust, and shortly thereafter borrows the same amount from the trust and repays the bank loan. This arrangement is designed for the parent who lacks liquid assets to fund a reversionary trust. The purpose of this scheme is to create a debt running from the grantor to the trust so that the grantor can pay interest to the trust and benefit from income splitting by effectively shifting that much income from himself to the trust or to his child. Shortly before the trust is to terminate, the grantor takes out a new bank loan and uses the proceeds to pay his debt to the trust. The trust then terminates and distributes its assets (the proceeds of the second bank loan) to the grantor pursuant to his reversionary interest. The grantor uses those proceeds to pay off the second bank loan. This plan has nothing to commend it. Even if the technical requirements of § 675 can be satisfied, it seems clear that the arrangement is a sham or step transaction. There are several variations of this plan with varying degrees of subtlety, but none of them is promising.

Non-reversionary Trust.

Instead of creating a short-term trust, which provides little estate tax savings, a parent may choose to dispose of the transferred assets permanently. As previously discussed, this can be accomplished by making a direct gift to the

194 Rosenfeld v. Commissioner, 706 F. 2d 1277 (2d Cir. 1983); Quinlivan v. Commissioner, 599 F. 2d 1277 (2d Cir. 1983), cert. denied, 444 U.S. 996 (1979); Brooke v. United States, 468 F. 2d 1155 (9th Cir. 1972); May v. Commissioner, 76 T.C. 7 (1981), aff'd, 723 F. 2d 1434 (9th Cir. 1984); Lerner v. Commissioner, 71 T.C. 290 (1978), acq. in result, 1984-1 C.B. 1.
minor child or by making a custodial gift. Another means of accomplishing this is to create an irrevocable trust in which the grantor retains no reversionary interest. A non-reversionary trust permits the grantor to obtain the income tax benefits of a short-term trust and also to reduce his estate tax liability by excluding subsequent appreciation of the donated assets from his gross estate. The gift of the remainder interest, taking possession after the expiration of the minor child's income interest, will be a future interest that does not qualify for the gift tax annual exclusion. So, except for the spousal remainder trust that is discussed below and for charitable remainder annuity trusts and unitrusts, the grantor will not obtain any transfer tax savings for the value of the remainder interest itself. The value of the remainder interest will constitute an adjusted taxable gift, with immediate gift tax consequences and with estate tax consequences on the grantor's death since the total of the grantor's adjusted taxable gifts will affect the marginal rate of estate tax that will be imposed on the grantor's gross estate.\textsuperscript{195} The grantor's potential estate tax reduction rests on the removal from his estate tax base of any subsequent appreciation of the transferred assets and of the income that is distributed to the minor beneficiary. To maximize estate tax savings, the grantor should seek to fund the trust with properties that he anticipates will substantially appreciate in value.

A major advantage of the non-reversionary trust is that the term of the trust need not be for 10 years or more. Since the grantor has no reversionary interest, the restrictions imposed by § 673 are not applicable. The 10-year restriction on reversionary interests makes it costly for a grantor to adopt a program of annual giving to a reversionary trust. The non-reversionary trust is especially useful if the grantor wishes to make additional contributions to the trust from time to time.

The transfer tax savings for making gifts to non-reversionary trusts will be maximized if the remainder interest in trust assets is created in such manner as to qualify for a gift tax and estate tax deduction. One means of accomplishing that is to create a charitable remainder annuity trust or a charitable remainder unitrust.\textsuperscript{196} The author will not examine the use and characteristics of charitable remainder trusts in this article.

An alternative means of qualifying the remainder interest in the trust for transfer tax deductions is to employ a spousal remainder trust—a trust whose income is payable to the minor child for a specified term after which the trust estate is to be distributed to the grantor's spouse. As will be shown, the spousal remainder trust does not usually provide substantial estate tax savings.

\textit{Spousal remainder trusts.}

This arrangement permits the grantor to provide an income interest for the

\textsuperscript{195} See, op. cit., n. 149.
\textsuperscript{196} §§ 2055(e) (2), 2522(c) (2). A charitable remainder annuity trust and a charitable remainder unitrust are defined in § 664(d).
minor beneficiary for whatever term he deems appropriate. The term of the income interest need not be as long as 10 years since § 673 is inapplicable. The grantor can make additional contributions at later dates without incurring adverse income tax consequences.

Except for the brevity of the trust’s term that is permitted, the income tax and gift tax consequences of transferring an income interest to the minor beneficiary are the same as those described earlier that attend a transfer to a short-term trust. Note that, under § 677, the grantor will be taxed on capital gains that the trust recognizes because capital gain income will be held in trust for future distribution to the grantor’s spouse. For that reason, § 644 does not apply.

The remainder interest in the trust will be given to the grantor’s spouse. The spouse’s interest must be structured so that it qualifies for the estate and gift tax marital deduction. A remainder interest is not a terminable interest, and so it can qualify for the marital deduction. Care should be taken to insure that the spouse’s interest is not contingent on the occurrence or nonoccurrence of an event, such as requiring that the spouse survive the termination of the income interest. The trustee’s powers should be restricted so that there is no possibility that those powers will detract from the value of the spouse’s remainder interest and thereby endanger the grantor’s qualification for a marital deduction. If the spouse’s remainder interest does qualify, there will be no transfer tax costs to the grantor’s parting with that interest.

If the trust were not created and if the grantor’s spouse should survive him, the grantor could bequeath to her the property that would have comprised the trust estate. Because of the marital deduction, this bequest would not cause any estate tax liability. The estate tax savings from giving the spouse a remainder interest in the inter vivos trust arise where the spouse does not survive the grantor. In that event, the spouse can bequeath the property in such manner that it is not included in the grantor’s gross estate on his death. But, this benefit could be obtained equally well by the grantor’s making outright gifts to the spouse.

The major objective of the spousal remainder trust, therefore, is to permit the grantor to adopt a shorter term for the minor’s income interest. A parent may wish to provide substantial amounts of income for the period that the child is in college but may not wish to have that amount of income available to the child after he graduates. The availability of a shorter term than 10 years can be very useful. The grantor can make larger contributions to such a trust since the value of the income interest, which qualifies for the gift tax annual exclusion, will be lower when the term of the income interest is shorter.

Consider the following illustration. G has a daughter, D, who is entering her sophomore year at State U. G wishes to have a trust for D provide her with about $10,000 annual income until she graduates. G is able to obtain a 10% return on his investments. G will need to transfer $100,000 to a trust to provide $10,000

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197 §§ 2056, 2523.
of annual income. If G creates a reversionary trust, D's income interest must extend for at least 10 years to avoid grantor trust treatment. If G were to transfer $100,000 to such a trust, the gift to D is $61,445.70. Even after electing split-gift treatment, this gift will exceed the annual exclusion by more than $41,000. Moreover, the income will continue to be payable to D for 7 years after she graduates.

Instead, G creates a spousal remainder trust in which D is given an income interest for a three-year term. The value of D's income interest in the $100,000 that G transferred to the trust is $24,868.50. Note that G's spouse can elect split-gift treatment for the gift of the income interest to D even though the spouse has a remainder interest in the trust since the value of the spouse's interest is ascertainable. After electing split-gift treatment, the amount of the gift in excess of the annual exclusion is slightly less than $5,000. No income will be payable to D after her graduation.

There are pitfalls to using the spousal remainder trust. The success of this program rests on what may be an inadvertent statutory omission. Section 673 does not impose grantor trust treatment where a spouse of the grantor has a remainder interest in a trust whose term is less than 10 years. Yet, §677 applies equally to income distributions to the grantor or to the grantor's spouse. It is unlikely that §673 can be extended to cover a spousal remainder trust, but the issue has not yet been raised.

Another concern is that this arrangement will not provide the desired results if the grantor’s spouse is a part owner of any of the contributed assets. In that event, the spouse would be the grantor of part of the trust, and so part of the trust’s income will be taxed to the spouse under §673. Gifts of jointly held property, community property or property that is treated similarly to community property should be avoided.

The spousal remainder trust should not be employed if there is any question as to the stability of the grantor’s marriage. Even where the marriage is stable, the grantor must be made to understand that this plan requires the grantor to part irrevocably with the transferred property and to vest that property indefeasibly in the hands of the spouse.

Student loans.

In deciding whether to make gifts to children or to trusts on their behalf, consideration should be given to the effect that such gifts might have on the child’s qualification for low interest student loans for college and post-graduate studies.

If a child obtains a student loan, the parent may wish to consider signing as a co-maker of the promissory note for the repayment of that debt if that will not impair the child’s qualification for future loans. If the parent is a co-maker of the note, any interest payments made by the parent on that debt will be

\[198\] Treas. Reg. § 25.2513-1(b) (4).
deductible by him since he is a co-obligor. However, no income of the child's or of a trust that was created by the parent should be used to make principal or interest payments on such debts. Any income from guardianship funds, custodial funds or from a trust created by the parent that are used to satisfy the debt may be taxed to the parent as having been made in satisfaction of his legal obligation. Since the debt is also that of the child's or trust's income that is applied to the debt, but caution dictates avoiding that issue.

V. 1985 TAX PROPOSALS

A number of proposals for tax amendments, generally referred to as "tax reforms," were made at the end of 1984 and in 1985. Three of those proposals warrant serious attention. In November 1984, the Treasury Department promulgated its recommendation for tax reform, which proposal is sometimes referred to as "Treasury I." After the White House examined Treasury I, the Treasury Department promulgated a new tax reform proposal which reflected the changes in the original proposal that the President desired. This second proposal, which is sometimes referred to as "Treasury II" or more commonly as the "President's Proposal," was promulgated in May, 1985. In 1985, the Ways and Means Committee substantially modified the President's proposal and reported its own tax bill, H.R. 3838. The Ways and Means bill, which is titled "The Tax Reform Act of 1985," was passed by the House in December, 1985. The bill will be taken up by the Senate in 1986. At this writing, it is unresolved as to whether a tax bill will become law, and, if so, what form it will have. In this article, I will focus on the Ways and Means bill, which passed the House.

There are two areas of the proposals that will impact significantly on the availability of means for reducing children's educational costs. The first of these areas is the proposed tax treatment of children's unearned income, and the second is the proposed treatment of trusts and estates. Before examining those areas, it will be useful to consider the tax rate schedule, the standard deduction and the amount of personal exemption that the Ways and Means bill would establish.

The Ways and Means bill would abandon the zero bracket amount concept and, in lieu thereof, would return to the standard deduction device. The standard deduction is available only to taxpayers who do not itemize their deductions. As proposed, the standard deduction would be comprised of two parts: a basic deduction of a dollar figure, the amount of which depends upon the filing status of the taxpayer (for example, single, married filing jointly,

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199 Sections 101 and 102 of H.R. 3838 (the Tax Reform Act of 1985).
200 § 63(a), (b) as proposed by section 102(a) of H.R. 3838.
married filing a separate return), and an additional standard deduction if the taxpayer or his spouse are aged or blind. The basic standard deduction is: $4,800 for a joint return or a surviving spouse, $4,200 for a head of household, $2,950 for an unmarried individual who is not a head of household or surviving spouse, and $2,400 for a married individual who files a separate return. No standard deduction is available to an estate or trust. The additional standard deduction is $600 for each item in which the taxpayer and spouse qualifies as aged or blind. These amounts are altered by a transitional provision for a taxable year that begins in 1986. Commencing with the year 1988, the dollar amount of both basic and additional standard deductions would be indexed for inflation.

For a taxpayer who qualifies as a dependency exemption for some other person, the taxpayer can utilize his standard deduction only to the extent of such taxpayer’s earned income for that year. Thus, the standard deduction of such a taxpayer cannot be used to reduce his passive income.

The bill would increase to $2,000 the amount of deduction for each personal exemption, including dependency exemptions, for a taxpayer who does not itemize his deductions. If a taxpayer itemizes his deductions, the amount of deduction for each of his personal exemptions, including dependency exemptions, effectively is reduced to $1,500. The manner in which the bill effectuates that reduction for itemizers may contain a flaw that permits the deduction of an exemption amount in excess of $1,500 for certain itemizers in special circumstances.

An estate is given a personal exemption of $600. A trust is given a personal exemption of $100.

If a taxpayer qualifies as a dependency exemption for some other person, the amount of deduction for that taxpayer’s personal exemption is $1,000 plus the lesser of $1,000 or the taxpayer’s earned income in excess of his standard deduction for that year. In essence, this provision limits the amounts of such

\[\text{\textsuperscript{201} \$63(c)(2) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{202} \$63(c)(4) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{203} \$63(c)(5) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{204} \$63(c)(6) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{205} \$63(f) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{206} \$63(c)(4) as proposed by section 102(a) of H.R. 3838.}\]

\[\text{\textsuperscript{207} \$151(f)(2) as proposed by section 103(a) of H.R. 3838.}\]
a taxpayer's personal exemption that can be deducted from his passive income to $1,000.

Beginning in 1987, the dollar amounts of deductions for personal exemptions would be indexed for inflation.\textsuperscript{208}

The exemption deduction for age and blindness would be repealed, and tax relief for those conditions would be provided by the additional standard deduction described above.\textsuperscript{209}

The tax schedule proposed by H.R. 3838 includes the following rates.

For married taxpayers filing jointly and for a surviving spouse:
- the first $22,500 of taxable income is taxed at a 15% rate;
- the next $20,500 of taxable income is taxed at a 25% rate;
- the next $57,000 of taxable income is taxed at a 35% rate;
- the remaining taxable income (i.e., taxable income in excess of $100,000) is taxed at a 38% rate.

For unmarried taxpayers who are neither a head of household nor a surviving spouse:
- the first $12,500 of taxable income is taxed at a 15% rate;
- the next $17,500 of taxable income is taxed at a 25% rate;
- the next $30,000 of taxable income is taxed at a 35% rate;
- the remaining taxable income (i.e., taxable income in excess of $60,000) is taxed at a 38% rate.

For estates and trusts and for a married taxpayer filing separately:
- the first $11,250 of taxable income is taxed at a 15% rate;
- the next $10,250 of taxable income is taxed at a 25% rate;
- the next $28,500 of taxable income is taxed at a 35% rate;
- the remaining taxable income (i.e., taxable income in excess of $50,000) is taxed at a 38% rate.

Commencing in 1987, the tax rate schedules will be indexed to account for inflation.\textsuperscript{210}

\textit{Minor Child}

Under current law, a minor child is taxed the same as any adult single taxpayer. One difference is that a taxpayer who qualifies as a dependency exemption for another cannot utilize his zero bracket amount for his passive income, but can use his personal exemption deduction to reduce such passive income. A minor child usually qualifies as a dependency exemption for his...

\textsuperscript{208} § 151(f) (3) as proposed by section 103(a) of H.R. 3838.
\textsuperscript{209} Section 103(b) of H.R. 3838.
\textsuperscript{210} Section 101(a) of H.R. 3838.
parent, and so that limitation often applies to minors.

If adopted, H.R. 3838 will impose even greater restrictions on the deductions permitted to a child who qualifies as a dependency exemption. As already noted, the bill would retain the restriction that such a child’s standard deduction (which the bill substitutes for the zero bracket amount concept) cannot be deducted from passive income. In addition, such a child will be permitted to deduct no more than $1,000 of his personal exemption from passive income (subject to a future increase because of indexing). If the child does not qualify as someone’s dependency exemption, those restrictions will not apply, and the child can deduct all of his $2,000 personal exemption and his standard deduction from passive income.

A more important change to the taxation of minor children is the treatment of certain passive income of a child who is less than 14 years of age. Section 1201 of H.R. 3838 would add a new subsection to §1. Under this new provision, the passive income of certain minor children may be subjected to the maximum tax rate that is applicable to individuals—38% under the current version of the bill. This special treatment applies only to a child who has not attained his 14th birthday and who has at least one parent who is living at the end of the taxable year in question. The income of a child who has attained age 14 in that year or in a prior year is not subject to any special treatment, other than the rules described above concerning the availability of personal exemptions and standard deductions for taxpayers who qualify as someone’s dependency exemption.

The special tax treatment of minors under 14 years of age applies only to certain passive income. It has no application to such child’s earned income. The passive income to which this special rule applies is referred to as “net parental source unearned income.” For the sake of brevity, “net parental source unearned income” is sometimes referred to hereafter as “PUI.” The purpose of the PUI concept is to identify passive income that is earned by assets that the child acquired (directly or indirectly) from a living parent or stepparent of that child. Income earned by assets acquired from other persons or from the investment of the child’s earned income is taxed to the child in the same manner as is income earned by adult individuals. An asset of the child’s that was not acquired from a living parent or stepparent is referred to as having been acquired from a nonparental source. An asset that was acquired by the child by reason of the death of a parent or stepparent is treated as having been acquired from a nonparental source, and so the income from such an asset is excluded from this provision. To be excluded from the special tax treatment imposed by this proposed provision, the assets acquired from nonparental sources must be identified and segregated from the child’s other assets. The statute describes an asset of the child that has been properly identified as having been acquired from a nonparental source as a “qualified segregated asset.” The manner in which such assets are to be identified in order to constitute qualified segregated assets

\[\text{\textsuperscript{211}} \text{§ 63(c) (5) as proposed by section 102(a) of H.R. 3838.}\]
\[\text{\textsuperscript{212}} \text{§ 151(f) (2) as proposed by section 103(a) of H.R. 3838.}\]
is left to the Secretary to resolve by promulgating regulations.213

If a child’s passive income cannot be shown to have been derived from a qualified segregated asset, it will be included in the child’s PUI. The PUI for a taxable year is the difference between the child’s passive income (other than income from qualified segregated assets) for that year less any deductions attributable to that income. The PUI cannot exceed the child’s taxable income. Therefore, such parental source passive income can be reduced by up to $1,000 of the child’s personal exemption.

Once the child’s PUI is determined, it will be taxed at a rate determined differently from other income of the child. The PUI will be taxed at the maximum marginal rate applicable to individuals (38% under the bill) unless the child has a parent or parents whose marginal tax rate is less than the maximum marginal rate and such parent or parents elect to allocate to the child all or part of such parent or parents’ unused lower tax bracket amounts. The manner in which such lower tax bracket amounts are to be allocated by parents would be determined by regulations to be promulgated by Treasury.214

D, a 10-year old daughter of H and W, has PUI of $20,000 in Year One. H and W file a joint return for that year and report taxable income of $85,000. Under the proposed tax rate schedule, the marginal tax rate applicable to H and W for that year is less than the 38% maximum rate. H and W could have earned an additional $15,000 of taxable income before they would have crossed over to the highest tax bracket. That $15,000 would be taxed at a 35% rate under the proposed tax schedule. Thus, H and W have $15,000 of unused 35% tax bracket amount which they can allocate under proposed § 646 among certain trusts and their children who have not attained age 14. If H and W elect to allocate all of their unused 35% tax bracket rate to D, the tax on D’s $20,000 of PUI will be $7,150 ($15,000 at a 35% rate and $5,000 at a 38% rate). If H and W allocate only $5,000 of their unused 35% bracket amount to D, the tax on her PUI will be $7,450 ($5,000 at a 35% rate and $15,000 at a 38% rate). If H and W fail to allocate any of their unused 35% tax bracket rate to D, her entire $20,000 of PUI will be taxed at a 38% rate.

The allocation of unused tax bracket amounts is made annually. Once an amount is allocated by a parent, that allocation is irrevocable. If upon a subsequent audit, the parent is determined to have a greater amount of taxable income than the parent reported, the parent cannot use any of the lower rate tax bracket amount that was previously allocated to a child or to a trust in determining the tax on the additional amount of income.215 Thus, in the example above, if H and W allocated all $15,000 of their unused 35% tax bracket rate to D, and if an audit results in a $4,000 increase in H and W’s taxable income, that additional $4,000 of income will be taxed at a 38% rate since no lower tax bracket rate is available.

215 Ibid.
Trusts

If adopted, H.R. 3838 will make major changes in the income taxation of trusts and beneficiaries. In this article, I will not discuss charitable trusts, alimony trusts and foreign trusts. I will address those aspects of the proposed amendments that would impact on trusts established for the benefit of children. Under the proposed revisions, different treatment is provided for six separate categories of domestic trusts: grantor trusts, non-grantor trusts where the grantor is living, non-grantor trusts where the grantor is deceased, qualified beneficiary trusts, qualified children’s trusts, and Mallinckrodt trusts.

Grantor trusts. Grantor trusts are treated the same under H.R. 3838 as they are under current law. Thus the grantor of a grantor trust is treated as the owner of the trust’s assets, or of that portion of the trust’s assets to which the grantor trust rules apply, for all purposes of applying the income tax rules. The bill, however, would narrow the circumstances in which the grantor trust rules will apply. There would be only three circumstances in which a trust will be so characterized. First, if the grantor or the grantor’s spouse retains the power to borrow from the trust without adequate interest or security or to purchase, exchange or otherwise deal with trust corpus or income for less than adequate consideration in money or money’s worth, the trust will be a grantor trust. Also, if the grantor or grantor’s spouse has borrowed corpus or income from the trust and has not completely repaid the loan, including all interest, before the beginning of a taxable year, the trust will be a grantor trust for that year. Second, a trust, or a portion of a trust, will be a grantor trust if the grantor or his spouse retain a current power to revest in the grantor or his spouse title to all or a portion of the trust. Third, a trust, or a portion of a trust, will be a grantor trust if the income of all or a portion of the trust is required to be, or may, in the discretion of the grantor or his spouse be: distributed to the grantor or his spouse; held or accumulated for future distribution to the grantor or his spouse; applied to the payment of premiums on insurance on the life of the grantor or his spouse (unless the policy is dedicated to a charitable purpose). Income of a trust will not be considered taxable to a grantor merely because such income may be applied for the support and maintenance of a person (other than the grantor’s spouse) whom the grantor is legally obligated to support, but the grantor will be taxed on any income that is so used.\textsuperscript{216}

A person other than the grantor will be treated as the owner of all or a portion of a trust with respect to which such person has a power \textit{exercisable by that person alone}, to vest corpus or income of the trust in himself. A person other than the grantor also will be treated as the owner of all or a portion of a trust where such person partially released or modified a power of the type that is described above and, after that release or modification, the person possesses such control over the trust as would cause a grantor to be treated as the owner of trusts.

\textsuperscript{216} § 652 as proposed by section 1211(a) of H.R. 3838.
the trust under grantor trust rules. A trust of this type is a Mallinckrodt trust. The grantor trust rules have priority over the Mallinckrodt rules so that a non-grantor will not be treated as the owner of any portion of a trust which the grantor is deemed to own.\footnote{\textsection 653 as proposed by section 1211(a) of H.R. 3838.}

Non-grantor trusts. The following discussion deals with trusts that are neither grantor nor Mallinckrodt trusts. The tax treatment of such a trust depends upon whether the grantor is living in that taxable year. Certain types of trusts, designated respectively as a "qualified beneficiary trust" and a "qualified children's trust" are given special tax treatment and are discussed below.

Before considering the remaining categories of trusts, let us consider several principles that apply to all types of trusts that are neither grantor nor Mallinckrodt trusts. First, the concept of distributable net income would no longer be used. A trust will be taxed on its income, and the beneficiaries will not be taxed on trust income regardless of whether it is distributed to them. This does not apply to the beneficiary of an alimony trust. Second, the taxable income of a trust is determined in the same manner as it is for an individual except for a few special provisions concerning personal exemptions and charitable deductions. A trust has no standard deduction, and it has a personal exemption deduction of $100. Third, the throwback rules would be repealed as there would be no need for them. Fourth, a trust can recognize a gain on the distribution to a beneficiary of an appreciated asset if the distribution is made in satisfaction of a pecuniary gift—i.e., the bill makes no change in current law's treatment of such distributions. Finally, a beneficiary's basis in property that the trust distributes to him in kind is equal to the trust's basis in such property immediately prior to the distribution increased by any gain or reduced by any loss recognized by the trust on making that distribution.\footnote{Section 1211(a) of H.R. 3838.}

Once the taxable income of a trust has been determined, it is necessary to determine the tax rate to apply to that income. I will first discuss a trust where the grantor is living and then one where the grantor is deceased. That discussion will not deal with two special types of trusts—the qualified beneficiary trust and the qualified children's trust—which are discussed separately immediately afterwards.

The first item to be resolved is the identity of the grantor of a trust. This problem arises most frequently when there are multiple grantors. Under the proposed \textsection 645, where several persons transfer property to the same trust, the portion of the trust that is attributable to each transferor is treated as a separate trust of which that transferor is the grantor. However, if a married couple make transfers to a single trust, they may elect on the trust's first year's tax return to treat one of them as the grantor of their combined transfers.

Where the grantor is living, the trust's taxable income will be taxed at a 38% rate except to the extent that the grantor allocates to the trust any of his unused
If the grantor does allocate to the trust any of his unused tax bracket amount, trust income of that amount will be taxed at the grantor’s unused rate. The manner in which this procedure operates is the same as that described above where a parent allocates an unused tax bracket amount to a child who has not attained the age of 14. The following illustration may be helpful to understanding how this allocation operates.

G created the T trust for the benefit of his two aunts. In Year One, the T trust has taxable income of $30,000. In that year, G has taxable income of $40,000. G filed a joint return with his wife for that year. G has an unused tax bracket amount of: $3,000 at a 25% rate, and $57,000 at a 35% rate. If G allocates all $3,000 of his 25% rate tax bracket amount and $27,000 of his 35% rate tax bracket amount to the trust, those rates will be applied to provide T with a tax liability of $10,200. If G fails to allocate any of his unused tax bracket amount to T, the trust’s taxable income will be taxed at a 38% rate, providing a tax liability of $11,400. If G allocates to T only $1,000 of his 25% rate unused tax bracket amount and only $10,000 of his 35% rate unused tax bracket amount, the remaining $19,000 of T’s taxable income would be taxed at a 38% rate.

If the grantor is not living, then the grantor’s estate and the trusts created by him must share the tax bracket amounts set forth in § 1(d) for trusts and estates. Thus, a single tax schedule is shared by the estate and all of the trusts. The tax bracket amounts are allocated among the estate and the trusts according to the provisions of the grantor’s will. If the grantor fails to make a provision for such allocation in his will, the tax bracket amounts will be allocated among the estate and trusts according to an agreement made by the trustees and the executor within 1 year of the grantor’s death. If there is no such provision in the grantor’s will and if no such agreement is made by the trustees and executor, the tax bracket amounts will be allocated equally among the trusts and the estate. Only trusts which notify the executor of their existence within 9 months of the grantor’s death are eligible for an allocation of a tax bracket amount unless such an allocation is provided by the grantor’s will. A qualified beneficiary trust and a qualified children’s trust are excluded from sharing with the estate and other trusts in that single tax rate schedule; the tax treatment of those two special trusts is described below.

Qualified Beneficiary Trust. The treatment of trust income that is described above does not apply to a qualified beneficiary trust—i.e., a trust for the benefit of a single beneficiary. A qualified beneficiary trust is a trust whose income and corpus may only be distributed to a single designated beneficiary, and, to the extent not so distributed to that beneficiary during his life, will be distributed to that beneficiary’s estate or as that beneficiary appoints under a general power of appointment (as defined for gift tax purposes). A QTIP trust, that is, a trust which qualifies as qualified terminable interest property for estate and gift tax

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219 § 642(a), (e) (1) as proposed by section 1211(a) of H.R. 3838.
220 § 642(b) as proposed by section 1211(a) of H.R. 3838.
marital deduction purposes, is treated as a qualified beneficiary trust.  

The taxable income of a qualified beneficiary trust is treated the same as a non-grantor trust where the grantor is living except that only the unused tax bracket amounts of the beneficiary can be allocated to the trust. Thus, the trust’s taxable income is taxed at a 38% rate except to the extent that the beneficiary allocates any of his unused tax bracket amount to the trust. If, in any taxable year, the beneficiary has not attained the age of 14 and has at least one living parent, the beneficiary cannot allocate any of his unused tax bracket amounts to the trust. In those years, the grantor is permitted to allocate his unused tax bracket amounts to the trust.  

If the assets of a qualified beneficiary trust are held in further trust after the death of the beneficiary (for example, pursuant to an exercise or lapse of the beneficiary’s general power of appointment), the trust is thereafter treated as having been created by such beneficiary.  

Qualified Children’s Trust. A qualified children’s trust is a trust all of the corpus and income of which may only be distributed to or for the benefit of the children of the grantor, and, to the extent not so distributed during the term of the trust, will be distributed to: the grantor’s children, the estates of deceased children, or as one or more deceased children may appoint under a general power of appointment (as defined for gift tax purposes). While only children of the grantor can have any beneficial interest in such a trust, the interests of each child need not be fixed in the trust instrument provided that the discretion to spray income or corpus is granted only to an independent trustee. A descendent of a deceased child of the grantor is treated as a child of the grantor who can be a beneficiary of such a trust. Also, after-born and after-adopted children can be added as beneficiaries of the trust. A trust which has only a single beneficiary (a qualified beneficiary trust) cannot be a qualified children’s trust—i.e., the qualified beneficiary trust provisions take priority.  

The tax rate applicable to the taxable income of a qualified children’s trust is 38% unless lower unused tax bracket amounts are allocated to the trust. The minor beneficiaries of such a trust can allocate to the trust any of their unused tax bracket amounts. A minor beneficiary is one who has not attained the age of 21 before the close of that taxable year. However, no allocation can be made by a beneficiary who has not attained the age of 14 and who has at least one parent living at the end of the taxable year. In addition to the unused tax bracket amounts allocated by such minor beneficiaries, the grantor is permitted to allocate any of his unused tax bracket amounts to the trust. This permission is in contrast to the treatment of a qualified beneficiary trust where the grantor is barred from allocating any of his unused tax bracket amounts unless the beneficiary is under the age of 14.  

221 § 642(c) (2) as proposed by section 1211(a) of H.R. 3838.  
222 §§ 642(c) (1), (e) (1), 646(b) as proposed by section 1211(a) of H.R. 3838.  
223 § 642(c) (2) (C) as proposed by section 1211(a) of H.R. 3838.  
224 § 642(d) (2) as proposed by section 1211(a) of H.R. 3838.  
225 §§ 642(d) (1), (e) (2), (3), 646(b) (1) as proposed by section 1211(a) of H.R. 3838.
Reducing Educational Costs After the 1985 Tax Reform Act.

If H.R.3838 is enacted, the opportunities for reducing a child’s educational costs will be substantially circumscribed. Not all such opportunities would be lost, however. A few of the avenues that would remain open are noted below.

Under current law, a trust can qualify as a separate taxpayer which can split its income with the beneficiaries by making distributions to them. The benefit of income splitting between trust and its beneficiaries would be eliminated by H.R.3838.

One technique that would be reduced in use and perhaps entirely eliminated by the proposed amendments is the reversionary or short-term trust, which, currently, is the most popular device that is employed for cost reduction purposes. A short term trust typically would be taxed at the grantor’s marginal rate, or at the maximum rate that is applicable to an individual, and so there would be no tax benefit to creating such a trust. The trust could utilize its $100 personal exemption, but that small benefit is more than outweighed by the cost of establishing and administering such a trust. However, one possibility remains for using short-term trusts. A reversionary trust, regardless of the brevity of its term, does not constitute a grantor trust merely because of the grantor’s reversionary interest. A non-grantor short-term trust could be established for a beneficiary or beneficiaries who have attained age 14 and such beneficiaries could be granted powers to vest trust income or corpus in themselves so that portions of the trust will be a Mallinckrodt trust under proposed § 653. If successful, trust income will be taxed to the beneficiaries as the owners of the trust.

The reduction in tax costs that can be obtained after H.R.3838 is adopted rest on the lower tax bracket of the parent’s child. Also, the amount of income that can be sheltered by the child’s personal exemption and, where available, by the child’s standard deduction will reduce tax costs significantly. Direct gifts and gifts to a custodian can serve that purpose. Except for children who are under the age of 14, the proposed rules do not significantly change the benefits and detriments that currently arise from making such gifts.

For a child who is under the age of 14, it would be useful to transfer sufficient assets to produce approximately $1,000 of income since that amount of passive income can be sheltered by the child’s personal exemption. If larger amounts are desired, it might be possible to have direct or custodian gifts made by a relative other than a parent or stepparent so that such funds will constitute qualified segregated assets. Of course, if the consideration for the gift to the child is traceable to the parent or stepparent, the gift will be deemed to have been acquired from a parental source. But, this test may be difficult to administer even if all the relevant facts are disclosed to the Commissioner, which may not always be the case. Consider the following example.

Grandfather, G, has a substantial amount of life insurance the ownership of which, for estate tax reasons, he wishes to assign to his daughter, D. D has an eight-year old son, S, whom D would like to have taxed on passive income. G
assigns the life insurance policy to D, and G plans to pay the premiums that subsequently become due on the policy. Instead, D pays the premiums, and G makes gifts to S of amounts that approximate the amount of premium that D pays on the policies. It would seem that the gifts to S would be qualified segregated assets if properly identified in compliance with forthcoming regulations. While, under the amendments proposed to be made to the generation-skipping provisions, G's direct gift to S could have generation-skipping tax consequences, the proposed tax exemption of $1,000,000 should render those consequences of relatively small significance.

If a parent wishes to have income used for a child's college expenses, one disadvantage of direct gifts and custodian gifts is that the child obtains control of the corpus of such gifts at an early age. In such cases, the parent might create an irrevocable trust for such child with final distribution of corpus deferred until the child attains some specified age. Such a qualified beneficiary trust would be useful to obtain the benefit of the child's lower tax bracket once the child attains the age of 14.

If a parent has several children of disparate ages, a qualified children's trust may prove to be a useful vehicle. By appointing an independent trustee, the parent can provide for the spraying of trust income and corpus so that the children attending college will be supported by the trust. The trust could benefit from the lower tax brackets of those children who are under the age of 21 (but who have attained their 14th birthday) even if no distributions are made to such children in that year. Also, Crummey type powers might be employed to make portions of a trust for children a Mallinckrodt trust whose assets are treated as owned by the children.