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Taxation - Federal Income Taxation - Problems Created by the Complex Trust Provisions of the 1954 Code

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TAXATION—FEDERAL INCOME TAXATION—PROBLEMS CREATED BY THE COMPLEX TRUST PROVISIONS OF THE 1954 CODE—The provisions of the Internal Revenue Code of 1954 for the taxation of the income of trusts are the most extensive revisions ever made in this tax area. Although the general pattern of taxing trusts as separate taxable entities on a conduit principle is continued, the new law in effect codifies what was previously set out in a single statutory section[1] and in regulations,[2] case decisions, and Treasury rulings and decisions. While most of the problems arising under the 1939 code have been solved in the new law, some have properly been neglected while others are left to be determined through litigation. This comment will not be expository of all of the trust provisions but rather will attempt to deal with some of the more important interpretative difficulties likely to be encountered in the new law involving the taxation of the income of those trusts which may accumulate income, distribute corpus, or pay or set aside amounts for charitable purposes. It will be assumed that the reader is familiar with the basic statutory pattern of the trust sections of the new code.[3]

[1] I.R.C. (1939), §162.

[2] Treas. Reg. 118, §39.162.

[3] The general statutory plan of the 1954 Internal Revenue Code sections involving complex trusts is: §§641-643, general rules for taxation of estates and trusts; §§661-663, estates and trusts which may accumulate income or which distribute corpus; and §§665-668, treatment of excess distributions by trusts.

I. *Exclusion from Taxation of Certain Gifts and Bequests*

Not all distributions from income or corpus are treated as distributions taxable to the extent of distributable net income. An exception is made in the case of certain gifts or bequests. The 1954 code excludes as an income distribution any amount which, under the terms of the governing instrument, is (1) payable as a gift or bequest of a specific sum of money or specific property; (2) payable to a beneficiary in a lump sum or in not more than three instalments; and (3) not payable only from the income of the trust.[4]

As the distributions which are excludable are limited to three instalments, there arises a question as to what type of distribution will be considered an instalment. What the courts will interpret as an "instalment" is speculative. An answer can be predicated on the idea that Congress, in allowing three instalments, considered four or more separate payments as something other than a bequest or gift of a single amount. It would appear that a distribution which would continue intermittently over more than a taxable year would at least approach something beyond a lump sum payment. However, from the statutory language of this section, which refers to amounts payable "under the terms of the governing instrument,"[5] it appears that the exemption should not be lost by virtue of any subsequent arrangements between the beneficiary and the trustee. Hence an instalment might be divided up and paid at intervals spanning a period greater than a year if the trustee and beneficiary so agree. In all probability, additional current payments to a beneficiary will not be regarded as instalments. Thus, a beneficiary who gets yearly distributions of income plus a lump sum payment of $10,000 on his marriage will not be taxed on the latter distribution as the annual distributions would not be considered instalments.

Since Congress indicated no time limitation for the spacing of the instalments, it follows that they need not be at specific times so long as the payments are kept below four in number. If the trustee is permitted to distribute the payments at his discretion, the distributions would be taxable. If he is required by the governing instrument to distribute in three instalments, payable at a time which he feels is proper, the exclusion for gifts or bequests would apply. Discretion will be allowed to exist, apparently, as to the time of payment of a specified three or less instalments, but discretion will not be permitted as to the

[4] I.R.C. (1954), §663(a)(1).
[5] Ibid.

amount of the instalments. Likewise, the exemption will not operate where three payments are specified and more are allowed at the trustee's discretion, as this would be doing indirectly what could not be accomplished directly.

II. *Separate Shares of Beneficiaries*

A concept of separate shares, applicable only to complex trusts, was introduced for the first time by the 1954 code. Where a single complex trust has more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust are treated as separate trusts, but only for the purpose of determining the amount of distributable net income which is taxable to each beneficiary.[6] The object of this subsection is to prevent a beneficiary from being taxed on a distribution of corpus by reason of the fact that trust income is being accumulated specifically for another beneficiary.[7] A defect existing under prior law is thus eliminated. By way of illustration, suppose a trust has distributable net income of $10,000 and income beneficiaries *A* and *B*, and the trustee (1) pays $5,000 of the income to *A*, (2) accumulates *B*'s $5,000 share of income for distribution to him in the future, and (3) pays *A* $5,000 from the corpus in a discretionary disbursement. Were it not for this provision, *A* would be taxed on $10,000 rather than $5,000 although the latter figure represents the share of income intended for him. Other variations in the use of this section are numerous. The grantor may be allowed to allocate different classes of distributable net income to different beneficiaries, with one beneficiary getting income from tax-exempt securities and the other receiving the remaining income.[8] The rules by which to determine the existence of substantially separate and independent shares,[9] and their manner of treatment, are matters which are left to the Treasury to prescribe by regulations.[10]

[6] I.R.C. (1954), §663(c).

[7] S. Rep. 1622, 83d Cong., 2d sess., pp. 84, 355 (1954).

[8] See "Federal Income Tax Statute," 2 A.L.I. 131, 417, 442 (February 1954 draft) for an explanation of further possibilities of this section. The A.L.I. proposal in regard to the treatment of separate shares is almost identical to that which Congress adopted.

[9] "The determination, however, should have to be made only once, based on the terms of the instrument and the likelihood of various contingencies; it should not depend yearly on the actual occurrence or non-occurrence of the contingency. A share should not normally be treated as substantially separate and independent one year, and not so separate the next." Id. at 445.

[10] I.R.C. (1954), §663(c).

Although the separate share provision is not intended to alter the determination of the existence of separate trusts,[11] conflict between these two concepts seems inevitable. Congress has indicated that the test for determining the existence of separate shares should be founded on whether the grantor has clearly intended each beneficiary to have a definite share.[12] However, the manifested intent of the grantor is also the test for ascertaining how many separate taxable trusts have been created by one trust instrument.[13] The courts will be forced to draw a fine, artificial hairline between the intent needed to create separate and independent shares and the intent needed to create more than one trust. In the former, the separate interests are treated as separate shares only for the purpose of allocating distributable net income and cannot be applied to obtain multiple personal exemptions or to allow the splitting of undistributed income into multiple shares for purposes of being taxed at lower bracket rates.[14] In multiple trusts these advantages are available. In determining whether multiple trusts have been created by a single trust instrument from a single corpus, evidentiary facts outside the trust instrument will be significant, particularly the separate or joint character of the accounts and records maintained.[15]

Rather than attempt to demonstrate in the trust instrument the intent required for the creation of separate shares, it is recommended that a grantor of a complex trust having several beneficiaries reach for the more fruitful tax advantage offered in creating multiple trusts. A simple statement in the instrument that it is the grantor's intention to create multiple trusts would seemingly accomplish this objective.

III. *The Five-Year Throwback Rule*

In selecting a means by which to check the practice of accumulating income for tax-saving purposes, Congress has chosen the concept[16]

11 S. Rep. 1622, 83d Cong., 2d sess., p. 355 (1954).

12 Id. at 85.

13 United States Trust Co. v. Commissioner, 296 U.S. 481, 56 S.Ct. 329 (1936); Helvering v. McIlvaine, 296 U.S. 488, 56 S.Ct. 332 (1936); Fidelity Union Trust Co. v. Kelly, (3d Cir. 1939) 102 F. (2d) 333.

14 S. Rep. 1622, 83d Cong., 2d sess., p. 355 (1954).

15 United States Trust Co. v. Commissioner, 296 U.S. 481, 56 S.Ct. 329 (1936); Helms Bakeries, 46 B.T.A. 308 (1942), acq. in 1942-1 Cum. Bul. 8; Hale v. Dominion Nat. Bank, (6th Cir. 1951) 186 F. (2d) 374. See KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES §1.16 (1948), for a detailed consideration of multiple trusts.

16 Another possible solution for income taxation of trusts is to tax all undistributed trust income at the maximum surtax rate. This idea was explored in James, "Irascible Comments on the Revenue Laws," 9 UNIV. CHI. L. REV. 58 at 63 (1941). "No one has

of distributable net income and the five-year throwback rule to replace the impractical 65-day and 12-month rules of former law.[17] Under the new code, if distributions exceed current distributable net income by more than $2,000, the entire excess over distributable net income will be thrown back in each of the five preceding years (in inverse order) and taxed to the beneficiaries to the extent that distributable net income in those years was not, in fact, distributed. This tax is not allowed to be more than it would have been had the beneficiary actually received the additional amounts in the preceding years. A double tax on the income is eliminated by allowing the beneficiary a credit for the proportionate part of the tax paid by the trustee in the prior years.[18]

A. *Exceptions to the Rule.* Absolute as it is, Congress has permitted four major exceptions to the throwback rule. First, the rule will not apply to amounts accumulated before the beneficiary's birth or before he reaches the age of twenty-one.[19] This will permit the trustees to pay for the support and maintenance of a beneficiary until he reaches his twenty-first birthday. No particular difficulty arises in the case of small accumulations, but in so limiting the exception, it would seem that the drafters were under the generally unfounded apprehension that upon becoming twenty-one a beneficiary becomes competent to handle money. In effect, the present throwback rule approaches equating the law of the nation with that of New York[20] and a few other states,[21] where accumulations of income are not permitted except during the minority of a beneficiary.

The following example illustrates a problem created by the exception just described. A trust is established to accumulate income for a beneficiary who is a minor, the accumulation to continue until the beneficiary is thirty years old. The accumulated income is then over a

ever advanced any reason for taxing trusts at the same rate as individuals, and no serious constitutional questions would be raised by taxing them at different rates. If the undistributed income of private trusts were taxed, let us say, at a basic rate of 80 per cent, the income of such trusts would be forced out and distributed to beneficiaries."

[17] I.R.C. (1939), §§162(d)(2), 162(d)(3). To alleviate hardships on trusts which were created in reliance on the 65-day rule of prior law, fiduciaries of trusts existing prior to January 1, 1954 can irrevocably elect to adhere to the pre-65 day rule, if by the terms of the trust, amounts in excess of income of the preceding taxable year may not be distributed in any taxable year. I.R.C. (1954), §663(b).

[18] I.R.C. (1954), §§665-668.

[19] I.R.C. (1954), §665(b)(1).

[20] 49 N.Y. Consol. Laws (McKinney, 1945) §§61a, 62, 63; 40 N.Y. Consol. Laws (McKinney, 1949) §§16, 17, 17a.

[21] For a collection of the statutes on accumulations in force in the United States, see 4 PROPERTY RESTATEMENT, c. 36, topic 1 (1944); 1948 SUPPLEMENT RESTATEMENT, Property note, c. 36, topic 1 (1949).

period of ten years gradually dispersed to the beneficiary, together with distributions of the entire current income. How will it be ascertained what part of the distribution constitutes accumulated income which is exempt from the throwback rule? What part constitutes accumulated income subject to the throwback rule because accumulated in the nine years after the exemption expires? As the trustee or beneficiary should not be permitted to classify the accumulated income arbitrarily, it would be advisable that some definite standard be adopted. If the exempt accumulation is deemed to be distributed on a first-in first-out theory, the throwback rule could have no application. During the first five years of distributions, from age thirty to thirty-five, there would be no undistributed net income since all current income is being distributed. Hence, when the accumulated income theoretically subject to the throwback rule is subsequently distributed from ages thirty-five to forty there is no period into which the undistributed net income may be thrown back as the rule is limited to a period of five years. It can thus be seen that an application of a FIFO method of accounting would, in some instances, defeat the effort to prevent tax avoidance. Employment of either a method of rateable apportionment of each class of accumulated income during the ten years, or a last-in first-out theory, would reduce the possibility of tax avoidance. The Senate has indicated that this problem should be clarified by the regulations.[22]

Further complications are raised by this section when income is accumulated for a beneficiary who never comes into being or fails to reach the age of twenty-one. It might be argued that this exemption applies only to the specified beneficiary, and that when the accumulated income is distributed to other beneficiaries the exemption from the operation of the throwback rule is lost. However, since these accumulations might be made in reliance on the exemption from the throwback rule, the purpose of the rule would not be defeated if the subsequent beneficiaries were to be given the benefit of the exempted accumulations. It is likely, therefore, that once the exemption for accumulations is obtained it will never be lost as to that accumulation if the original trust provision was not created as a tax avoidance device for the subsequent beneficiaries.

Another statutory exception to the throwback provision is applied to amounts payable to a beneficiary to meet the "emergency" needs of such beneficiary.[23] The specific facts and circumstances that will give

[22] S. Rep. 1622, 83d Cong., 2d sess., p. 357 (1954).
[23] I.R.C. (1954), §665(b)(2).

rise to an "emergency" will only be determined through continued litigation. The Senate indicated that unforeseen or unforeseeable circumstances requiring immediate help would qualify if the beneficiary was in actual need of a distribution. The courts will in all probability make use of previous decisions of state courts which have interpreted trust instruments containing similar emergency provisions.[24] Clearly the emergency test should be a subjective one. Reason dictates that a "high income" bracket beneficiary, temporarily short of liquid resources, should be able to get the necessary $100,000 to prevent the foreclosure of the mortgage on his mansion as readily as a "low income" bracket beneficiary is able to get $3,000 to retain his homestead.

The third exception to the throwback rule takes the form of amounts payable at specified ages, if (1) there can be no more than four such distributions to such beneficiary, (2) the period between distributions is at least four years, and (3) such distributions were specifically required by the trust instrument on January 1, 1954.[25] This subsection was included to prevent inequities to existing trusts in which provision had been made for the benefit of minors and dependents, the typical case being that in which the trustee is directed to accumulate the income for a limited period and pay to the beneficiary only those amounts that he, the trustee, might deem necessary. It was felt that such trusts had legitimate purposes.[26] These trusts were generally not within the gift exclusion as they were not gifts of specific sums of money[27] but rather sums determinable by the trustee.

The last exclusion from the throwback rule is a final distribution made more than nine years after the date of the last transfer to the trust.[28] Originally this provision was similar to the Clifford regulations[29] in providing for a period of ten years, but it was changed to nine at the last minute. Those regulations, now embodied in the code, provide that where a grantor creates a trust for the life of the beneficiary,

[24] See Dobbin's Estate, 148 Pa. Super. 177, 24 A. (2d) 641 (1942), where the right of the cestui of a spendthrift trust to withdraw sums "in the event of emergency" was held to warrant withdrawal to prevent foreclosure of a mortgage on property which would result in the loss of a large investment of the cestui. In Lyter v. Vestal, 355 Mo. 457, 196 S.W. (2d) 769 (1946), the court held that a provision for an "emergency" withdrawal from the trust corpus referred to a situation in which the financial resources of a widow, including her income from the trust estate, were in such a state of insufficiency that encroachment was immediately necessary. See also In re Shiel's Will, 120 N.Y.S. (2d) 632 (1953).

[25] I.R.C. (1954), §665(b)(3).

[26] S. Rep. 1622, 83d Cong., 2d sess., p. 86 (1954). For the congressional hearing that gave rise to the passage of this subsection, see S. Hearing on H.R. 8300, 83d Cong., 2d sess., part IV, p. 1830 (1954).

[27] I.R.C. (1954), §663(a)(1).

[28] I.R.C. (1954), §665(b)(4).

[29] Treas. Reg. 118, §39.22(a)-21 as now incorporated in I.R.C. (1954), §673 et seq.

retaining for himself the reversionary interest, and the beneficiary dies before the passing of ten years, the trust is valid for Clifford purposes even though it could reasonably be expected that the beneficiary would not live for the full ten years.[30] In enacting the new code, the Senate apparently overlooked this consideration. The inclusion of a provision making an exception such as the one appearing in the Clifford regulations would merely qualify the nine-year limitation. It would not interfere with the intended function of the limitation, which was to prevent the establishment of trusts for accumulating income and making final distributions within reasonably short periods so as to avoid the throwback rule. As the law now stands at present, if a grantor creates a trust for a person with a life expectancy of not more than nine years, and the income is accumulated because it is not then needed by the beneficiary, the five-year throwback rule will operate to tax the accumulated income when the beneficiary dies within the nine-year period.

Under this section as it is specifically written a transfer of a small gift to the trust by a third party, when authorized by the trust instrument, will apparently prevent the application of this exemption from the throwback rule. It would seem that Congress neglected to consider this. The provision should have included the additional words "by the grantor" at the end of the statutory sentence.

B. *Effectiveness of the Rule.* There is little doubt that the throwback rule is a penalty provision which has rendered a trust to accumulate fairly impotent as a tax avoidance device for beneficiaries subject to high surtaxes. Nevertheless, there seems to be some question whether the complexity of the throwback provision will prevent its practical administration. The simplest throwback problem will burden the average fiduciary with paper work. When further factors are added such as charitable distributions, net capital losses, extraordinary and taxable stock dividends, dividends-received credit, foreign income, and different levels of distribution to a number of beneficiaries, the possibility that a fiduciary will be buried is not too remote.

As extensive as the five-year throwback rule is, there are still some situations where it does not operate properly. For example, it can be avoided by an arrangement whereby the trust accumulates all of its income for several years and then distributes only the current income for five years. In the next year the accumulated income is distributed

[30] Ibid.

to the beneficiaries tax free since no undistributed net income existed for any of the prior five years.

How the throwback rule will work out in actual practice is difficult to predict. It is possible that in a given case it will work to the advantage of the beneficiary. If the trust is in a high bracket in the taxable year in which it receives income, but the beneficiary is in a low bracket in the taxable year in which he receives the accumulated income, the beneficiary will get a windfall of the proportionate part of the trust's tax as a credit against his entire tax liability regardless of the source of his income. If, in the year that the trust receives the income, the tax bracket of the trust is substantially higher than that of the beneficiary in his taxable year, it is even possible that the credit will completely cover the beneficiary's outside income.[31]

IV. *Conclusion*

In all probability there will be a Revenue Act of 1955 which will make the necessary technical amendments to close the scattered loopholes and clarify the ambiguities of the present statute. With the introduction by the 1954 code of new principles of taxing complex trusts, problems have been created for the draftsman of trust instruments. Cautious drafting, motivated by legitimate trust objectives rather than by tax avoidance aims, will yield fair and equitable taxation, the congressional goal in enacting the new code. How well the renovated theory of the new code will work will not be known until the law has had an opportunity to be tried in practice. We will have to wait and see.

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[31] For a detailed illustration of this possibility, see RESEARCH INSTITUTE OF AMERICA, 1954 REVENUE ACT COORDINATOR, ¶54 C-407 (1954).