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ESTATE, TRUST, AND DECEDENT INCOME

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Many taxpayers, for some reason, are reluctant to share their wealth, even with their families. Many taxpayers, for the same reason, are eager to divide their surtax brackets, especially with their families. Trusts often permit the division of surtax brackets to a greater degree than they require the sharing of wealth. Trusts are, therefore, popular with many taxpayers.

That part of the subject assigned to me which deals with the taxation of the income of trusts under the Internal Revenue Code of 1954 has the familiar flavor of the historic battle of ingenuity between taxpayer's counsel in devising, and the government in frustrating, plans for the simultaneous eating and having of cake.

Although the tax consequences are favorable, dying evidently is believed to involve other consequences too extreme and final ever to become a popular means of avoiding income taxes, and, in the sections of the 1954 code applicable to the taxation of a decedent's post-mortem income and the income of his estate, the sovereign presents a more benign countenance, indulging the presumption that the death of the citizen stemmed from non-tax considerations.

The sections of the Internal Revenue Code of 1954 dealing with these two aspects of taxes and death are collected in Subchapter J of Chapter I of Subtitle A and are headed "Estate, Trusts, Beneficiaries, and Decedents."

Subchapter J is one of the eighteen subchapters of Chapter I, which is devoted to "Normal Taxes and Surtaxes." Together with five other chapters, it comprises Subtitle A, "Income Taxes," one of the six subtitles of the Internal Revenue Code of 1954.

Subchapter J is divided into two parts:

Part I—Estates, Trusts and Beneficiaries
Part II—Income in Respect of Decedents

Part I is divided into six subparts:

Subpart A—General Rules for the Taxation of Trusts and Estates
Subpart B—Trusts Which Distribute Current Income Only
Subpart C—Estates and Trusts Which May Accumulate Income on Which Distribute Corpus
Subpart D—Treatment of Excess Distributions of Trusts
Subpart E—Grantors and Others Treated as Substantial Owners
Subpart F—Miscellaneous

Having created six subparts and found them good, Congress rested and did no work on the seventh. Part II contains only two sections and is not divided into subparts.

The number of the first section of each subpart of Part I and of the first section of Part II, like the first number on each block along Fifth Avenue in New York, begins a new series of ten, whether or not the previous subpart contains ten sections. Thus, although there are twenty-five sections in Subchapter J, the numbers run from 641 to 692.

Part I covers roughly the same ground as Supplement E, "Estates and Trusts," of the 1939 code, Sections 161 to 172. However, Section 165 of the 1939 code, "Employees Trusts," has been moved over to Subchapter D of the 1954 code, "Deferred Compensation, Etc.," and Section 169 of the 1939 code, "Common Trust Funds," is part of Subchapter H, "Banking Institutions," and are not covered here.

The remaining sections of Supplement E emerge as Part I after being thickly diluted with the draft prepared by the American Law Institute and greatly expanded by lifting the *Clifford* regulations to the statutory level.

Part II is derived from Sections 126 and 154 of the 1939 code. The latter, which deals with the income taxes of the Armed Forces on death, will not be dealt with in this article.

Trusts which constitute associations taxable as corporations are not mentioned in Subchapter J, nor were they in Supplement E. The controlling law is found in the decisions of the courts construing the definition of a corporation carried from the 1939 to the 1954 code without change as part of a general definitions section.

The basic concepts of the taxation of trusts and estates have been preserved and, in fact, strengthened by the 1954 code, but there have been major changes of organization, form, and machinery and several important changes of substance.

I

The first principle of the law pertaining to the taxation of estate and trust income is the dual nature of a trust or estate for tax purposes. Just as a partnership is for some purposes treated as an aggregate and for some purposes as an entity, a trust or an estate (which, after all, is not more than a particular kind of trust, arising by operation of law) is for some purposes a separate tax-paying entity and for other purposes a mere conduit for the distribution of income and principal, or both, to its beneficiaries. Almost all of the complications of the law pertaining to this branch of my subject consist of little chips which come loose from the rough edges of these two concepts when they are squeezed together into an artificial union.

In the capacity of a trust as a separate tax-paying entity there are no very revolutionary differences between it and an individual taxpayer. Both are subject to taxation at the same rates, although a trust is expressly denied the optional standard deduction and is incapable of enjoying the tax advantages of matrimony.

An estate has a personal exemption of $600, as under prior law. The 1954 code makes a new distinction, which I will discuss later, between trusts which are required to distribute all of their income currently, on the one hand, and estates and trusts which may accumulate income or which distribute corpus, on the other. Although the code does not use the terms "simple" and "complex," all of the explanations I have seen refer to the former as simple and the latter as complex. Simple trusts are given a personal exemption of $300, an increase of $200 over the former exemption allowed to all trusts. This is to soak up small amounts of capital gain or stock dividends which constitute additions to corpus under local law or the trust instrument, but which are income for tax purposes. Complex trusts retain the $100 exemption.

The moral of this chapter is pretty plain. Not so much because of the separate personal exemptions, but because tax brackets start again at the bottom for each separate taxpayer, use as many separate trusts as possible. If a single instrument is used to create trusts for several beneficiaries each having a fixed share of the corpus, whether one or several trusts will result for tax purposes will depend upon the intention of the grantor as evidenced by the language used. Therefore, either use language so plain as not to be open to debate or use separate instruments. A trustee may be authorized to consolidate the accounting and investment treatment of several separate trusts without thereby sacrificing their separate identity for tax purposes.

As I have said, a trust in its capacity as a separate tax-paying entity is treated for most tax purposes the same as an individual. Its income is not only taxed at the same rates but also determined and computed in the same manner. With two important exceptions, it has the same deductions as an individual. The first of those exceptions is that a trust has an unlimited deduction for amounts of gross income paid, permanently set aside or used for charitable purposes during the taxable year. This is not so very remarkable, considering that the grantor could have set up a charitable trust in the first place. To this exception there is the exception that, if the trust is caught finagling with the grantor in what the code calls prohibited transactions or is guilty of unreasonable accumulations of amounts set aside for charitable purposes or devotes the contributions to earning unrelated business income, like New York University's spaghetti factory, then the unlimited charitable contribution is lost and the trust, if guilty of prohibited transactions or unreasonable accumulations, has the same charitable contribution deduction limit as an individual under the 1954 code. A trust gets no deduction for contributions allocable to the production of unrelated business income but is allowed the same deductions as an individual in computing that income. A contribution by a trust to the Mueller Spaghetti Company, for example, would be non-deductible, but the Spaghetti Company could deduct its contributions to New York University.

The other distinctive deduction of a trust is the deduction for distributions to its beneficiaries given to effect the bifurcation of its function between the accumulation and distribution of its income. I shall defer discussion of that deduction until the trust as a conduit for the distribution of income has been covered.

To the extent that the income of a trust is currently distributable to its beneficiaries, the trust is treated principally as a conduit, and the tax consequences are generally the same as if the trust had not been set up and the income distributed to the beneficiaries had been taxed directly to them in the first place without the intervention of any trust. Of course if the trust and the beneficiary have different taxable years, there has to be a rule to permit each to cast up its accounts on the annual basis, and that rule, as you would expect, is that the beneficiary has to include in his taxable income the taxable income passing to him through the conduit of a trust having a taxable year ending before or simultaneously with the close of his own taxable year.

There is no special trust problem in determining when income is earned, but the ingenuity of taxpayers in figuring out ways of sitting on the fence until it was certain which way it would save the most taxes to jump, has led to the development of some special rules as to when income is considered as distributed. First, as to trusts which are required by the terms of the trust instrument or by local law to distribute all of their income currently, the law has always been and still is that the entire taxable income of a taxable year is treated as having been distributed within the taxable year whether or not it is actually distributed. As to trusts in which it lies within the discretion of the trustee whether income is to be currently distributed or accumulated, the old rule was that income which was properly paid or credited to the beneficiaries within the tax year was treated on the conduit principle and the remaining income on the separate tax paying entity principle. Taxpayers developed the wait-and-see habit to such an extent that the taxable year was artificially extended sixty-five days for the purpose of deciding what distributions were to be considered as having been made to the beneficiaries. The 1954 code, as we shall consider, has developed what was supposed to be much heavier artillery than the sixty-five-day rule to use against taxpayers who would exploit lower brackets available to trusts for the current taxation of incomes to be later distributed tax-free to high-bracket beneficiaries, and has no need for the sixty-five-day rule. Accordingly, it has been abrogated, but to avoid retroactive repeal, it will still apply to the first sixty-five days following the close of a trust's first tax year falling under the new law, that is, a year beginning in 1954 or later and ending after August 16, 1954. A proposed regulation would allow an election to continue on the sixty-five-day rule.

We have now developed our broad pattern far enough to see that trusts are separate tax-paying entities with respect to the income which they accumulate and are conduits to the extent of their currently distributable income and that all income which is required to be distributed within the taxable year is treated as a current distribution taxable to the beneficiary.

A corollary of these rules is the principle that there is one group of credits and deductions allowable to the trust by virtue of its status as a taxpayer and which it may take even though it distributes all of its income, and another group, such as depreciation, for example, which attach to particular sources of income and have to be allocated between trust and beneficiary depending upon whether, as to that particular income, the trust is treated as a taxpayer or as a conduit.

The trust may take its personal exemption, the net-operating loss carry-over deduction, and the unlimited deduction for charitable contribution, without regard to how it accumulates or distributes its income. Credits for partially tax exempt interest, foreign taxes, and the new dividends-received credit available to individuals are allowed to the trust only to the extent that they are not properly allocable to the beneficiary. Depreciation, depletion, and amortization have to be allocated between the trust and the beneficiary. The only one of these allocations which promises to be troublesome is the allocation of the new $50 exclusion feature of the dividends-received credit. This exclusion is in the nature of an exemption and thus would seem allowable to any taxpayer who enjoys $50 or more of dividend income. The way the law works, however, it looks as if a trust which has $100 worth of dividend income, of which it accumulates $50 and distributes $50 will wind up paying tax on $50, even though it would seem that the trust in its taxpayer role is entitled to accumulate $50 worth of dividend income tax-free and deduct the other $50 which it currently distributes. It may be that the regulations will straighten this out, although for reasons which will become apparent as we go along, this would be inconsistent with the mechanism established for gearing the income of the trust with the distributions to the beneficiaries.

Before leaving the subject of the deductions and credits available to the trust and the beneficiaries, it is appropriate to mention that the 1954 code permits the beneficiaries succeeding to the trust's property upon termination of the trust to avail themselves of any unused portion of a carry-over of a net operating loss or capital loss and any deductions except for personal exemption and charitable contributions in excess of the gross income of the trust or estate for its final year. Under former law the courts refused to allow such substitution on the ground that the trust and its beneficiaries were different taxpayers.

Our pattern now shapes up like this: To the extent of its current income accumulations, a trust is a separte taxpayer with the usual deductions and credit. To the extent of current income required to be distributed, a trust is a conduit, transmitting income and those special credits and deductions attributable to the income transmitted. Unused deductions are transmitted to the beneficiaries upon termination of the trust.

Another corollary of these principles implicit in what I have already said is that income passing through the conduit is unchanged in character in the hands of the beneficiaries. Capital gains remain capital gains; exempt interest is not made taxable by passing through a trust, and so on.

II

The next principle which I will discuss is that income of a trust or estate transmitted to beneficiaries whether currently or ultimately is generally subject to only one tax. If it is taxed to the trust because it is accumulated, it is then set up for tax-free distribution to the beneficiary upon termination of the trust. If it passes through the conduit of the trust as currently distributable income, it is taxable to the beneficiary and not to the trust. Congress, however, has fouled up the beautiful symmetry and simplicity of this pattern by a rather complicated throwback rule designed to frustrate well-laid plans to distribute lightly-taxed trust accumulations to high-bracket beneficiaries free of a second tax bite. As I shall show, his throwback rule may throwbackfire on the Treasury.

I can't hope to explain the throwback rule without first discussing the mechanism which the 1954 code employs for gearing the deduction allowed to the trust for distributions to its beneficiaries with the income that is taxable to the beneficiaries and showing how it operates, year by year, both in the case of what everybody except Congress calls simple trusts and in the case of what everybody but Congress terms complex trusts.

The need for such a mechanism grew out of cases like *Johnston v. Helvering* [1] and *McCullough v. Commissioner*,[2] which pointed up the ineptness of the 1939 code in finding a technique of treating the trust as a conduit. The 1939 code sought to accomplish this by simply allowing to the trust a deduction for net income currently distributable or distributed to beneficiaries. In *Johnston v. Helvering*, this resulted in the beneficiary's paying a tax on the proceeds of a mortgage salvage operation regarded as income by local law in a year where the trust suffered a loss, and in *McCullough v. Commissioner*, a non-taxable stock dividend was taxed to the beneficiary because the trust instrument decreed its distribution as income. The 1954 code prevents the occurrence of this kind of thing by a mechanism analogous to that employed in the area of determining the taxable nature of corporate distributions, that is, by first setting up a yardstick of taxable distributions. In the dividend field, the mechanism is the concept of accumulated earn-

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[1] Johnston v. Helvering, 141 F. (2d) 208 (2nd Cir. 1944), cert. den. 323 U. S. 715.

[2] McCullough v. Commissioner, 153 F. (2d) 345 (2nd Cir. 1946).

ings and profits. In the trust field, the mechanism is the concept of distributable net income.

Distributable net income is obtained, by doing a number of esoteric things to taxable income. Once obtained, it serves as a measure and a ceiling both of the deduction allowed to the trust for distributions and the income taxable to the beneficiaries by reason of those distributions. Since taxable income of the trust is the starting point in the computation of distributable net income and since all of the deductions of trust have already been taken out and only the personal exemption is added back (this I can understand), the result is that the beneficiaries participate in the trust's deductions even though the trust distributes all of its income. Under the 1939 code the trust's deduction for trustee's commissions would be lost if the trust distributed all of its income. Under the scheme of the 1954 code, this deduction goes to reduce the trust's income and thus reduces the amount upon which the beneficiaries are taxable. The operation of this mechanism differs somewhat in simple and complex trusts, and, although I have been tossing those terms around, I have not yet defined them.

A simple trust is one in which all of the current income, and only the current income, is directed to be currently distributed. This does not mean that a simple trust cannot, by definition, accumulate taxable income. The simple trust is permitted, either by the express terms or the necessary implications of the code provisions, to exclude from what is to be currently distributed to the beneficiaries such items as capital gains, stock dividends, and extraordinary dividends, and to provide for depreciation at a faster rate than that allowable for tax purposes. All that is apparently required for qualification as a simple trust is that all of the income, as that term is used in the trust instrument and under applicable local law, be currently distributable and that the trustee act in good faith under the instrument and local law in making allocations to corpus of items which are income for tax purposes. Thus, a simple trust with a built-in $300 per year accumulation feature would be an easy way to accumulate a nest egg tax-free for each of a high bracket taxpayer's numerous grandchildren. The fact that the trust also provides for corpus distribution does not disqualify it as a simple trust for years in which no such distribution is made nor does it lose the trust the $300 exemption even in such a year. However, since the code requires that a simple trust distribute current income only, the simplified treatment is not available in a year, such as, for example, the year of termination, in which there is corpus distribution. A simple trust may be intervivos or testamentary, but an estate in administration is expressly disqualified for treatment as a simple trust.

By elimination, estates and all other trusts are treated as complex trusts. The first big additional problem which we face when we come to estates and complex trusts is that we are frequently dealing with the distribution of corpus as well as of income, sometimes to the same and sometimes to different sets of beneficiaries. Gifts and bequests of property, as distinguished from gifts and bequests of income, are received tax-free by the beneficiaries.

Any amount properly paid or credited under the terms of the will or trust as a bequest or gift of a specific sum of money or specific property, either all at once or in not more than three installments, is treated as bequest or gift of property for this purpose. A gift or bequest which can be paid only out of income is not excluded. An annuity which is to be paid out of income, if possible, and out of corpus, if necessary, is treated as a current income distribution to the extent actually satisfied out of current income.

The deduction of the complex trust or estate for distributions to its beneficiaries is the sum of the amounts required to be currently distributed plus any portion of an annuity payable out of income or corpus which is actually paid out of current income, and all other amounts properly paid, credited, or required to be distributed during the taxable year, whether income or corpus, up to the ceiling of distributable net income.

Here the analogy to accumulated earnings and profits again becomes apt. I like to think of earnings and profits as a liquid of heavier specific gravity which sinks to the bottom of a vessel where there is a spigot that is turned on when corporate distributions are drawn off. As long as there are corporate earnings and profits there is no way, short of cracking open the vessel at the top by a partial liquidation or breaking it up by complete liquidation, of drawing off distributions from any other source.

So it is with a complex trust having some beneficiaries to whom current income distributions are required to be made and some beneficiaries who receive distributions which may be from non-current sources, whether income accumulated from past years or corpus. The members of the second class are the first-class citizens tax-wise, and the first class is distinctly second class tax-wise. To the extent of the available net distributable income the first group must include in their gross income all distributions required to be made to them. They have no way of drawing off the liquid from the tax-free top. The others (who may or may not be the same persons), the elite group, need include in their gross income only their share of the distributable net income remaining after the untouchables have soaked up the nasty, dirty taxable liquid. Furthermore, the elite class may deduct specifically non-taxable gifts and bequests paid out of corpus.

There is, however, left even to the untouchables the protection of the so-called character rule that income retains in the hands of the beneficiaries its character as capital gain, partially exempt, or wholly exempt income and the specific provisions allocating to particular classes of income particular kinds of deductions applicable therein, such as depreciation. In the absence of a direction by the grantor or testator, beneficiaries participate ratably in all classes of trust income and would share the benefit of the character rule and the allocation provisions in the same ratable manner.

III

In the cases with which we have been dealing so far, we have generally assumed that distributable net income was less than the amount distributed. What happens when the trust distributes more income than its current income out of income which it has accumulated in the past? Going back to our pattern, if this income has already been subject to taxation in the hands of the trust, it should not again be taxed when distributed to the beneficiary. But the 1954 code may spoil that pattern by requiring a throwback. A throwback has no connection with a fullback, but it is a kind of reverse forward pass. Before there can be a throwback there must be what the code calls an accumulation distribution, that is, a distribution in excess of distributable net income for that year. Even though there is an accumulation distribution, there is no throwback unless some other tests are met. First there are knocked out of the excess of distribution over distributable net income (1) any distributions accumulated before the birth of the beneficiary or before his attaining the age of 21, (2) distributions made to meet the beneficiary's emergency needs, (3) distributions not more than four in number spaced not more closely than four years between any two and required by a trust instrument in existence on January 1, 1954, upon a beneficiary's attaining specified ages, and (4) a final distribution of a trust made more than nine years after the last transfer to the trust. If the excess distributions exceed these four items by more than $2,000, there is an accumulation distribution as to the entire excess. If the excess distributions do not exceed the sum of these four items plus $2,000, there is no accumulation distribution and there can be no throwback.

If there is an accumulation distribution, then it is carried back, a year at a time, and applied against undistributed net income, that is, the deficiency of distributions compared with the sum of taxes of the trust and its distributable net income. The unabsorbed portion of the accumulation distribution, if any, is carried back again to the next preceding year, and this process is continued until the entire accumulation distribution is absorbed or until five years have been searched.

The amount reallocated to any year by this process is treated as a constructive distribution by the trust for that year. The beneficiaries do not, however, file amended returns for that year, nor does the trust receive a refund or credit of its taxes paid in the year of reallocation. Instead, the beneficiaries include in their income for the current year their share of the constructive distribution for the year of reallocation. In amount and character the constructive distributions are included in the beneficiaries' current income only as they would have been includable had they actually been made in the year of constructive distribution. Thus, if the income of the trust in the year to which the throwback pertains was 50 per cent non-taxable, the income included in the year in which the throwback originates is likewise 50 per cent non-taxable. The taxes of a particular beneficiary resulting from a throwback cannot exceed the taxes which he would have paid had the income constructively distributed been actually distributed to him in the years to which the throwback applies. Thus additional taxes are includable at the lower of (1) the effective tax rates on the current year, or (2) the aggregate of the former years.

The trust's taxes for the former year or years, instead of being refunded or credited to the trust, are credited to the extent of the overpayment resulting from the reallocation pro rata among the beneficiaries who bear the burden of the reallocation. These credits may be used in payment of the beneficiary's tax liabilities for the year in which the throwback originates, not only against the additional taxes resulting from the throwback, but against any other tax liability of the beneficiary for that year. I foresee still more social security for accountants in making the necessary computations. I also forsee some pretty bizarre possibilities. I shall use the illustration appearing at pages 1621 to 1622 of the 1954 Revenue Act Coordinator prepared by the Research Institute of America.

The trust and the beneficiaries report on the cash and calendar year basis. The trust derives all of its income from taxable interest. For 1955, 1956 and 1957 its net income was $30,000, $10,000 and $20,000 respectively. The trustee must distribute one-half of the income currently to A, and in his discretion may pay out of income or corpus (not for emergency or other excepted purpose) to B or C, or both, amounts totalling not more than $15,000 in any one year.

A received $15,000, $5,000 and $10,000 in 1955, 1956, and 1957, respectively. B received nothing in 1955, $5,000 in 1956, and $9,000 in 1957. C received nothing in 1955 or 1956, and $6,000 in 1957. Since A is not affected, the illustration deals only with B and C who are single and without dependents. In 1957, neither has income except from the trust. In 1955, B has outside taxable income of $5,000; C has none. The 1954 tax rates are assumed to continue.

In 1957 the trust has a distributable net income of $20,000. After the mandatory distribution of $10,000 to A, there is $10,000 left. B and C receive a total of $15,000, so there is an accumulation distributution of $5,000. This is first thrown back to 1956, but there is not undistributed net income. In 1955, however, the trust had $10,317 of undistributed income after its distribution to A and its tax of $4,683. Reallocation results in constructive distributions of $4,362 to B and $2,908 to C. B's tax, if the constructive distribution had been made in 1955, is lower than the increase resulting from adding it to 1957, and so he pays the lower figure, which is

$1,090, plus his 1957 tax on his other income of $1,048, or a total of $2,138. C is also better off with a 1955 constructive distribution of $404 as against a $640 1957 increase. C's tax for 1957 on his regular income not attributable to the throwback is $620. The total with the tax computed on a 1955 basis is $1,024 for C. The trust's tax overpayment of $2,834 is allocated 9/15 ($1,700) to B and 6/15 ($1,134) to C. B's tax for 1957 after the credit is $438, or $610 less than it would have been had he not been the victim of the throwback, and C, who would have paid $620 in 1957 but for the throwback, pays nothing. If C had received a distribution of only $4,000 in 1957, he still would have had a tax of $620 to pay. However, since he actually received $6,000, he has no tax to pay.

Before I leave this phase of my subject, I would like to try to complete the broad pattern which I started.

Trusts (and estates, which are a special kind of trust) are separate taxpayers. They are also conduits for the distribution of income. To the extent that they are not mere conflicts, they are taxable at the same rates as individuals, their income is determined in the same manner, and they have largely the same kind of credits and deductions. They have a special unlimited charitable deduction which may be lost by prohibited transactions, unreasonable accumulations, or unrelated business income. The extent to which trusts serve as mere conduits is determined by a special kind of deduction for their distributions to their beneficiaries. While technically all income is taxable to the trust and distributions deductible by the trust, the trust's distributive deduction and the beneficiary's taxable distribution are so geared together as to strengthen the conduit principle. This is accomplished by a concept of distributable net income which serves as a measure of both. It consists of the trust's taxable income with certain adjustments. It accordingly precludes taxation to the beneficiaries of items which are not part of the trust's taxable income. Certain deductions and credits peculiar to certain classes of income are allocated between trust and beneficiary as that income is distributed or accumulated. Others are available to the trust in any event. Unused deductions and credits are transferred to the beneficiaries on the termination of the trust. The new code provides that income of the trust retains its character in the hands of the beneficiaries. Trusts which are required to distribute currently all of their income and which distribute only income, commonly known as simple trusts, are given a simpler treatment in the code than estates and other trusts. Such trusts have a personal exemption of $300. Other trusts have a $100 personal exemption. Estates have a $600 exemption. A simple trust retains its exemption even in a year of corpus distributions. In estates and complex trusts, distributable net income is first attributed to income beneficiaries who are entitled to receive current income distributions and then the remainder to other beneficiaries. Gifts and bequests of specific property are transmitted by the trust tax-free to the beneficiaries. In the absence of specific direction in the trust instrument, a ratable portion of all classes of income are distributed to all beneficiaries. A new five-year throwback rule designed to recoup taxes saved through accumulation by trusts at low tax rates and distributing to the beneficiary in his low tax years is a feature of the code, and it may backfire or produce strange results in some cases.

IV

Subpart E of Subsection J deals with the taxation of the income of trusts to the grantor or some other person as substantial owner.

In a series of decisions in 1940, the United States Supreme Court greatly extended the sweep of Section 22(a) of the 1939 internal revenue code defining gross income in broad terms of gains, profits and income from any source whatever. These decisions included *Helvering v. Clifford,*[3] taxing to the grantor the income of a trust for a five-year term, with a reversion to the grantor, and the grantor as trustee having the power to distribute or accumulate income in his discretion and broad powers of management. The beneficiary was the wife of the grantor. They also included *Helvering v. Horst*[4] and *Helvering v. Eubank,*[5] taxing to the assignor income to which he had a fixed right and which he attmepted to assign to another. These cases were foreshadowed by *Lucas v. Earl.*[6]

The *Clifford* case spawned what I believe may well constitute the largest body of decisions on any point of tax law and which is very respectable by comparison with the volume of cases on any other narrow point of law, tax or non-tax. Erudite articles have been written as to whether any of the factors of the *Clifford* case standing alone—shortness of term, grantor as trustee with power to determine whether income should be distributed or accumulated, breadth of administrative powers of the trustee, relationship of husband and wife between grantor and beneficiary—would be enough to invoke the doctrine of the case, and whether or not the approach was in terms of examining broadly the whole bundle of rights.

Late in 1945 the Treasury issued, and in 1947 substantially modified, the so-called *Clifford* regulations which attempted to introduce some order and definiteness into what had become an extremely complicated situation. Most of the cases had emphasized the necessity of examining each case in the light of all of the surrounding facts, with no one factor being controlling. The regulations specified numerous factors, any one of which caused the income of the trust to be taxable to the grantor. The regulations

[3] 309 U. S. 331 (1940).
[4] 331 U. S. 112 (1940).
[5] 331 U. S. 122 (1940).
[6] 281 U. S. 111 (1930).

provided, for example, that the fact that the trust was for a shorter period than ten years was standing alone enough to condemn the trust. These regulations received mixed treatment by the courts, and they did, almost admittedly, represent legislation by regulation. The most significant thing about the treatment of the *Clifford* principle in the 1954 code is the very fact that the regulations are now law, rather than any of the relatively minor modifications of the regulations.

The ten year minimum term has been adopted. In the regulations a term between ten and fifteen years was also suspect, provided other factors of control were present. This has been dropped. The code introduces a new two-year charitable trust. Although the grantor's revisionary interest in such a short term trust is probably too great to permit a charitable contribution deduction for the value of the property contributed, many taxpayers may be interested in such an arrangement, which permits the devotion of particular property to charitable use and gets the income clear out of the grantor's returns for that period at the price a very short-term commitment.

The regulations and the code treat the grantor as the continued owner where he reserves the power to control beneficial enjoyment by shuffling the income among beneficiaries of his choice. The code makes this power more restrictive by reserving such spray provisions to an independent trustee rather than a close relative, whether or not there is a resonably definite external standard. Under the regulations a spouse was barred from exercising such a spray power. The code in one breath relaxes this rule by allowing a spouse to serve if not subservient to the wishes of the grantor and then tightens it up by presuming the spouse to be subservient and requiring proof by the preponderance of the evidence in the case of the non-subservient spouse.

The power of the grantor to borrow from the trust without adequate interest or security has been made less sure-death by a provision that this is all right, if the trustee, provided he is not the grantor, has a similar power with respect to any person. As a trustee the grantor is permitted to hold and vote stock owned by the trust and direct the investment of trust funds. As grantor in a non-fiduciary capacity, he may do so only if the holdings of the trust and his own holdings are not significant from the standpoint of voting control.

In addition to the situations covered by the *Clifford* regulations, the grantor is taxable on the trust income in the situations, with a few minor modifications, covered by sections 166 and 167 of the 1939 code.

A power to revoke thus continues to cause the trust income to be taxable to the grantor. The new code provides that if such power will not arise for ten years the trust is recognized until then but becomes invalid then unless the power is renounced.

Income which may be distributed to the grantor, held or accumulated for the benefit of the grantor, or used to pay premiums on an insurance policy on his life continues to be taxable to the grantor, as under present law. There is no reason to think that the line of decisions restricting the sweep of the provisions with regard to insurance premiums to premiums on policies actually in force during the taxable year does not apply to the new language, which is substantially the same as the old. In view of the estate tax provisions abrogating the premium payment test with respect to the includability of proceeds of policies owned by some one else on the life of insured, it may be questioned whether or not the continuation of this income tax provision is consistent with the philosophy expressed in the new code.

Income from trusts for the support of dependents of the grantor continues to be taxable to the grantor to the extent that current income is actually so applied.

A beneficiary or other person than the grantor having the power to vest the corpus or income of a trust in himself is taxed as substantial owner unless he renounces the power within a reasonable time after learning of its existence and unless the grantor is taxable on the income. Although the 1954 code contains no provisions dealing with the reciprocal trust situation or the case of a nominal grantor, there is no reason to believe that the authority of existing court decisions has been weakened.

The income of alimony trusts continues to be taxable to the divorced wife as under present law, and she need be only separated under a written separation agreement rather than divorced or legally separated, as under present law. This conforms the law of alimony trusts to the changes made in the deductions and taxable income sections of the new code, assimilating the tax status of payments made under a written separation agreement to payments made under a decree of divorce or separte maintenance.

Prior to the enactment of the revenue act of 1942, income of a decedent was accrued in his final return. This led to a bunching of income. The 1942 act corrected this inequitable situation by permitting the estate or beneficiary to receive the income to which the decedent was entitled with the same tax consequences as would have ensued had the decedent lived to receive it. The 1954 code extends this treatment one step further. Under the former law the income entitled to be received derivatively by the beneficiary would be bunched in the beneficiary's final return in the event of the beneficiary's death. The '54 code corrects this situation and avoids a bunching of income taxes in the final return of a widow who was receiving, for example, royalties from a book written by her deceased husband. These would now be taxed to the children as received, and presumably to the grandchildren on the death of the children.

Under the 1939 code the death of the obligee of installment obligations precipitated the tax due on the value of the obligations unless a bond was filed conditioned upon the payment of taxes on the installment payments. This requirement is eliminated under the '54 code. The excess of the face value of the obligations over basis to the decendent is treated as an income item transmitted on death and is taxable to the estate or beneficiary when realized.

Under prior law the estate or beneficiary of a decedent could deduct for income tax purposes a proportionate part of the estate tax only if the income right originated with the decedent. This role has been changed to conform with the possibility of successive transmissions. The deduction of estate tax for income tax purposes formerly belonged to the estate. It now belongs to the beneficiary if the income right upon which the deduction is based has been distributed or is distributable to the beneficiary.

The deductible estate tax depends upon the aggregate value of all postmortem rights. A surviving annuitant under a joint and survivor annuity is expressly granted this deduction of estate tax paid on the transmitted income right. The value of the right for estate tax purposes is computed by determining the excess of the value of the annuity at the date of death over the amount excludible from the survivor's gross income during his life expectancy and multiplying this by the ratio of the estate tax and date of death valuations of the annuity. Since the decedent may have paid part of the cost, these figures may differ.

Most of the changes we have discussed are in the direction of better draftsmanship and organization and represent, for the most part, desirable changes substantively. There are, however, complications remaining in the new code, particularly as to the new provisions regarding complex trusts and estates and the throwback. The Internal Revenue Code of 1954, although it is an enormously impressive task and represents an infinite improvement over the 1939 code in the field we have been considering, looks as if it still will require some further overhauling in the light of operating experience.