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Living Trusts and Tax Avoidance

By HAYES R. HINDRY*

In February of 1940, the United States Supreme Court made a decision which radically affects the use of the living trust as an income tax avoidance device. This is the case of Helvering v. Clifford, 309 U. S. 331. In this case, the taxpayer established a trust for the exclusive benefit of his wife. The trust was for a period of five years. During that period, the taxpayer was named as trustee of the trust. So much of the income was to be paid to the beneficiary as the trustee deemed proper. At the end of the five-year period, the trustee was to distribute the corpus to the grantor, and any accumulated income to the beneficiary. The Trust instrument provided the normal trustee powers of investment, sale, collection of income, compromise of claims, holding of assets in the name of a nominee, limitation of liability of the trustee, and spendthrift clause. The taxpayer, upon the establishment of this trust, paid a gift tax. All of the income was distributed to the beneficiary during the first year of the trust. The Commissioner of Internal Revenue assessed the entire income to the grantor. The Board of Tax Appeals sustained the Commissioner, and the Circuit Court of Appeals reversed it. The Supreme Court said, "We granted certiorari because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes."

It is to be noted before proceeding to the decision in this case that Section 166 of the Revenue Act specifically deals with income from trusts, apparently establishing a criterion or standard for the determination of the individual to whom the income shall be taxable. Section 22 (a) of the Act states that gross income includes

> "gains, profits and income derived * * * from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

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The court elected to determine the responsibility for the tax exclusively upon the basis of this Section 22 (a), rather than Section 166. In its decision it stated:

> "Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. See Blair v. Commissioner, 300 U. S. 5, 12, 57 S. Ct. 330, 333, 81 L. Ed. 465. In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation. *And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as Section 22 (a) is concerned.*
>
> "In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of Section 22 (a).
>
> "So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. *If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of*

income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. *For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered.* But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive Section 22 (a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands, he would keep direct command over all that he needed to remain in substantially the same financial situation as before. *Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue.* Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of Section 22 (a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formality obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

"The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the 'victim of despotic power when for the purpose of taxation he is treated as owner altogether.' See Du Pont v. Commissioner, 289 U. S. 685, 689, 53 S. Ct. 766, 77 L. Ed. 1447." (Italics ours.)

The effect of this decision cannot be minimized. For under it, apparently, the doors are open for determination that the income of any living trust established by a husband or wife for the benefit of the other, or, for that matter, any living trust established by any member of a family for the benefit of another member of a family, might very readily, under the language of this decision, be determined to be taxable to the grantor during his lifetime.

The confusion which this decision has caused in the minds of the jurists and lesser courts throughout the land can be readily seen by a reading of the cases which have been determined since then, c. f., Helvering v. Hormel, 111 Fed. 2nd 1; Helvering v. Achelis, 112 Fed. 2nd 928; Commissioner v. Branch, 114 Fed. 2nd 985; White v. Higgins, First Circuit, decided December 12, 1940; Commissioner v. Berolzheimer, Second Circuit, decided December 23, 1940.

The Achelis case above referred to seems to me to contain the best statement of the rationale of this case when the court there said:

"The rationale of that decision was that the nexus of powers reserved by the settlor so nearly approached full dominion as to be its equivalent; the court did not suggest that the settlor of a trust could not so completely sever himself from the income of property for a period—even for a short period—as to make it no longer his."

That this decision is only the first step by the Internal Revenue Department in an attempt ultimately to destroy the use of living trust estates as an income tax avoidance measure is clearly indicated by the numerous times that that case has been made the basis of an attempt to present hitherto unheard of claims by the Revenue Department. To what extent they will be successful remains yet to be determined, although we must admit that the language of this decision makes it quite evident that a great part of the road to this ultimate destination has already been covered.

CORRECTION

In the article entitled, "Possibility of a Reverter as a Taxable Entity," which appeared in the January issue of DICTA, a note was attached citing a recent treasury decision which was later incorporated into Article 17, Regulation 70, of the Inheritance Tax Department. Unfortunately, an error was made which materially changed the meaning of this Regulation. The author states that the correct text of this Regulation is:

> "Where the transfer was made during the period between November 11, 1935 (that being the date upon which the Supreme Court of the United States rendered its decisions in the cases of Helvering v. St. Louis Union Trust Co., 296 U. S. 39, and Becker v. St. Louis Union Trust Co., 296 U. S. 48) and January 29, 1940 (that being the date upon which such Court rendered its decisions in Helvering v. Hallock and companion cases, 309 U. S. 106), and the Commissioner, whose determination therein shall be conclusive, determines that such transfer is classifiable with the transfers involved in such two cases decided on November 11, 1935, rather than with the transfer involved in the case of Klein v. United States, 283 U. S. 231, previously decided by such Court, then the property so transferred shall not be included in the decedent's gross estate under the provisions of this article, if the following condition is also met: Such transfer shall have been finally treated for all gift tax purposes, both as to the calendar year of such transfer and subsequent calendar years, as a gift in an amount measured by the value of the property undiminished by reason of a provision in the instrument of transfer by which the property, in whole or in part, is to revert to the decedent should he survive the donee or another person, or the reverting thereof is conditioned upon some other contingency terminable by decedent's death."

Junior Bar Meetings

According to plans announced by John W. O'Hagan, chairman of the Junior Bar Conference, regional meetings of the conference will be held at each of the localities where legal institutes are scheduled. The first meeting of the conference will be held at Greeley on March 14, at 12 o'clock. All lawyers under the age of 36 are invited and urged to attend.

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CALENDAR

Feb. 28-March 1......Legal Institute on Rules, Denver
March 7, 8......District and County Judges Meeting, Denver
March 14, 15......Legal Institute on Rules, Greeley
March 17, 18......Mid-Winter Meeting A. B. A. House of Delegates
March 21, 22......Legal Institute on Rules, Pueblo
March 24-28......Meeting Inter-American Bar Association, Havana
March 28, 29......Legal Institute on Rules, Grand Junction
September 12, 13 (tentative)......Annual Meeting Colorado Bar Association
September 22......Annual Meeting Commissioners on Uniform Laws
Sept. 29-Oct. 4......Annual Meeting American Bar Association, Indianapolis, Indiana