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THE 1969 REFORM ACT AND MULTIPLE ACCUMULATION TRUSTS

I. INTRODUCTION

A. *Scope*

This comment will examine the potential use of multiple accumulation trusts in the mitigation of income tax under the 1954 Internal Revenue Code as amended by the 1969 Tax Reform Act. By way of introduction, there will be a brief description of trust taxation in general and of the advantage of accumulation trusts inherent in the basic statutory scheme.

In Part II, the history of the use of multiple accumulation trusts will be discussed, including an examination of the "five year throwback" rule adopted in 1954 in an effort to limit the advantages of these trusts. Part III will describe the changes made by the 1969 Act which affect multiple accumulation trust taxation, including the unlimited throwback rule of ordinary trust income and a new capital gain throwback rule. Part IV will analyze the estate planning considerations under the Reform Act.

For the purposes of this comment, unless otherwise noted, the term "multiple accumulation trusts" will mean a set of two or more trusts which are not required to distribute all income currently and which have the same grantor and the same beneficiaries. All trusts referred to are wholly domestic trusts. Also, it is assumed that neither the grantor nor any other person is treated as the substantial owner of the trust under sections 671-78 of the Internal Revenue Code, and that the trusts are not charitable remainder trusts under section 664 of the Code.

The term "income" will be used as defined in the Code:

> [T]he term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the . . . trust for the taxable year determined under the terms of the governing instrument and applicable local law.[1]

B. *Trust Taxation In General*[2]

1. Introduction

Since 1917 trusts have been taxable entities.[3] A tax is imposed on taxable income which is computed in the same manner as in the case of an individual,[4] with certain statutory exceptions.[5] For purposes of this discus-

1. INT. REV. CODE of 1954, § 643 (b). Unless otherwise indicated, textual references to sections or to the "Code" are to the Internal Revenue Code of 1954, as amended.
2. The basic discussion of trust taxation in this section is not intended to be exhaustive; it does not point out many problem areas. It is simply an analysis of the basic aspects of the Code needed to appreciate the special problems of multiple accumulation trusts.
3. Act of Oct. 3, 1917, ch. 63, § 1200 40 Stat. 329.
4. INT. REV. CODE of 1954, § 641. Of course, certain deductions are inapplicable to trusts, even though there is no exception in the Code (*e.g.*, medical deduction or retirement income credit).

sion the most important special deduction is the "distribution deduction" for distributions to beneficiaries.[6] The purpose of this deduction is to prevent the double taxation which would result from taxing both a trust and beneficiaries on the same income. It has always been basic tax policy to tax all trust income once—but only once.

Fundamental to an understanding of trust taxation is the term "distributable net income" (sometimes called the DNI). The DNI is a basic tool used in computing the distribution deductions referred to above and also used in applying the throwback rules discussed in parts II and III, *infra.*

"Distributable net income" is defined in section 643 (a) of the Code as the taxable income of the trust modified as follows:

1) Increased by the amount of the deduction for distributions to beneficiaries.

2) Increased by the amount of the deduction for the trust's personal exemption (section 642 (b)).

3) Decreased by the amount of capital gains to the extent that they are allocable to corpus and are not paid, credited or required to be distributed to any beneficiary.

4) Increased by the amount of capital losses except to the extent that they are taken into account to determine the amount of capital gains which are paid, credited or required to be distributed to any beneficiary.

5) Increased by the amount of the 50 percent capital gain deduction of section 1202.

6) Decreased by the amount of extraordinary dividends and taxable stock dividends which the trustee, acting in good faith, allocates to corpus (for simple trusts).

7) Increased by the amount of any tax-exempt interest (net).

8) Increased by the amount of the $100 "dividends received" exclusion.

2. Simple Trusts

For purposes of determining the distribution deduction and the amount includable in a beneficiary's income, trusts are divided into two categories: simple trusts and complex trusts.[7] A simple trust is a trust the terms of which require it to distribute all income[8] currently and do not provide for charitable contributions under § 642 (c).[9] However, a trust is not a simple

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5. For example, there are special rules for credits for partially exempt interest, charitable deductions, and there are special "personal exemptions" for trusts. *See* INT. REV. CODE of 1954, § 642.

6. INT. REV. CODE of 1954, §§ 651, 661. This amount, in general, will be taxed to the beneficiary; *see* pt. I, § B (2) & (3) of this comment.

7. The terms "simple" and "complex" are not found in the Code, but are used in the regulations.

8. For rules with regard to which items are permitted to be allocated to corpus, *see* Treas. Reg. § 1.651 (a)-2 (1956); Treas. Reg. § 1.643 (b)-1 (1956).

9. INT. REV. CODE of 1954, § 651 (a). The fiduciary must be under a duty to distribute the income currently even if, as a practical necessity, the income is not distributed until after the close of the trust's taxable year. Treas. Reg. § 1.651 (a)-2 (1956).

trust for any year in which the trust distributes amounts in excess of current income.[10]

Simple trusts are allowed a "distribution deduction" for all amounts required to be distributed currently, not to exceed the DNI. For this purpose, DNI does not include items of income not included in gross income, and the deductions allocable thereto.[11]

Amounts equal to the deduction are included in the beneficiary's gross income, whether distributed or not.[12] Thus, except for amounts of taxable income which are allocated to corpus, the trust acts as a conduit for income to the beneficiary.

3. Complex Trusts

A complex trust is any trust which is not a simple trust.[13] This means a trust which may accumulate income or which distributes amounts in excess of income for a particular year. Complex trusts are allowed a distribution deduction for any amount of income required to be distributed currently plus any other amount properly paid, credited or required to be distributed, but not to exceed the DNI.[14] Distributions are deemed to be made pro-rata from each class of income received by the trust.[15]

The beneficiary is required to include in his gross income the amount of the deduction to the trust.[16] If there is more than one beneficiary of a trust and the total amount distributed is greater than the amount of the distribution deduction of the trust, the beneficiaries will include in their respective gross incomes amounts of the DNI proportionate to the distributions they have received.

In order to determine the allocation of the total amount to be included in gross income among the beneficiaries, the Code has constructed a "two-tier" system of allocation.[17] First, amounts required to be distributed currently are included in the appropriate beneficiary's income; if these amounts exceed distributable net income, the beneficiaries each include a proportionate amount in their income. Second, all other amounts paid, credited, or required to be distributed are included in the beneficiaries' income (to the extent of DNI) proportionately. For example:[18]

The terms of a trust require the distribution of $10,000 of income annually to A. Additional income may be accumulated or distributed to B, C, or D as the trustee in his sole discretion may determine. Also, the trustee may invade corpus for the benefit of A, B, C, or D. For the taxable year, the

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10. INT. REV. CODE of 1954, § 651 (a).
11. *Id.* § 651.
12. *Id.* § 652 (a). The amounts have the same character in the hands of the beneficiary as in the hands of the trust. *Id.* § 652 (b). For rules as to allocation among beneficiaries, *see* Treas. Reg. § 1.652 (a)-2 (1956).
13. INT. REV. CODE of 1954, § 661 (a).
14. *Id.*
15. *Id.* § 661 (b); Treas. Reg. § 1.661 (b)-1 (1956); Treas. Reg. § 1.661 (b)-2 (1956).
16. INT. REV. CODE of 1954, § 662. As with simple trusts, the amounts have the same character in the hands of the beneficiary as in the hands of the trust.
17. *Id.* § 662 (a).
18. Adopted from Treas. Reg. § 1.662 (a)-3 (d) (1956).

trust had DNI of $20,000. The trustee distributed $10,000 to A as required; of the remaining income, he distributed $3,000 each to B, C, and D. He also distributed an additional $5,000 to A. A includes $10,000 in his income under section 662 (a) (1) as an amount required to be distributed. The "other amounts distributed," totaling $14,000, are includable in the recipient's income to the extent of $10,000 (DNI less income required to be distributed currently). A includes an additional $3,571 (5,000/14,000 x $10,000), and B, C, and D each include $2,143 (3,000/14,000 x $10,000).

For purposes of determining the distribution deduction and the amount to be included in the beneficiary's gross income there is a special rule for determining the DNI for certain complex trusts. For trusts which have more than one beneficiary, with each beneficiary having a substantially separate and independent share, the shares are treated as separate trusts for the sole purpose of determining the distributable net income.[19] For example:[20]

A trust has distributable net income (before application of the separate share rule) of $20,000. The trustee is required to distribute $10,000 annually to A. The trustee may, in his sole discretion, distribute the rest of the income to B, or he may accumulate it for B's benefit. The trustee also has power to make discretionary distributions of the corpus to A. Assume for the taxable year that the trustee makes the mandatory $10,000 distribution to A plus a discretionary corpus distribution of $10,000. The trustee accumulates the excess income ($10,000) for the benefit of B. If the separate share rule did not apply, A would be taxed on $20,000 and the trust would have a distribution deduction of $20,000. Thus, A would be taxed on $10,000 of income that was accumulated for B. The separate share rule avoids this result. Distributable net income (which is the limiting amount on the deduction for the trust and inclusion for the beneficiary) is computed for each beneficiary's share separately. Thus, A's share has DNI of $10,000, the maximum income which can be distributed to him. Therefore, the distribution deduction to the trust is $10,000, and A includes $10,000 in his gross income; the excess $10,000 distributed to A is tax exempt return of corpus. B's share of the trust has DNI of $10,000, none of which has been distributed.

C. *Multiple Accumulation Trusts*

Even this cursory glance at trust taxation virtually points a finger at the tax savings potential inherent in the system through the use of accumulation trusts. All income which is distributed currently is taxed to the beneficiary at his incremental rate of tax; all income accumulated is taxed to the trust. Thus the trust, as a taxable entity (when income is accumulated), serves as an income-splitting device. Instead of all the income being taxed to the beneficiary, accumulated income is split off and taxed to the trust.

This income-splitting is the advantage of multiple accumulation trusts. Multiplicity in trusts adds nothing new to the idea; it merely expands on it. By creating multiple accumulation trusts instead of just one, the estate

19. INT. REV. CODE of 1954, § 663 (c). *See* Treas. Reg. § 1.663 (c)-3 (1956) for rules to determine when the "separate share rule" is applicable.
20. Adopted from 3 P-H 1971 FED. TAXES ¶ 28,194.

planner multiplies the tax advantages available through an accumulation trust. This section will examine limitations on the ability of a settlor to create multiple accumulation trusts that will be treated as separate taxable entities.

As early as 1937 it was noted in Congress that multiple accumulation trusts were being used by taxpayers to avoid income taxes.[21] Notwithstanding this, various legislative efforts to attack specifically the multiplicity of trusts as tax avoidance devices have all been defeated.[22]

In the Tax Reform Act of 1969, there are no provisions which directly limit multiple trusts. The Senate Committee Report on the Act acknowledge the use of multiple trusts to split income but did not propose to eliminate this use.[23] The Reform Act does include provisions which directly limit some potential abuses of multiple trusts,[24] but that is the extent to which Congress has chosen to limit the utilization of multiple accumulation trusts specifically (as opposed to accumulation trusts in general).

Before the enactment of the Tax Reform Act of 1969 the Internal Revenue Service attacked various multiple trust transactions in an effort to consolidate the trusts into one trust for tax purposes. An example is *Boyce v. United States*,[25] a significant case decided in 1961. Before this case it had generally been held that the intent of the testator controlled how many trusts were created.[26]

In *Boyce*, the settlor had created 90 identical trusts on the same day all for the sole benefit of his son. The total value of the property in the trusts was approximately $28,300. The settlor's wife was the sole trustee. All trust funds were deposited in a single bank account. (This was apparently permitted under the trust indentures.) However, the trustee did not comply with trust provisions requiring separate and accurate records for each trust and annual accountings to the beneficiary as to each trust. The first distribution to the beneficiary was made with 90 different checks, each marked with a trust's "number;" however, all subsequent distributions were made with a single check without indication of the amount distributed from each trust. It was stipulated that the sole purpose in attempting to create ninety trusts, instead of one, was to avoid income taxes by splitting the income from the property into 90 parts.[27]

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21. REPORT OF THE JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE, H.R. REP. No. 1546, 75th Cong., 1st Sess. 270 (1937). Several abuses to the extent of hundreds of thousands of tax dollar savings for a single taxpayer in one year were noted.

22. *See* H.R. REP. No. 9662, 86th Cong., 2d Sess. (1960), passed over after being approved by the Senate Finance Committee in 1960, S. REP. No. 1616, 86th Cong., 2d Sess. (1960). Many commentators have argued that multiple trusts should be consolidated. *See, e.g.,* Gordon, *Multiple Trusts: The Consolidation Approach,* 4 WAYNE L. REV. 25 (1957).

23. S. REP. No. 552, 91st Cong., 1st Sess. 124-133 (1969). *See* text accompanying note 50 *infra.*

24. *See* note 74 and text accompanying note 117 *infra.*

25. 190 F. Supp. 950 (W.D. La.), *aff'd per curium,* 296 F.2d 731 (5th Cir. 1961).

26. *See, e.g.,* Fiduciary Trust Co. v. United States, 36 F. Supp. 653 (S.D.N.Y. 1940); Childs, *Multiple Trusts,* 107 TRUSTS AND ESTATES 183 (1968).

27. 190 F. Supp. at 951.

The court in *Boyce* declined to adopt the government's argument that the lack of a "business purpose" and the presence of a "tax avoidance" motive could, alone, cause the trusts to be consolidated.[28] But the court did hold that the tax consequences of a transaction are determined by what the transaction actually is as opposed to what the form suggests it is, *i.e.,* "substance prevails over form."[29] The court stated that the form of a transaction is subject to especially close scrutiny when it is a family transaction or when tax avoidance is the sole motive for the transaction.[30] The court further held that the trustee and beneficiary had treated the trust property as being contained in a single trust and that such treatment determined the substance of the transaction.

In several cases since *Boyce,* the Internal Revenue Service has argued that a tax avoidance purpose in itself requires the consolidation of multiple trusts. No court has yet so held. In *Sence v. United States*[31] the relevant facts were almost identical with *Boyce.* The settlor transferred approximately equal acreage of a ranch to 19 trusts. It was found as a fact that the trusts were created for a tax avoidance purpose. In addition, the court found that the trust property was sometimes treated as belonging to a single trust, and sometimes treated as still belonging to the grantor. Furthermore, separate books were not set up for the trusts until two years after some of them were receiving income. The trust assets were commingled with the grantor's (he was also co-trustee) and they were not earmarked at all. Income from the trust realty was allocated among the trusts on the basis of acreage without regard to how much income was actually produced.

The court declined to decide if tax avoidance itself would require the consolidation of the trusts since it found that the trustees (the grantor and his daughter) "did not sufficiently maintain the trusts as separate and distinct entities."[32] Therefore, under the same reasoning as in *Boyce,* the trusts were consolidated.

In *Estelle Morris Trusts v. Commissioner*[33] the Tax Court was squarely faced with deciding whether or not a tax avoidance purpose in itself was sufficient to cause multiple trusts to be consolidated. In this case the settlors (husband and wife) executed 10 instruments, each of which purported to create two trusts. The beneficiaries were the settlors' son and daughter-in-law. The initial trustees were the settlors. The court found as a fact that 20 trusts rather than one were created principally to avoid taxes. However, the court also found that, at all times, the grantors (as trustees) and successor trustees "meticulously administered the several trusts as separate entities. . . ."[34] For example:

> "[c]ash was given and loaned to each trust separately. Individual bank accounts were established . . . for all transactions. . . . [S]epa-

28. *Id.* at 956.
29. *Id.*
30. *Id.* at 957.
31. 394 F.2d 842 (Ct. Cl. 1968).
32. *Id.* at 851.
33. 51 T.C. 20 (1968), *aff'd per curium,* 427 F.2d 1361 (9th Cir. 1970). *See,* 427 F.2d 1362 (dissenting opinion).
34. 51 T.C. at 36.

> rate sets of books and records were meticulously kept and maintained . . . ; each trustee was at all times careful to 'dot his i's and cross his t's.' "[35]

The court carefully examined the case law and history of proposed multiple trust legislation and, notwithstanding its finding of a tax avoidance purpose, concluded that the 20 trusts constituted permissible income-splitting.

The Internal Revenue Service has issued a Proposed Regulation (purportedly under revisions of the Code added by the 1969 Act) which, under certain circumstances, would consolidate multiple trusts. Proposed Treasury Regulation section 1.665 (a)-OA states:

> (e) Multiple trusts that—
>
> (1) have no substantial independent purposes (such as independent dispositive purposes), or
>
> (2) have substantially the same beneficiary and the same grantor and have as their principal purpose the avoidance or mitigation of the progressive rates of tax (including mitigation as a result of deferral of tax) or of the minimum tax for tax preferences imposed by section 56, shall be consolidated and treated as one trust for the purposes of subchapter J.

If this proposed regulation is ultimately adopted, it certainly must be considered in any estate plan which calls for multiple trusts. However, this writer is of the opinion that, in light of the relevant case law and legislative history, this regulation is of doubtful validity. It goes beyond the limitations on the use of multiple trusts to split income set by Congress in the Tax Reform Act of 1969.[36]

If the regulation is adopted and upheld by the courts (or if it is considered imprudent to risk litigation in a particular instance) then one must carefully document the non-tax reasons for the creation of multiple trusts and insure that the trusts have independent purposes.[37]

II. Taxation of Multiple Accumulation Trusts Before the 1969 Act

A. *The 1954 Throwback Rule*

Before 1954, there were no restrictions at all on the use of multiple accumulation trusts to split income.[38] In the 1954 recodification of the Internal Revenue Code, an effort was made to limit the abuses available to multiple accumulation trusts. In theory, the method used could have been reasonably effective, but it was so riddled with exceptions and limitations that it was virtually ineffective.

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35. *Id.* at 45.

36. *See* text accompanying notes 125-126 *infra*. In addition, compare the forbidden purpose of "mitigation as a result of deferral" with the fact that Congress defeated a Senate proposal to charge 3 percent (non-deductible) interest on deferred taxes; this defeated proposal would have eliminated the possibility of "mitigation as a result of deferral." In effect, Congress has condoned this. *See* pt. IV, § A (1) of this comment.

37. *See* note 107 *infra*.

38. Unless the Internal Revenue Service could successfully contend that multiple trusts were not in fact created; *see* pt. I, § C of this comment.

The method of attacking income-splitting through the use of accumulation trusts was a "throwback" rule. It should be noted that there were no limitations on the multiplicity of trusts as such; the throwback rule was directed towards accumulation trusts in general. Basically, the rule required a beneficiary to pay tax on trust income in the year it was actually distributed as though it had been distributed in the year it was earned by the trust.[39] This would eliminate the splitting of income. Because tax was imposed in the year the distribution actually took place, a deferral of tax could still be achieved.

Two basic concepts were necessary to the calculation of the tax imposed by the throwback rule. "Undistributed net income" for any taxable year was defined as the DNI for the year less the sum of amounts distributed plus the amount of taxes imposed on the trust allocable to the undistributed portion of net income.[40]

An "accumulation distribution" was, basically, the amount by which amounts distributed within the meaning of Code Section 661 (a) (2)[41] exceed the distributable net income reduced (but not below zero) by income required to be distributed currently.[42]

The throwback rule was implemented by two operative sections. Section 666 required that an "accumulation distribution" of a trust be deemed to be an amount distributed on the last day of the five preceding taxable years, to the extent of the "undistributed net income," for each such year starting with the most recent year. In addition a pro rata share of the taxes imposed on the trust was similarly deemed to have been distributed.[43]

Under section 668, amounts deemed to have been distributed in preceding years were included in the beneficiary's gross income in the year of distribution, but the tax was limited to the amount of additional tax he would have had to pay had they been included in his gross income on the days they were deemed to have been distributed.[44] In order to prevent double taxation, the beneficiary received an appropriate credit for taxes paid by the trust in preceding years.[45]

B. *Exceptions and Limitations*

One limitation on the throwback rule was built into the operative statute (section 666) which "threw" the accumulation distribution back to preceding years. The throwback was limited to five years. Thus an accumulation distribution attributable to a year more than five years prior to the year of distribution escaped the throwback rule; income-splitting was preserved for such a distribution.

Additional exceptions were built into the definition of "accumulation distribution" (section 665 (b)). There were five exceptions:

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39. INT. REV. CODE of 1954, § 668 (a) (prior to 1969 amendments).
40. *Id.* § 665 (a), (d) (prior to 1969 amendments). *See* Treas. Reg. § 1.665 (d)-1 (1956).
41. Section 661 was not changed by the 1969 amendments.
42. INT. REV. CODE of 1954, § 665 (b) (prior to 1969 amendments).
43. *Id.* § 666 (prior to 1969 amendments).
44. *Id.* § 668 (prior to 1969 amendments). *See* Treas. Reg. § 1.668 (a)-4 (1956), and examples therein.
45. INT. REV. CODE of 1954, § 668 (b) (prior to 1969 amendments).

1. Amounts accumulated for a beneficiary before birth or during minority.

2. Amounts paid to meet emergency needs of the beneficiary.

3. Amounts paid to the beneficiary upon his attaining a specific age (with certain limitations.)

4. A final distribution if more than nine years after the date of the last transfer to the trust.

5. A de minimus exception for accumulation distributions less than $2,000.[46]

C. *Use of Multiple Trusts*

As has been stated, the "five-year throwback rule" did not limit multiple trusts. Therefore they were still available to defer taxes to a greater extent than a single accumulation trust. In addition, the exceptions to the throwback rule actually encouraged the use of multiple trusts to avoid the rule. For example:[47]

(1) A grantor creates sufficient trusts so that the income from each is $2,000 per year. Each trust distributes $4,000 every other year, with $2,000 of current income taxed to the beneficiary and the $2,000 excess falling within the de minimus exception. Thus, one half of the income is split off and taxed to the trusts at a minimum rate.

(2) Parent-Subsidiary Trusts. A grantor creates one or more parent trusts, each with seven subsidiary trusts. The parent distributes all current income to subsidiary trust number one in year one, to subsidiary trust two in year two and so on. In year seven subsidiary trust one distributes its income, all of which was earned more than five years before, and there is no throwback. The next year, all current income from the parent is distributed to subsidiary trust one again, subsidiary trust two distributes, and so on.

(3) A grantor creates multiple trusts, each to accumulate all income until termination. The trusts are to terminate and make final distribution at yearly intervals beginning 10 years after creation. Sufficient corpus is put into each trust so that it will have the desired amount in it, including accumulated income at the time it makes its final distribution.

III. The Reform Act

A. *Scope and Limitations*

The 1969 Tax Reform Act made several changes which limit the tax savings potential of accumulation trusts and hence of multiple accumulation trusts.

There are two substantive aspects to the changes made in the "throwback rule:" (1) removal of the exceptions and limitations on ordinary income throwback and, (2) adoption of a throwback rule for capital gains. In addition, a new scheme for calculation of the tax was adopted.[48]

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46. *Id.* § 665(b) (prior to 1969 amendments).

47. These examples are adopted from Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax,* 29 S. Cal. L. Rev. 402 (1956).

48. This new method of calculating tax is adopted from the pre-1969 rules for certain foreign trusts; *see* Int. Rev. Code of 1954, § 669 (prior to 1969 amendments).

There are special transitional rules for distributions made in taxable years beginning before January 1, 1974.[49] Unless otherwise noted, it will be presumed in the discussions which follow that these special rules do not apply.

B. *Changes in the Throwback Rules*

1. Purpose of the changes

In the Senate Report on the Tax Reform Act, the Committee summarized the inadequacies of the pre-1969 throwback rule:

> The progressive tax rate structure for individuals is avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income, rather than the grantor or the beneficiary. This means that the income in question, instead of being added on top of the beneficiary's other income and taxed at his marginal tax rate, is taxed to the trust at the starting tax rate. The throwback rule theoretically prevents this result, but the 5-year limitation and the numerous exceptions seriously erode the basic principle that a beneficiary who receives income from property should pay tax on that income at his (rather than the trust's) marginal rates.
>
> This avoidance device is compounded by the use of multiple trusts—the creation of more than one accumulation trust by the same grantor for the same beneficiary. The splitting of the income among many taxable entities may result in still further reductions of overall tax burden, since the accumulated income may be taxed to each separate trust at lower rates than would be the case if only one trust were created. Although the use of multiple trusts has been attacked by the Internal Revenue Service, the courts have held that such trusts are valid in some cases.[50]

Thus, the changes made by the Reform Act attempt to achieve "the basic principle that a beneficiary who receives income from property should pay tax on that income at his (rather than the trust's) marginal rates."[51]

2. Basic Changes

In order to achieve this result, two basic changes were made in the throwback rule itself. The first is the change in the definition of an "accumulation distribution."[52] All exceptions in the definition were eliminated.[53] Thus, the definition now is simply:

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49. *See* INT. REV. CODE of 1954, § 665 (e), and notes 53, 59 *infra*. For additional transitional rules for capital gain distribution, *see* note 74 *infra*.

50. S. Rep. No. 552, 91st Cong., 1st Sess. 1769 (1969), accompanying H. R. 13270, 91st Cong. 1st Sess. (1969).

51. *Id.* at 1770.

52. INT. REV. CODE of 1954, § 665 (b). *See* pt. II, § C of this Comment.

53. *See* pt. II, § C of this Comment. However, the Tax Reform Act of 1969, Pub. L. No. 91-172, § 331 (d) (2) (A) (Dec. 31, 1969) [hereinafter cited as "the Reform Act"], states that distributions made during taxable years beginning before

"for any taxable year of the trust, the amount by which—
(1) the amounts specified in paragraph (2) of section 661 (a) for such taxable year, exceed
(2) distributable net income for such year reduced (but not below zero) by the amounts specified in paragraph (1) of section 661 (a)."[54]

It should be observed that
"although amounts properly paid, credited, or required to be distributed under section 661 (a) (2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result. . . ."[55]

For example,[56] assume the trustee of a trust may accumulate or distribute income to A; the trust has income (as defined in section 643 (b)) of $22,000, and expenses *allocable to corpus* of $5,000. Distributable net income is $17,000. If the trustee distributes $20,000 to A, there is an accumulation distribution computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently		-0-
Other amounts distributed (section 661 (a) (2))		$20,000
Distributable net income	$17,000	
Less: Income required to be distributed currently	-0-	
Balance of distributable net income		$17,000
Accumulation distribution		$ 3,000

In trusts to which the separate share rule applies,[57] accumulation distributions are calculated for each share separately. This is done in substantially the same manner as before the Reform Act.[58]

The second basic change made in the throwback rule is found in the operative provision (section 666 (a)) under which the accumulated income is actually "thrown back" to preceding taxable years. There are two parts to this change, the most significant being the elimination of the five-year limitation on accumulation distribution throwbacks.[59] This means that

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January 1, 1974 are not accumulation distributions to the extent that the amounts distributed were accumulated in taxable years beginning before January 1, 1969 and would have been excepted from the definition of accumulation distribution under § 665 (b) (1)- (4) as it was before the Reform Act. (This covers all exceptions except for the $2,000 de minimis exception.) *See* Proposed Treas. Reg. § 1.665 (b)-2A, 36 Fed. Reg. 2610 (1971).

Amounts which come under this transitional rule exception do reduce the undistributed net income of the year to which they are allocated; however, no amount of taxes imposed on the trust is deemed distributed under § 666 (b) and (c). *See* Proposed Treas. Reg. § 1.665 (b)-2A (a), 36 Fed. Reg. 2610 (1971).

54. INT. REV. CODE of 1954, § 665 (b).

55. Proposed Treas. Reg. § 1.665 (b)-1A (a) (3), 36 Fed. Reg. 2611 (1971).

56. Proposed Treas. Reg. § 1.665 (b)-1A (d), ex. (3), 36 Fed. Reg. 2611 (1971).

57. INT. REV. CODE of 1954, § 663 (c); *see* text accompanying note 16 *supra*.

58. *See* Treas. § 1.665 (e)-2 (1956); Proposed Treas. Reg. § 1.665 (g)-2A, 36 Fed. Reg. 2612 (1971).

59. This is subject only to the limitations in the definition of "preceding taxable year," § 665 (e), which limits the throwback to years beginning after January 1, 1969 for distributions made in years beginning after December 31, 1973. For distributions in years beginning before January 1, 1974, the five-year limitation is retained.

(except for the transitional rules) when there is an accumulation distribution, income will be deemed to have been distributed in the year it was earned by the trust commencing with the year 1969.

The other change made in section 666 (a) is the change from a "LIFO" method to a "FIFO" method of allocation. Previously, accumulation distributions were first allocated to the most recent of the preceding taxable years;[60] under the new section, distributions are first allocated to the earliest preceding taxable year.[61]

3. Technical Changes

There were, of course, a number of minor technical changes made in the throwback rule by the Reform Act. Because of their relative unimportance, these will not be examined in detail.

The definition of "taxes imposed on the trust" was changed.[62] This in turn affects the definition of "undistributed net income,"[63] the amount of "taxes deemed distributed"[64] and the amount of credit authorized for beneficiaries when there is an accumulation distribution.[65] Another change, discussed briefly in subsection 2 *supra,* is in the transitional rules built into the definition of "preceding taxable year."[66]

C. *Capital Gains Throwback*

Before the Reform Act, capital gains which were allocated to corpus when earned (and not paid out currently) were only taxed to the trust and therefore at the trust's tax rates. If later distributed, there was no throwback of the capital gains so that the gain would be taxed at the beneficiary's tax rate. The reason for this result is that capital gains, to the extent allocated to corpus, are excluded from distributable net income,[67] and under section 666 (a) accumulation distributions are deemed to have been distributed in preceding taxable years only to the extent of the undistributed net income (which is defined in terms of the DNI) for such preceding year.

In the Reform Act, a capital gain throwback rule was adopted so that "capital gains of accumulation trusts allocated to corpus of the trust [would be treated] in a manner similar to ordinary income accumulations."[68]

60. INT. REV. CODE of 1954, § 666 (a) (prior to 1969 amendments); for years beginning before January 1, 1970, this rule is retained. Reform Act § 331 (A) (d) (2) (B).

61. INT. REV. CODE of 1954, § 666 (a).

62. *Id.* § 665 (d). The change is essentially from a calculation of the difference between taxes paid and what would have been paid had all the distributable net income been distributed, to a ratio calculation. *See* Treas. Reg. § 1.665 (d)-1 (1956), and Proposed Treas. Reg. § 1.665 (d)-1A, 36 Fed. Reg. 2612 (1971).

63. INT. REV. CODE of 1954, § 665 (a). Similarly, *see* § 665 (f) for the definition of "undistributed capital gain."

64. *Id.* §§ 666 (c), 669 (e).

65. *Id.* § 667.

66. *Id.* § 665 (e).

67. *Id.* § 643 (a) (3). Capital losses are similarly excluded "except to the extent such losses are taken into account in determining the amount of [capital] gains which are . . . distributed to any beneficiary during the taxable year." *Id. See* pt. I, § B (1) of this Comment.

68. S. REP. No. 552, 91st Cong., 1st Sess. 127 (1969).

Congress believed that this was necessary "to prevent the use of trusts to accumulate capital gains at low rates for future distribution to high tax bracket beneficiaries without any additional tax."[69]

1. Definition of Terms

Two new terms were added by the Tax Reform Act, the definitions of which are necessary to understand the capital gain throwback. "Undistributed capital gain" is the amount of capital gains in excess of capital losses allocated to corpus minus the amount of taxes imposed on the trust attributable to such gains.[70] A "capital gain distribution" for any taxable year, is

> "that portion of an accumulation distribution which exceeds the amount of such accumulation distribution deemed under section 666 (a) to be undistributed net income of the trust for all preceding taxable years,"[71]

to the extent of undistributed capital gain of the trust for all preceding taxable years.[72]

For example: A trust which is not required to distribute any income, has made the following accumulations in 1971, 1972 and 1973:

Taxable Year	Undistributed net income	Undistributed capital gain
1971	$10,000	$5,000
1972	$10,000	-0-
1973	$10,000	$5,000

In taxable year 1974, the trust has distributable net income of $2,000 and $1,000 capital gains allocable to corpus. The trustee distributes $45,000 to the beneficiary. There is a capital gain distribution in taxable year 1974 of $10,000 computed as follows:[73]

69. *Id.*
70. INT. REV. CODE of 1954, § 665 (f).
71. Proposed Treas. Reg. § 1.665 (g)-1A, 36 Fed. Reg. 2614 (1971).
72. *Id.* It is submitted by this writer that this definition, in spite of the fact that it is the result clearly intended by Congress, is inconsistent with the clear language of the Code and hence incorrect. For the purposes of this comment, however, it will be assumed to be correct.

Under the terms of § 665 (g) a capital gain distribution is limited "to the extent of undistributed capital gain *for such taxable year*" (emphasis added), not to the extent of undistributed capital gain for all *preceding taxable years.* Section 665 (f) defines undistributed capital gain "for any taxable year of the trust" to be, basically, net capital gain for that year which was not distributed (minus taxes attributable thereto). The unambiguous meaning of this definition is that undistributed capital gains for a particular year do not include capital gains from any preceding taxable year. This interpretation is substantiated in Proposed Treas. Reg. § 1.665 (f)-1A (a), 36 Fed. Reg. 2613 (1971). Thus it is submitted that the capital gain throwback is limited substantially beyond the intention of the Congress and that careful planning will avoid the effect of the rule entirely.

73. The computation follows the wording of the Code, except for the problem discussed in note 72 *supra.*

Amounts specified in section 661 (a) (2)		$45,000
Distributable net income	$2,000	
Less: Amount required to be distributed currently	-0-	
(Accumulation distribution)		$43,000
Less: Undistributed net income for all preceding years		$30,000
(*i.e.*, ordinary income throwback)		$13,000

The $13,000 is a capital gain distribution to the extent of undistributed capital gain for *all preceding* taxable years, *i.e.*, $10,000. Thus, in 1974, the trust has made a capital gain distribution of $10,000.

2. Operation of the Capital Gain Throwback

The operative section for the throwback of capital gains is section 669. This throwback rule operates essentially like the ordinary income throwback. Thus, a capital gain distribution is deemed to be an amount properly paid (under section 662 (a) (2)) on the last day of each preceding taxable year, to the extent of undistributed capital gain for such preceding year.[74] As with ordinary income throwbacks, the capital gain is thrown back first to the earliest appropriate taxable year. Also, an appropriate amount of taxes imposed on the trust attributable to the undistributed capital gain is deemed to be distributed.[75]

There is a significant limitation on the effect of the capital gain throwback rule. The operative section (669 (a)) begins: "In the case of a trust which is not required to distribute all of its income currently. . . ." Recalling that "income" does not include capital gains if under the governing instrument and applicable local law they are properly allocated to corpus,[76] a trust which is required to distribute all *income* currently will not have any capital gain throwback even though it later has a capital gain distribution.[77]

This limitation is further expanded by the construction given to the phrase "a trust which is not required to distribute all of its income currently. . . ." The last sentence of section 668 (a) states:

> "For purposes of this subpart [D], a trust shall not be considerd to be a trust which is not required to distribute all of its income currently for any taxable year prior to the first taxable year in which income is [*actually*] accumulated."

Thus, any trust (whether or not *required* to distribute all of its income

74. INT. REV. CODE of 1954, § 669 (a). Section 331 (d) (2) (C) of the Reform Act excepts from capital gain throwback distributions made before January 1, 1972 by a trust in existence on December 31, 1969. This exception is limited to one trust per beneficiary (except for a marital deduction trust). *See* Proposed Treas. Reg. § 1.669 (c)-2A, 36 Fed. Reg. 2626 (1971).

75. INT. REV. CODE of 1954, § 669 (d), (e).

76. *See* INT. REV. CODE of 1954, § 663 (b).

77. This is true whether the distribution occurs at termination of the trust or pursuant to a discretionary power in the trustee to distribute corpus.

currently) which always distributes all of its income[78] currently[79] will never have a capital gain distribution throwback. If the trust accumulates income for the first time in a taxable year after years in which it has undistributed capital gain, a later capital gain distribution will not be thrown back to the years preceding the year in which income was first accumulated.

For example,[80] a trust has made the following accumulations (assume the undistributed net income is the same as income under applicable local law and that no income was accumulated prior to 1970):

Year	Undistributed net income	Undistributed capital gain
1969	none	$10,000
1970	$1,000	$ 3,000
1971	none	$ 4,000

The trust has distributable net income in 1972 of $2,000 and recognizes capital gains of $4,500 that are allocable to corpus. On December 31, 1972 the trustee makes a distribution of $12,000 to the beneficiary. The amount of the capital gain distribution and the allocation to preceding taxable years is calculated as follows:

Amount distributed	$12,000
Less: DNI	$ 2,000
	$10,000
Less: total undistributed net income for all preceding taxable years (this will be ordinary income throwback)	$ 1,000
Potential Capital gain distribution	$ 9,000
But, only to the extent of total undistributed capital gain for all years of the trust beginning with the first year in which income is accumulated and ending before this taxable year	$ 7,000
Balance (corpus)	$ 2,000

There still remains undistributed capital gain from 1969 of $10,000 (which will never be deemed distributed) and $4,500 of undistributed capital gain from 1972.

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78. This does not include, of course, capital gain properly allocable to corpus. In addition, certain items of gross income may be properly allocable to corpus (*e.g.*, extraordinary dividends or income set aside for a depreciation reserve), even though included in distributable net income. Thus a trust may have undistributed net income for a particular year, and still not have accumulated any "income" for purposes of § 668 (a) (3). *See* Proposed Treas. Reg. § 1.668 (a)-1A (c), 36 Fed. Reg. 2619 (1971).

If a trust has separate shares, and any share accumulates income, all shares are considered to have accumulated income for purposes of § 668 (a) (3). Proposed Treas. Reg. § 1.668 (a)-1A (c), 36 Fed. Reg. 2619 (1971).

79. The distribution may actually be made within the first 65 days of the next taxable year. INT. REV. CODE of 1954, § 663 (b).

80. Adopted from the example in Proposed Treas. Reg. § 1.665 (g)-1A, 36 Fed. Reg. 2614 (1971).

D. *Treatment of Amounts Deemed to Have Been Distributed*

Prior to the Reform Act, amounts deemed distributed in preceding taxable years were included in the beneficiary's gross income in the year in which the distribution actually took place.[81] The tax attributable to those amounts, however, was limited to the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiary on the day on which they were deemed to have been distributed.[82]

1. The "Partial-Tax" Scheme

The Reform Act adopts a more detailed system for the computation of the beneficiary's tax, although the amounts deemed distributed in preceding years are still included in the income of the beneficiary in the year when the distribution takes place.[83] This new system may be termed a "partial-tax" system of calculation. In order to determine the total income tax imposed on a beneficiary for a taxable year in which he has included amounts in his gross income pursuant to section 668 (a) one must take the sum of three "partial taxes:"

1. The amount of tax which would have been due on the beneficiary's income without inclusion of the amounts added to his income by section 668 (a).[84] Thus, this is a tax for the taxable year as if there had been no "throwback" additions.

2. The additional tax due to (ordinary income) accumulation distributions.[85]

3. The additional tax due to capital gain distributions.[86]

2. Calculation of the Partial Taxes

The first partial tax is simply calculated by computing the tax (at the rate and manner as if section 668 had not been enacted) on the beneficiary's taxable income for the year in question, without including the amounts deemed distributed in preceding years under sections 666 and 669.[87]

The rules for the calculation of the second and third partial taxes are found in section 668 (b) and 669 (b) respectively. With minor exceptions, these rules are the same; therefore, unless otherwise noted, the rules as discussed for (ordinary income) accumulation distributions apply also to the calculation of the third partial tax.

Except for certain limitations, discussed *infra*, the beneficiary may elect either of two alternative methods of calculating the second or third partial

81. INT. REV. CODE of 1954, § 668 (a) (prior to 1969 amendments).
82. *Id. See* Treas. Reg. § 1.668 (a)-4 (1956).
83. INT. REV. CODE of 1954, § 668 (a). Therefore, the returns for prior years for the trust and beneficiary are not amended. Accumulation distributions are allocated among beneficiaries in substantially the same manner as is done for current distributions. *See* Proposed Treas. Reg. § 1.668 (a)-2A, 36 Fed. Reg. 2620 (1971).
84. INT. REV. CODE of 1954, § 668 (a) (1).
85. *Id.* § 668 (a) (2).
86. *Id.* § 668 (a) (3).
87. *Id.* § 668 (a) (1).

tax.[88] These two methods are referred to respectively as the "exact" method and the "short cut" method.[89]

The "exact" method requires a determination of the sum of the taxes which are attributable to the amounts deemed distributed in the preceding taxable years.[90] The "taxes attributable" to the amounts deemed distributed is the difference between the tax calculated for each prior year with the inclusion of the amounts deemed distributed and the tax for each such year calculated without including them.[91] Both of these tax calculations must reflect the beneficiary's marital, dependency, exemption and filing status for the particular year.[92]

Aside from the obvious record-keeping burden which is involved in the use of the exact method, it may appear at first glance to be fairly straightforward. However, there are numerous complications which may arise.[93] For example, in computing the tax for a preceding year with the inclusion, any item which depends on the amount of gross income, adjusted gross income, or taxable income must be recomputed for the year. This would apply, for example, to the amount of allowable charitable contribution deductions, and to the amount of non-deductible medical expenses.[94]

The "short-cut" method of computing the second and third partial taxes is essentially an averaging of the increase in the beneficiary's tax for the three years preceding the distribution which is attributable to adding to his income for each of the three years an average of the amount deemed distributed for all the preceding years. These are the steps in making the computation:[95]

1. Determine the number of taxable years of the trust in which amounts are deemed to have been distributed.[96]

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88. Section 668 (b) (1) actually states that the tax is the lesser of the two alternative methods, but Proposed Treas. Reg. § 1.668 (b)-1A (a) (2), 36 Fed. Reg. 2620 (1971); and § 1.669 (b)-1A (a) (2), 36 Fed. Reg. 2624 (1971), indicate that the method used in the return shall be accepted as the method producing the lesser tax. Presumably, however, the return is not conclusive and could be amended within the period of the statute of limitations.

89. Proposed Treas. Reg. § 1.668 (b)-1A (a), 36 Fed. Reg. 2620 (1971); § 1.669 (b)-1A (a), 36 Fed. Reg. 2624 (1971).

90. INT. REV. CODE of 1954, §§ 668 (b) (1) (A), 669 (b) (1).

91. Proposed Treas. Reg. § 1.668 (b)-1A (b) (1), 36 Fed. Reg. 2620 (1971); § 1.669 (b)-1A (b) (1), 36 Fed. Reg. 2624 (1971).

92. Authorities cited note 91 *supra*. If the beneficiary was not in existence on the last day of the particular year, it is assumed: (1) that he was in existence; (2) that he had no gross income except for amounts deemed distributed in prior distributions (*see* text accompanying note 100 *infra*); (3) that he was unmarried and had no dependents; (4) that he had no deductions except the standard deduction; and (5) that he was entitled to one personal exemption. Proposed Treas. Reg. § 1.668 (b)-2A (a), 36 Fed. Reg. 2622 (1971).

93. Although these complications may also apply to the "short-cut" method (*see* Proposed Treas. Reg. § 1.668 (b)-3A (b) (1), 36 Fed. Reg. 2623 (1971); § 1.669 (c)-2A (b) (1), 36 Fed. Reg. 2626 (1971)), from the standpoint of the degree of the burden on the beneficiary they will usually be much greater under the "exact" method.

94. Authorities cited note 93 *supra*.

95. Proposed Treas. Reg. § 1.668 (b)-1A (c), 36 Fed. Reg. 2621 (1971). *See also* text accompanying note 103 *infra*.

96. This number does not include any years into which an amount is deemed distributed which is less than 25 percent of the "true" average of the amounts

2. Divide the total amount deemed distributed in the preceding years by the number of years in which amounts are deemed to have been distributed as calculated in step (1). This quotient is the average amount deemed distributed per preceding year.[97]

3. Compute the tax on the beneficiary for each of the three years immediately preceding the year in which the distribution is made, including in gross income the quotient (the average amount deemed distributed in each preceding year) which was calculated in step (2).

4. Compute the tax on the beneficiary for each of the three years immediately preceding the year of the distribution without inclusion of the amount determined in step (2).

5. For each of the three years for which the tax calculations have been made, find the difference between the tax with the inclusion (step (3)) and without the inclusion (step (4)). This difference, for each such year, is the increase in tax attributable to the addition to the beneficiary's gross income made pursuant to step (3).

6. Find the average of the increases determined for each of the three years in step (5). This figure is the average increase in the beneficiary's tax for one year.

7. Multiply the increase for one year (determined in step (6) by the number of the trust's taxable years in which amounts are deemed to have been distributed.[98] This product is the total partial tax which was to be determined.[99]

In computing the partial tax (by either method), it is necessary to compute the beneficiary's gross income in a preceding year without inclusion of the amounts deemed distributed in the year as a result of the particular accumulation distribution in question. *Other* accumulation or capital gain distributions may affect that gross income.

Section 668 (b) (3) of the Code sets forth the rules for determining the effect of other accumulation or capital gain distributions on the calculation of the second partial tax (*i.e.*, for accumulation distributions). The income of the beneficiary in any preceding taxable year in which income is deemed distributed as a result of the current accumulation distribution in-

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deemed distributed per preceding year. For example, an accumulation distribution of $90,000 in 1979 is deemed to have been distributed as follows: $29,000 in each of the years 1972, 1973 and 1974 and $3,000 in the year 1975. The "true" average of amounts deemed distributed per preceding year is $22,500 ($90,000 divided by four actual preceding years). However, since $3,000 (the amount deemed distributed in 1975) is less than $5,625 (25 percent of the "true" average of the amounts deemed distributed per preceding year), 1975 is not counted and only the years are counted in the averaging process under the "shortcut" method. Proposed Treas. Reg. § 1.668 (b)-1A (c) (1) (i), 36 Fed. Reg. 2621 (1971).

97. The amount determined under this section is deemed to consist of the same proportion of each class of income as in the total amount deemed distributed in preceding taxable years. *See* Proposed Treas. Reg. § 1.668 (b)-1A (c) (1) (ii), 36 Fed. Reg. 2621 (1971).

98. *See* note 96 *supra*.

99. Technically, the tax credit allowed beneficiaries for taxes paid by the trust on income now deemed to be distributed is a subtraction from the partial tax. INT. REV. CODE of 1954, § 668 (b) (1).

cludes amounts deemed distributed to the beneficiary in the preceding year as a result of a prior accumulation distribution. "Prior accumulation distribution" means an accumulation or capital gain distribution from the same or another trust which was made in a preceding year, and any accumulation distribution from another trust made in the current year which the beneficiary has determined to be deemed to have been made first.[100] Capital gain distributions made in the same year by the same trust are not "prior accumulation distributions."[101]

The effect of other distributions on the computation of the third partial tax (for capital gain distributions) is generally consistent with the approach taken for the second partial tax. Thus, accumulation and capital gain distributions made in prior taxable years, accumulation distributions made in the current year, and capital gain distributions made in the current year from another trust which the beneficiary has determined to be deemed to have been made first[102] must be included in the gross income of preceding years.

Finally, in calculating the taxes attributable to the amounts deemed distributed (under either method) one must take into account the effect of the distributions (deemed to have been made) on carrybacks and carryovers (net operating losses, charitable contributions and capital losses).[103]

For example: In 1978, a trust makes an accumulation distribution to X of $50,000 which is deemed under section 666 (a) to have been distributed in 1972. X had income in 1972, 1973 and 1974 and a net operating loss (NOL) in 1975 which offset his income in those years, as follows:

Year	Actual income or (loss)	Income (after net operating loss carryback before inclusion of amounts deemed distributed)
1972	$ 10,000	-0-
1973	$ 50,000	-0-
1974	$ 50,000	$10,000
1975	$ (100,000)	-0-

100. Proposed Treas. Reg. § 1.668 (b)-2A (b), 36 Fed. Reg. 2620 (1971). The determination referred to in this sentence is the determination made pursuant to § 668 (b) (4).

101. Proposed Treas. Reg. § 1.668 (b)-2A (b), 36 Fed. Reg. 2620 (1971). Neither the Code nor the Proposed Regulations determine the effect of a capital gain distribution made in the same year from a different trust. Presumably, such distributions are not included in the preceding year's gross income.

102. This determination is made pursuant to Proposed Treas. Reg. § 1.669 (c)-1A (b), 36 Fed. Reg. 2626 (1971).

103. Proposed Treas. Reg. § 1.668 (b)-3A (b) (2), 36 Fed. Reg. 2623 (1971); § 1.669 (c)-2A (b) (2), 36 Fed. Reg. 2626 (1971). Although this is a reasonable interpretation of the statutory phrase "taxes attributable to the amounts deemed distributed . . ." (§ 668 (b) (1) (A)), it is inconsistent with the definition of the phrase in Proposed Treas. Reg. § 1.668 (b)-1A (b) (1), 36 Fed. Reg. 2670 (1971). *See* text accompanying note 91 *supra*.

As a result of the allocation of the 1978 accumulation distribution to 1972, X's income for 1972, 1973, 1974, and 1975, after taking into account the 1975 NOL, is deemed to be as follows:

Year	Income (after NOL) including amounts deemed to have been distributed.
1972	-0- (10,000 + $50,000 −$60,000 NOL)
1973	$10,000 ($50,000 −$40,000 balance of NOL)
1974	$50,000
1975	-0-

Therefore, the tax on the 1978 accumulation distribution to X is the tax X would have paid in 1973 and 1974 had he had the above income in such year less the tax due on X's income for those years (after accounting for the NOL) without inclusion of the amount deemed distributed in 1972.[104]

The effect of an NOL can become more complex if an accumulation distribution is deemed to have been distributed in more than one preceding taxable year. Thus, given the income of X for 1972, 1973 and 1974 and the NOL in 1975 which offset his income in those years, as in the preceding example, if in 1978 there was an accumulation distribution of $100,000 deemed to have been distributed $50,000 in 1972 and $50,000 in 1973, the partial tax attributable to that distribution is calculated (using the exact method) as follows:[105]

A. Calculate the tax attributable to amounts deemed distributed in 1972 (without regard to amounts deemed distribtued in 1973):

Total tax on:

Year	Income (after consideration of NOL, and including amounts deemed distributed in 1972)
1972	-0- ($10,000 actual income + $50,000 deemed distributed −$60,000 of the NOL)
1973	$10,000 ($50,000 actual income −$40,000 balance of the NOL)
1974	$50,000 (actual income)
1975	-0-

Less, the total tax on:

Year	Income (after consideration of the NOL, without inclusion of amounts deemed distributed)
1972	-0-
1973	-0-
1974	$10,000
1975	-0-

104. Proposed Treas. Reg. § 1.668(b)-3A(b)(2), 36 Fed. Reg. 2623 (1971) (example). The example in the Proposed Regulations does not indicate that the amount of tax as determined without the inclusion of the amounts deemed distributed is to be subtracted from the amount of tax determined with the inclusion in order to calculate the tax attributable to the distribution. This is probably an oversight.

105. Actually, neither the Code nor the Proposed Regulations address themselves to this situation; the method set forth in the text follows the general rules involved, although there are other possible interpretations as to the correct method. *See* note 106 *infra.*

B. Add to the net tax attributable to the amount deemed to have been distributed in 1972 the tax attributable to amounts deemed distributed in 1973 (without regard to amounts deemed distributed in 1972):

Total tax on:

Year	Income (after consideration of NOL and including amounts deemed distributed in 1973)
1972	-0- ($10,000 actual income —$10,000 of the NOL)
1973	$10,000 ($50,000 actual income + $50,000 deemed distributed —$90,000 balance of the NOL)
1974	$50,000 (actual income)
1975	-0-

Less, total tax of:

Year	Income (after consideration of NOL without inclusion of amounts deemed distributed)
1972	-0-
1973	-0-
1974	$10,000
1975	-0-

The sum of the taxes attributable to the amounts deemed distributed in each year respectively is the total partial tax.[106]

106. It will be noted that the amounts deemed distributed in 1972 affect X's income in 1973 and 1974 indirectly through the NOL. However, the suggested method does not take this altered income into account in calculating the tax attributable to the amounts deemed distribued in 1973. This approach is inferred from the rules set forth in the text on the effect of accumulation distributions on the beneficiary's income. *See* text accompanying note 94 *supra*. The rules require the beneficiary to take into account income deemed to have been distributed as a result of *prior* accumulation distributions. Thus, under the doctrine of *expressio unius est exclusio alterius*, income deemed to have been distributed as a result of the *current* accumulation distribution should not have an effect on the calculation of the tax attributable to the current distribution.

One may argue that § 666 (a) (which states that distributions are deemed to have been made in preceding years "commencing with the earliest of such years") requires the beneficiary to take the amounts deemed distributed in earlier years (as a result of the current distribution) into account when calculating the tax attributable to amounts deemed distributed in the later year. Thus, the tax attributable to amounts deemed distributed in 1972 is calculated in the same manner as in the text example. The tax attributable to the amounts deemed distributed in 1973 would be calculated by taking into account the effects of the amounts deemed distributed in 1972:

Total tax on:

Year	Income	
1972	-0-	($10,000 + $50,000 deemed distributed —$60,000 of the NOL.)
1973	$60,000	($50,000 + $50,000 deemed distributed —$40,000 balance of NOL.)
1974	$50,000	(actual income)
1975	-0-	

IV. Estate Planning Considerations

In determining what devices are appropriate in any estate plan, first consideration must always be given to carrying out the settlor-testator's dispositive desires. Tax saving considerations should always be supplementary. Multiple accumulation trusts are tools which the planner has at his disposal to use when he determines they are appropriate. The determination of appropriateness of any device must, of course, take into account the tax cost or savings involved. It is an analysis of this aspect of multiple accumulation trusts which is described in this part.[107]

A. *Current Advantages of Multiple Accumulation Trusts*

1. Tax Deferral

If the throwback rules under the Tax Reform Act achieved the ideal for which they are designed, then the beneficiary who received the income would be taxed on the income at his rates;[108] income-splitting and hence tax saving would be eliminated.

Notwithstanding the absence of tax *saving*, tax *advantages* in multiple accumulation trusts still exist. Although the beneficiary may, ultimately, have to pay the same amount of tax as he would have paid had he received all the income currently as earned, the payment of the tax may be postponed for any number of years.

Under the Senate version of the Tax Reform Act, a non-deductible interest charge of 3 percent would have been levied on tax liability resulting from the throwback.[109] This provision was clearly aimed at eliminating the potential for tax deferral of large amounts which exists in multiple accumulation trusts. Since the interest provision was eliminated by the Conference Committee, the potential still exists.

2. Tax Savings

In addition to the deferral of taxes, under certain conditions multiple accumulation trusts may still be effective in saving taxes. The limitation on

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Less, the total tax on:

Year	Income
1972	-0-
1973	$10,000
1974	$50,000
1975	-0-

There are, of course other permutations which could be suggested as possible methods of calculating the tax in this situation. It should be noted that the only difference between the two methods is the tax bracket at which the amounts deemed distributed in 1973 are taxed. Under the suggested method, $10,000 is taxed at the lowest rates and $40,000 is taxed at the $10,000-plus rates. Under the alternative method, all $50,000 is taxed at the $10,000-plus rates.

107. For an excellent discussion of the dispositive uses of multiple trusts, including a discussion of non-tax motives for establishing multiple trusts, *see* Friedman & Wheeler, *Advantages and Problems of Multiple Trusts*, N.Y.U. 20th Inst. on Fed. Tax. 181 (1962).

108. *See* note 51 and accompanying text *supra*.

109. *See* S. Rep., *supra* note 50.

the operation of the capital gain throwback[110] gives rise to a tax saving. Capital gains may be split among multiple trusts and accumulated at very low tax rates. If the gain has been accumulated in taxable years of the trust before any "income" was accumulated then, on distribution, there will be no throwback and no resultant "bunching" of the income in one taxable unit.[111]

The short-cut method of computing the partial taxes also provides opportunity for tax savings.[112] This is because it furnishes a means of avoiding the effect of other accumulation and capital gain distributions.[113] As discussed *supra,* in computing the partial tax the income of the beneficiary for all preceding years must include amounts deemed distributed in such year by prior accumulation distributions. If the partial tax is being calculated by the exact method, then in calculating the beneficiary's gross income in the preceding year all prior accumulation distributions deemed distributed in that year must be included; this increase in his gross income, of course, leads to an increase in his incremental tax rate. But, if the short-cut method is being used, the amounts deemed distributed by prior accumulation distributions will not increase the tax bracket, because the beneficiary's income in only the three preceding years are used to calculate the partial tax, not the year in which the distribution was deemed to have been made.[114] The following is an example of how this would work:

In year 1980, trust one makes an accumulation distribution to X of $50,000 deemed to have been distributed in 1971. In 1984, trust two makes an accumulation distribution to X of $50,000 deemed to have been distributed in 1971. Assume that X has a constant income over all years from 1971 to 1984 of $10,000 per year.

In calculating the partial tax for the 1984 distribution, either the exact or short-cut method may be used. If the exact method is used the tax attributable to the 1984 distribution is the difference between the tax on $110,000 ($10,000 and $50,000 from the 1980 accumulation distribution and $50,000 from this 1984 distribution) and the tax on $60,000 ($10,000 and $50,000 from 1980). In other words the 1984 distribution is taxed at the $60,000-plus tax brackets.

If the short-cut method is used, the tax attributable to the 1984 distribution is the difference between the tax on $60,000 ($10,000 and $50,000 from the 1984 distribution) and $10,000. The $50,000 from the 1980 distribution is not involved in the calculation since it was neither distributed[115] nor deemed to have been distributed[116] in 1981, 1982, or 1983. These were

110. *See* text accompanying note 76 *supra.*
111. *See* text accompanying note 76 *supra.*
112. *See* text accompanying note 95 *supra.*
113. INT. REV. CODE of 1954, §§ 668 (b) (3), 669 (c); *see* text accompanying note 100 *supra.*
114. This assumes the year in which the prior distribution is made is more than three years before the current year.
115. INT. REV. CODE of 1954, § 668 (a). The amount of an accumulation distribution is included in the beneficiary's income when distributed.
116. *Id.* § 668 (b) (3); the amounts are deemed to be included in income in those years.

the years used to calculate the tax attributable to the distribution made in 1984. Thus, the 1984 distribution is taxed at the $10,000-plus tax brackets.

This opportunity to save taxes by the use of the short-cut method is severely limited by section 668 (b) (2) (B). That section states that if two or more other trusts have made prior accumulation distributions, any part of which was deemed to be distributed in a particular preceding taxable year, and the accumulation distribution of the trust in question is deemed to have been distributed in the same year, the short-cut method may not be used.[117] Thus, with two trusts, the short-cut method may be used without limitation. If more than two trusts are used, the short-cut method may be used to save taxes as described above for two of the trusts, and the other trusts will merely effectuate tax deferral.

B. *The Cost of Multiple Trusts*

Against any advantages of multiple trusts must be balanced the disadvantages or costs. Multiple trusts, of course, have the same costs which single trusts have but these costs are multiplied. They include the cost of establishing and administering the trusts.[118] In addition, the burdens imposed on all accumulation trusts by the throwback rules of the Tax Reform Act are quite substantial. Trust records and the beneficiary's tax records must be kept for at least all years in which a trust has undistributed net income plus the statutory limitation period.[119]

The clerical burden of determining the partial-taxes under the throwback rules can be quite severe.[120] This is an important consideration, especially if the trusts will last a substantial length of time or if the beneficiary is likely to have complex tax problems of his own. For this reason multiple accumulation trusts are most attractive for unborn or infant beneficiaries; the tax computations will be the simplest and most straightforward.

The tax computation cost applies similarly to a single accumulation trust. However, when dealing with multiple trusts, not only is there the additional factor of tax computations for each trust, but there can also be a more complex computation. This is due to the fact that in calculating the tax resulting from one accumulation distribution, other prior accumulation distributions deemed distributed in the same year must be taken into account.[121]

C. *Risks and Prospects for the Future*

The risk involved in the creation of multiple trusts is the chance that the advantages which are relied upon may become illusory, or that additional disadvantages (or costs) may materialize.

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117. *See* Proposed Treas. Reg. § 1.668(b)-1A(d), 36 Fed. Reg. 2622 (1971); § 1.669(b)-1A(d), 36 Fed. Reg. 2625 (1971), for the corresponding limitation for capital gain distributions.

118. *See* text accompanying note 32 *supra* for the danger involved in not administering the trusts as separate entities.

119. *See* Proposed Treas. Reg. § 1.668(b)-4A, 36 Fed. Reg. 2623 (1971).

120. *See* pt. III, § D (2) of this Comment.

121. *See* text accompanying note 100 *supra*.

The basic danger of losing the advantages of multiple trusts is the chance that they may be consolidated for tax purposes. This could conceivably be done through the Proposed Regulation previously discussed,[122] or it could be done as a result of the case law doctrine of "substance over form."[123] Additional costs may materialize simply as a result of litigating issues such as these.

Additional legislation directed specifically at multiple trusts is always a possibility. From past experience, it may be inferred that any new legislation will apply to existing schemes but that it will not be retroactive.[124] However, with regard to tax avoidance by multiple trusts, the Treasury Department has "concluded that the matter could not be dealt with adequately by a statute directed at multiple trusts,"[125] and, furthermore, that "[t]his type of legislation was fraught with difficulties in determining the similarity of beneficiaries under many varying circumstances."[126] The sincerity of this position is questionable in light of the proposed regulation previously discussed.[127]

V. Conclusion

It is quite clear that multiple accumulation trusts are not nearly as useful and advantageous after the Tax Reform Act as they were before. However, they are still available and potential advantages do remain.

The most difficult question is not how to use multiple trusts, but when to use multiple trusts. Each instance must be decided on its own facts. There are a few factors which should be weighed most carefully. First, the estate must be of considerable size to warrant the costs involved. This will be the overriding factor in most situations. The second factor is the potential for capital gain income, which still enjoys considerable advantages. Third, one must consider the age and tax situation of the beneficiaries.

In short, multiple trusts should not be used improvidently but still offer certain tax advantages to be derived in an appropriate situation.

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122. *See* text accompanying note 36 *supra.*
123. *See* text accompanying note 29 *supra.*
124. *See, e.g.,* Int. Rev. Code of 1954, § 665 (e).
125. Remarks by the Honorable Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, 51st Midwinter Trust Conference, Trust Division, American Bankers Association, in New York City, Feb. 10, 1970.
126. *Id.*
127. *See* text accompanying note 36 *supra.*