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William R. Pietz

Indiana University School of Law

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INCOME TAXATION OF ESTATES AND TRUSTS—GIFT OF SPECIFIC PROPERTY

INTRODUCTION

Under the income tax subtitle of the Internal Revenue Code of 1954, estates and trusts are treated as distinct taxable entities if current income is neither distributed currently nor required to be distributed currently to the beneficiaries.¹ Estates and trusts are treated as conduits to the beneficiaries of income distributed currently or required to be distributed currently. Therefore, the beneficiaries are taxed on distributed and distributable income.²

Under the 1954 Code, local law distinctions between income and corpus are ignored. Except for distributions in excess of distributable net income, the recipient-beneficiary must report as taxable income the amount of net income required by the terms of the creating instrument to be distributed currently, whether or not actually distributed,³ and all other amounts properly paid or distributed, regardless of whether amounts received comprise corpus or income.⁴ Generally speaking the ceiling on this taxable income is the distributable net income of the trust or estate for a given period.⁵ This amount approximates, after certain technical adjustments, the inflow of taxable income to the trust or estate. It is allocated first to beneficiaries to whom income is required to be distributed currently, and then the amount unabsorbed is allocated among all other beneficiaries who receive distributions.⁶ Payments to these two classes of beneficiaries are referred to as "first and second tier" distributions, respectively. Amounts distributed in excess of distributable net income are excluded from the beneficiary's gross income.

A significant exception to these general principles is accorded by section 663(a) (1) which provides another channel of tax-free distribution by its stipulation that certain gifts and bequests will neither reduce the taxable income of the estate or trust nor represent taxable income to the beneficiary.⁷ According to section 663(a) (1), a distribution which

1. INT. REV. CODE of 1954, Subch. J [hereinafter INT. REV. CODE of 1954 is cited only by section numbers].

2. §§ 661-62.

3. § 662(a) (1).

4. § 662(a) (2).

5. § 662.

6. *Id.*

7. § 663(a) (1) reads:

(a) Exclusions.—There shall not be included as amounts falling within section 661 (a) or 662 (a)—

(1) Gifts, bequests, etc.—Any amount which, under the terms of the

under the terms of the pertinent instrument is properly paid as a gift or bequest of a specific sum of money or property, which is paid or credited in not more than three installments, and which is not required to be derived solely from income will not be taxable to the recipient.⁸

Without section 663(a)(1), in any year in which the distributable net income of the trust or estate exceeded the amount of income actually distributed, a property distribution not in excess of the unabsorbed second tier income would be taxable income to the recipient, even though it represented corpus. Thus section 663(a)(1) has the apparent purpose of insuring that the broad benefits of section 102, which excludes from gross income "the value of property acquired by gift, bequest, devise, or inheritance," will not be entirely sacrificed.

The Conference Committee, in drafting section 663(a)(1), labored to define clearly the distributions excluded as gifts or bequests,⁹ but its gaunt framework must be augmented to impart certainty to financial planning. A need for clarification and for a reappraisal of the value of the present formulation of section 663(a)(1) in reducing the complexities confronting the estate planner and fiduciary furnishes the impetus for the following comments.

DEFINITION OF "SPECIFIC"

The major problem presented by section 663(a)(1) is ascertaining the meaning of "specific." *Inter alia*, the following questionable transfers by trust or will come readily to mind: the residue of an estate, fixed sums to be paid from the residue, proceeds to be derived from the sale of designated assets, assets instructed to be purchased for distribution, the undelineated contents of a safe deposit box, a checking account on which payment is not immediately barred, interests subject to conditions subsequent, property upon which stock dividends or stated or unstated interest may accrue, gift declarations specific as to intended recipient rather than as to the assets to be disbursed, or gifts of a designated pool of assets to be disbursed at a fiduciary's discretion among a class of beneficiaries. The number of additional variations requiring elaboration of the term specific will be a function of one's imagination and aversion to quibbling.

governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of estate or trust shall not be considered as a gift or bequest of a specific sum of money.

8. If income may be accumulated and at a future date payments may be made from either income or corpus, the exclusion is applicable. Treas. Reg. § 1.663(a)-1(b)(3) ex. (3) (1956).

9. H.R. REP. No. 2543, 83d Cong., 2d Sess. 54 (1954).

There appears to be no helpful judicial precedent other than the determination that payments received under local law as additions to a legacy as compensation for use of the legacy funds for the period prior to distribution constitute interest and the accrual of such interest for an indefinite period will not alter the characterization of a bequest.¹⁰ Evidently those with an awareness of section 663(a)(1) have chosen to remain squarely within its ambit and to forsake flexibility in favor of safety.¹¹

At present the only authoritative clarification is found in the Internal Revenue Service Regulations, which unjustifiably narrow the selection of estate planning techniques by choosing a restrictive time focus as the central determinant of specificity. Thus "the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death or under the terms of an *inter vivos* trust instrument as of the date of the inception of the trust."¹²

10. *United States v. Flockemer*, 307 F.2d 171 (5th Cir. 1962). The court expressly disapproved a contrary holding in *Davidson v. United States*, 149 F. Supp. 208 (Ct. Cl. 1957). This latter case, holding that payments prescribed by local law in excess of income actually earned on the legacy may not be termed interest, was concerned with section 162 of the 1939 code and not with the definition of "specific sum" as used in the present section 663(a)(1). The former case relied upon *Wolf v. Commissioner*, 84 F.2d 390 (3d Cir. 1936), and also cites *Foster's Estate v. Commissioner*, 131 F.2d 405 (5th Cir. 1942), and *Clarke v. Commissioner*, ¶ 44246 P-H TAX CT. MEM. (1944).

11. It may be noted that the courts have long provided an operative common law definition of specific property in the law of wills. Thus if a legacy is specific, *i.e.*, "a legacy of something distinguished from the rest of the testator's estate," it cannot be used to pay the estate's creditors until all other estate property has been exhausted. *Elwyn v. DeGarmendia*, 148 Md. 109, 111, 128 A. 913, 914 (1925). Such a bequest may be satisfied by no other assets; the legacy is said to be "adeemed," or nullified, by transfer or detraction of the earmarked property. *See* T. ATKINSON, *WILLS* §§ 132, 134, 136 (2d ed. 1953). This concept of the law of wills is of small utility in clarifying section 663(a)(1). Its implementation has resulted in drawing overly fine lines such as that between the gift of "my shares of X stock" and "100 shares of X stock," with only the former receiving the accolade "specific" regardless of the testator's actual ownership of stock. *Id.* § 132, at 734 and authorities cited. This and similar technicalities, which according to Note, *The Ademption of Legacies of Stocks and Bonds*, 41 *YALE L.J.* 101, 106 (1931) are "remnants of a conceptualistic mode of thinking that is fundamentally foreign to the modern outlook," have no particular relevance in determining whether a tax should accrue. Moreover, the definition is not precise because the courts have altered its content whenever necessary to avoid ademption. In addition, testators have sought to create security from creditors' claims and still avoid ademption by resorting to the demonstrative legacy, *i.e.*, a legacy to be satisfied by specific property the balance of which, if any, may be satisfied by application of any other estate assets. To hold the tax definition of "specific" coterminous with its common law predecessor would penalize using the otherwise-advantageous demonstrative gift. The fact that at common law a lump sum gift of money not expressly payable from a designated fund is not generally considered specific while section 1.663(a)-1(b)(1) of the regulations says that mere ascertainment of the amount involved will suffice indicates that the traditional legal connotation of "specific" will not be determinative. The concept is cited here as an example of the intricate distinctions necessitated by restrictive interpretation.

12. *Treas. Reg. 1.663(a)-1(b)(1)* (1956).

The term "ascertainable" might suggest that irrevocably designating all variables which interact to fix ultimately the amount to be awarded and which are regarded more or less as exogenous by the trustee or executor will suffice. However, as demonstrated by the Regulations' disposition of marital formula bequests,¹³ this is not the result intended by the Commissioner.

Since the enactment of section 2056, which grants a deduction from the gross estate of a maximum of one-half the decedent's adjusted gross estate for amounts transferred to the surviving spouse, estate planners have found it advantageous to qualify for the maximum deduction by using marital deduction formula clauses. The frequency of their use makes their treatment under section 663(a)(1) crucially important. The usual schemes are of two types: (1) a "pecuniary" formula clause which specifies a dollar amount equal to the maximum federal estate tax marital deduction and (2) a "fractional share" formula clause which specifies a fraction composed of a numerator equal to the maximum estate tax marital deduction and a denominator equal to the residuary estate (or equal to a designated pool of assets) by which each asset in the residuary estate (or the pool of assets) is multiplied. The amount of the maximum marital deduction is, by definition, dependent upon the adjusted gross estate¹⁴ which is dependent upon the total expenses incurred in administration; the amount of these expenses deducted from the gross estate rather than being deducted for income tax purposes;¹⁵ the executor's success in obtaining a fair price on disposal of various assets; and the estate valuation date.¹⁶ The fractional share formula clauses grant executors widely varying degrees of discretion as to the actual items remaining in the residue or pools, depending upon the complexity of the composition of the estate and the specificity in the testator's definition of the relevant pool of assets.

The Regulations declare that bequests determined by such formulae are bequests neither of specific sums nor of specific property since the identity of the property and the amount of the money are dependent both on the exercise of the executor's discretion and on the payment of administration and other charges, neither of which are facts existing on the date of the decedent's death. [They assert that] "it is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied. . . ."¹⁷

The opinion had been ventured by one commentator that "a care-

13. *Id.*

14. § 2056(c)(1).

15. §§ 2053, 2056(c)(2)(A).

16. § 2032(a).

17. Treas. Reg. § 1.663(a)-1(b)(1) (1956).

fully worded pecuniary formula marital bequest" should qualify under the statute.¹⁸ The pecuniary clause does not appear to be generically different from the fractional share clause since each depends upon the value of the estate, which is not determinable until after the date of death. It could, perhaps, be argued that the primary objectionable feature of the fractional share formula is the power of the executor to determine the actual items which remain in the residue or pool which the spouse will receive. In contrast, the freedom to affect only the total value received under a pecuniary formula is not significant, but normally an executor will have the option to satisfy the dollar amount of the bequest with assets of his choice. The language of the Regulations appears to be sufficiently broad to prevent both types from qualifying.¹⁹

The Service has ruled that the liability upon the estate created by a pecuniary formula constitutes a "fixed and definite sum;" therefore, a capital gains tax is assessed on the estate when that liability is satisfied by a transfer of assets which have appreciated over their valuation for assessment of the estate tax.²⁰ While qualification of pecuniary formulae for the excision of section 663(a)(1) would still confront the testator with the dilemma of either avoiding a capital gains tax to the estate by use of the fractional share formula or of avoiding an income tax on the beneficiary by use of a pecuniary plan, it would seem that any formula held to establish a fixed and definite amount should also be held to establish a specific sum.

Logically the scope of "specific sum" need not correlate precisely with that of "fixed and definite amount" since each is dependent upon different Code sections, but intuition suggests a broad overlap. Evidently the draftsmen of the capital gain ruling²¹ shared this insight since they felt compelled to declare in a subsequent revenue ruling²² that "the regulations are not to be considered inconsistent." They aver that the revenue ruling, which posits realization of income from payment of a bequest, "is not concerned with the ascertainability of a specific sum of money at the date of death but, rather whether a marital trust fund is provided for in a fixed and definite amount at the time of distribution."²³ Apparently "at the date of death" was added because no time reference necessarily inheres in the words "specific sum." The ruling seemingly implies that it must be conceded that the marital formula does yield a

18. Stevens, *Troublesome Will Provisions*, 34 TAXES 809, 817 (1956).

19. Treas. Reg. § 1.663(a)-1(b)(1) (1956).

19. Treas. Reg. § 1.663(a)-(b)(1) (1956).

20. Rev. Rul. 270, 1956-1 CUM. BULL. 325.

21. *Id.*

22. Rev. Rul. 87, 1960-1 CUM. BULL. 286.

23. *Id.*

specific sum, as an average reasonable reader could understand the term, but valid reasons exist for the belief that Congress contemplated a time limitation in using the term.

A moment's reflection suggests that the adjective "specific" has attached to it sufficiently unspecific everyday connotations to support a variety of interpretations. By the common admonition, "be specific," the speaker may be demanding either a precise description of all or some of the attributes of a given subject or he may be insisting that the exact identity of the subject in question be revealed instantly. Perhaps no more accurate summation of the inquiry necessary to a proper interpretation of section 663(a)(1) can be formulated than the simple, direct query, "Did Congress mean 'specific.'" or 'specific'?" A gloss must be added, and the relevant line of inquiry thus becomes ascertaining legislative purpose.

As noted the present rules of trust and estate income taxation ignore any distinction between income and corpus. The 1939 Code, which adhered to this dichotomy,²⁴ was the target of criticism because it provided excessive leeway for manipulation by the fiduciary bent upon labelling distributions by no other criterion than tax minimization.²⁵ Subchapter J of the 1954 Code seeks to restrict this maneuvering and not to abandon the distinction between income and corpus. The devices of the Code merely attempt to approximate indirectly the effect obtainable by a more stringent adherence to that distinction. Section 663(a)(1) is properly viewed as an extension of this scheme. It preempts from income taxation amounts which in reality represent corpus. In addition it reflects the notion that gifts do not comprise the proper subject of income taxation. Congress could not have decided to employ section 663(a)(1) as a vehicle for thwarting these purposes by incorporating into section 663(a)(1) a hyper-technical requirement of specificity. Mathematical precision at the date of death has no necessary relevance.

It seems likely that "specific" was intended to be synonymous with "designated" and simply requires that the gift reflect the expressed wishes of the settlor or testator with respect to disposition of corpus. More importantly, the term probably was intended to denote a lump sum transfer payable without regard to earnings as opposed to fluctuating payments which might represent income. The trustee's discretion would be relevant whenever he might determine whether an item is to be labelled income or corpus. It should not be considered significant that he may merely alter its precise amount. Clearly, abuse will be restricted by

24. Int. Rev. Code of 1939, ch. 1, § 1961(b), 53 Stat. 66 (now INT. REV. CODE OF 1954, § 641(b)).

25. See Kamin, Surrey, & Warren, *The Internal Revenue Code of 1954: Trusts, Estates, and Beneficiaries*, 54 COLUM. L. REV. 1237 (1954).

requiring that a gift or bequest be specifically earmarked by the grantor or settlor as a particular asset already belonging to the estate or trust, but this requirement may be satisfactorily implemented with less stringency than the Regulations embody.

Some insight into congressional purpose might be found in the House and Senate Reports.²⁶ Both reports state that "a lump-sum gift or bequests" will not be taxable to the beneficiary provided that such a gift or bequest is required by "the specific terms of the will or trust instrument."²⁷ The reader is struck by the uncomplicated reference to "a lump sum gift or bequest" and by the use of "specific" as modifying not the gift but the terms of the instrument. It may be contended that in order to be sufficiently specific the terms must fix a mathematically precise sum, but this appears to contravene the ordinary import of the statement.

One may decide that small significance should attach to possibly inadvertent phrasing in committee reports. It is submitted, however, that if the central significance now attached to specificity by the Regulations had been considered by the committees, no such careless formulation would likely appear even in the hastily assembled reports. Furthermore, the very next sentence in the House Report applies the exclusion to "a distribution of a portion of the trust corpus."²⁸ While again the language may have been unwitting, the statement on its face directly refutes the Regulations which specifically deny the exclusion to a "residuary estate or the corpus of a trust."²⁹ Of course, the House Report may be merely alluding to a more precisely described bequest which is in fact a portion of the corpus.

The succeeding sentence in the report refers simply to "pecuniary legacies or specific bequests of property"³⁰ as qualifying for the exclusion. The brief examples which follow illustrate the meaning of "three installments" and "not solely out of income"; nothing is said of the "specific" criterion. In short, the Regulations seem to place greater stress on the word specific than Congress intended.

Some practical difficulties augur poorly for the test of mathematical precision. The Service has ruled that a gift to a trust of a named dollar amount to be paid from the residue of an estate qualifies for exclusion after giving "due consideration to the remoteness of the possibility that the value of the estate will decrease to the extent that the residue thereof

26. H.R. REP. No. 1337, 83d Cong., 2d Sess. 204 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 354 (1954).

27. *Id.*

28. H.R. REP. No. 1337, 83d Cong., 2d Sess. 204 (1954).

29. Treas. Reg. § 1.663(a)-1(b)(2)(iii) (1956).

30. H.R. REP. No. 1337, 83d Cong., 2d Sess. 204 (1954).

will not be sufficient to fund the trust."³¹ This ad hoc test may often eliminate predictability and thus further complicate estate planning.

The Regulations³² supplement the rule applicable to marital formulae by providing that no gift of "a residuary estate or of the corpus of a trust" will qualify. However, this disqualification might be sidestepped by also conferring a gift of a lump sum of money to the same beneficiary. The fiduciary may then declare that payouts emanate from the residue when the estate has little unabsorbed distributable net income and from the lump sum when unabsorbed distributable net income abounds.

The above section of the Regulations assumes that, because the amount of the residue or corpus will ultimately vary with receipts and expenses, the entire amount must be said to partake of the character of income. When the trustee's accounts reveal the inaccuracy of this assumption, the result may be criticized.

The Regulations concede that a bequest of an amount equal to a partnership interest constitutes a specific sum.³³ Presumably the logical justification would be the sum's independence of both the trustee's discretion and subsequent events. The value of a partnership interest may be appraised as of the date of death and an obligation to distribute that precise amount arises.

A bequest of the proceeds generated by the sale of a specific asset seems analogous to the distribution of an amount equal to a partnership interest. While in the former case the precise sum cannot be calculated as of the date of death, one may argue that at the time of death the bequest is represented by a specific article of property, fluctuation in the value of property is not relevant under section 663(a)(1), and the mere conversion of that specific article into funds should not subject the proceeds to the Regulations' specific sum test. No policy consideration distinguishes the recipient of property from the recipient of the proceeds of that property and the law should not penalize reliance on the expertise of a trustee in liquidating property.

However, extension of the logic of the Regulations to the above problem would yield the conclusion that, since by the terms of the instrument the taxpayer receives a sum of money dependent in amount on the date and conditions of sale, which may be within the fiduciary's discretion, the bequest is not a specific one. This might be avoided by designating the date and general terms of sale, an unacceptable solution which elides the advantage of the trustee's professional ability in adjusting to market conditions. According to the Regulations, however, unpre-

31. Rev. Rul. 214, 1957-1 CUM. BULL. 203.

32. Treas. Reg. § 1.663(a)-1(b)(2) (1956).

33. *Id.* § 1.663(a)-1(b)(1).

dictability of expenses is equally dispositive.³⁴ It is not clear how broad a spectrum of factors may be considered analogous to expenses because not ascertainable at the testator's death, but clearly market price fluctuations render the proceeds indeterminate.

In the reverse situation, *viz.*, when a fiduciary is instructed to purchase certain assets, such as a designated number of shares of stock, the beneficiary's interest at the relevant date is represented by an amount of money which cannot be immediately ascertained. Nor does he possess an interest in the particular assets. Thus a consistent application of the Regulations would deny the exclusion. It should be stressed that the variables determining the amount received are independent of the estate or trust income, but the Regulations seem to stress mathematical ascertainability.

The permissible time dimension could be broadened by stipulating that, to qualify, lump sum gifts must be subject to adjustment by only external factors. Such a broad restriction, however, appears arbitrary because it is not a necessary adjunct of the statutory purpose. For example, where a will describes an asset, such as the testator's automobile, but at the date of death this description is met by two or more such assets, no different tax treatment should obtain merely because there is more than one asset. Selection by the trustee should have no relevance.

The Regulations are, however, not wholly inflexible. With respect to conditions subsequent, for example, they concede that if installments to party *A* are to terminate upon the death of *A* with payment of the remaining amount to shift to party *B*, this contingency would not render *A* taxable.³⁵ The obvious question whether *B*'s interest would be excludable is not discussed. Inferentially it is not, as the amount is not ascertainable at the grantor's death. No justification appears for differing tax results when the fund which was formerly payable to *A* is now disbursed to *B*. Excessive refinement simply prompts inconsistency.

Analysis of precisely what degree of specificity must inhere in the description of property could be circumvented by a decision that specificity applies not to the property but, rather, to the recipient. For example, if a fraction of the residue of an estate is bequeathed to a specific beneficiary, it might be said that the portion of the estate which all parties understand to be the entitlement of a designated party constitutes a sufficiently specific sum. The average reasonable man might refer to such share as "the specific sum payable to party *X*" and the statute might be read in this light.

The Regulations' stern approach toward awards of a portion of the

34. *Id.*

35. *Id.* § 1.663(a)-1(b)(4).

corpus of residuary estate evidently indicates that mere specificity with regard to legatee or donee will not suffice. In fact, this question can be readily disposed of. On balance, it would probably be unwarranted to infer that in enacting a statute which alludes to "specific sum" and "specific property" and contains no reference to a "specific beneficiary," Congress intended designation of the beneficiary as an overriding criterion.

However, the above point should prove academic. So long as the directions of the grantor or testator dictate the fiduciary's choice of assets on the date of distribution, an interpretation which focuses solely on the recipient is unnecessary since it will yield no result not achievable by extending the time focus to date of distribution. Allusion to a specific beneficiary represents merely a different verbal formulation of the problem.

Of greater practical significance is the intermediate situation where a designated pool of assets is distributed in accordance with the trustee's discretion among a designated class of beneficiaries, a so-called "sprinkling trust." In this case it might be contended that the beneficiaries are specific while the property to be allocated comprises an unknown; on the other hand, that the property is specific but the beneficiaries are not may be a more nearly accurate characterization.

In the marital formula cases the fiduciary's discretion leaves indeterminate the total amount of the distribution. With respect to the total gift in a sprinkling trust, no similar defect is manifest but the award to each beneficiary could be subject to even greater fluctuation than the formula proceeds. Consequently, the Regulations could be cited as authority for either application or non-application of the exclusion. If the purpose of section 663(a)(1) is viewed as the exemption from tax of gifts which in fact represent corpus and which may be of an insufficiently liquid nature to provide in themselves a means for payment of a tax, the exclusion seems justified.

With respect to these later questions, it is evident that variations possible only in theory, in which a testator or settlor simply requires that certain assets be distributed without defining the class of beneficiaries or designates the various beneficiaries without regulating the flow of assets among them, represent extremes which merit no consideration, but little is certain beyond this.

TIMING OF DISTRIBUTIONS

The Regulations' treatment of installment distributions reflects greater liberality. Thus, in computing whether the number of payments has attained the proscribed total of four, personal items, such as house-

hold articles and automobiles,³⁶ and specifically devised real property, which according to law passes directly to the devisee,³⁷ are omitted and bequests for which no time of payment or crediting is set and which are paid or credited in the ordinary course of administration of an estate are treated as paid in a single installment.³⁸ In addition, where a trust instrument prescribes alternate payments to several beneficiaries but no individual receives more than three installments, the exclusion remains available.³⁹ This ruling may lead to abuse since there appears to be no obstacle to creating several trusts each of which makes no more than three payments to the same individual but the payment dates of which are so arranged that after receiving three payments from one trust the individual receives payments from a second trust. In this manner an annuity is created.

The exclusion clearly applies to payments which may stem either from accumulated income or from corpus so long as they are not expressly required to emanate solely from income. This leniency is a consequence of the difficulty entailed in accurate categorization of such payments through tracing, but the instant example presents a definite intent to provide a flow of income in contravention of Congress' obvious purpose in establishing an arbitrary three payment cut-off. Were such a scheme embodied in a will, all such payments could conceivably be characterized as one bequest. However, some taxpayers have created several inter vivos trusts so that income earned has been taxable to the trusts rather than at the recipient's marginal rate, and section 663(a)(1) could further such tax avoidance by permitting distribution in any desired period without inclusion in the recipient's gross income, thereby eliminating any need to consider the amount of unabsorbed distributable net income.⁴⁰

36. *Id.* § 1.663(a)-1(c)(1)(i).

37. *Id.* § 1.663(a)-1(c)(1)(ii).

38. *Id.* § 1.663(a)-1(c)(1)(iii).

39. *Id.* § 1.663(a)-1(c)(2).

40. An obstacle posed by section 673 of the Code, under which income of a trust interest which reasonably may be expected to revert to the grantor within ten years remains taxable to the grantor, must be circumvented by providing a sufficient gap between the first and last payment of each trust. An annual annuity would necessitate creation of at least four trusts making distributions to a different beneficiary at any given time or four trusts payable consecutively to one beneficiary. When section 663(a)(1) applies, the "throwback rule" of sections 665-68 will not increase taxes on cumulative distributions. Some difficulty may lie in the scheduling of payments. The instrument must prescribe fixed sum distributions and any additional income distributed would be subject to the usual trust rules. Section 663(a)(1) dictates that the trustee be given power to invade corpus if necessary and the possibility that this might impair the earning capacity needed for future distributions suggests the selection of fixed income securities.

Of course this possible loophole is symptomatic of something more than a need for refashioning section 663(a)(1). At present the House Ways and Means Committee has noted the enormous revenues lost through multiple trusts and some courts have struck down the least artfully conceived schemes as "sham," but the skillfully executed program

While the Regulations ignore discrepancies between required payments and actual payments,⁴¹ the statute appears somewhat ambiguous. The first principal clause embraces "any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest"⁴² while the second principal clause describes an amount "which is paid or credited all at once or in not more than three installments."⁴³ Because of the omission of "properly" from the parallel second clause it might be contended that to qualify for exclusion an amount must be properly paid, *i.e.*, named assets must flow to intended recipients, but departure from the prescribed payment sequence in order to fulfill the three installment requisite will precipitate the exclusion. The fact that the phrase "under the terms of the governing instrument" which precedes the two clauses is set off by commas while no punctuation separates the clauses suggests strongly that the phrase modifies, and therefore limits, both clauses. However, a court could deem this not conclusive.

Since tax reduction may represent an incentive for ignoring a testator's wishes and since a test centering on actual payments would of necessity be after-the-fact so that years may expire before revelation of whether the third installment will exhaust or fail to exhaust the total gift, the present ruling is meritorious.

Equally satisfactory is the fact that all of the Regulations' comments and examples pertain to the terms of the instrument rather than actual payment, since consistent application of this policy obviates any inquiry into when a fiduciary may have forfeited the exclusion by proliferating the installments.

The accumulation trust, which permits the trustee to make such disbursements as he sees fit after the lapse of a comparatively lengthy period, creates further difficulties. The after-the-fact determination promises sufficient uncertainty to prove unworkable and a flat allowance of favorable treatment for all such plans could abrogate the installment

of multiple trusts retains a strong chance of withstanding scrutiny. *See Hearings on Income Taxation of Trusts and Estates Before the Joint Comm. on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. 286 (1937).

This remains true despite the close analogy to the "business purpose doctrine" which permits treatment of multiple corporations as a unit and the "family solidarity doctrine" which achieves a similar purpose in the case of certain types of multiple trusts. The entire problem is reviewed with unusual candor and clarity in *Boyce v. United States*, 190 F. Supp. 950 (W.D. La. 1961). The court felt compelled to adhere to substance over form in a "preposterous" case involving ninety poorly separated trusts with the identical beneficiary "even if there is such a large loophole in the law as plaintiff contends." *See Ervin, Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402 (1956); *Friedman & Wheeler, Effective Use of Multiple Trusts*, 36 TAXES 588 (1958).

41. Treas. Reg. § 1.663(a)-1(b)(2)(iv) (1956).

42. § 663(a)(1).

43. *Id.*

limitation altogether. Although this tendency toward widespread avoidance would be mitigated by the donor's reluctance to relinquish control to the trustee to so considerable an extent, the most workable gloss which may be placed upon the unclear statutory language is that of denying the exclusion where the terms of the instrument do not explicitly stipulate a limitation of three installments. While this denies the benefit of doubt, it prevents an accumulation of taxable income in the period in which the making of a third payment which fails to exhaust the specified property reveals that all distributions are includable in gross income.

RECOMMENDATION

There exists widespread agreement that, with respect to the entire treatment of trusts and estates embodied in Subchapter J of the Code,⁴⁴ "the inequities and complexities of the current law have made it unworkable and unsatisfactory."⁴⁵ These attributes have too often distracted the attention of estate planners from the attainment of other objectives such as security, growth, and enjoyment of property. Section 663(a)(1), in conjunction with several other provisions, contributes substantially to these problems.

It is generally recognized that perhaps the greatest inequity in the subchapter is represented by the case in which an unwitting executor distributes residuary property in a year in which distributable net income remains unabsorbed. If he retains income destined for one beneficiary while distributing to a second beneficiary property which does not represent income, this recipient is taxed to the full extent of the income up to the value of property received. The problem is acute because estates have no income required to be distributed currently and therefore all distributions are placed in the same tier and share the entire distributable net income. If the income is then distributed in a year in which little current income is earned, the recipient partially escapes taxation. The tax burden is shifted to the recipient of property who may be forced to sell his newly gotten assets through other than normal retail channels in order to generate cash for payment of his suddenly swollen tax bill. Furthermore, if in any prior period the estate incurred expenses attributable to the property, they will have been used to reduce taxable income of that year's distributees in order to insure that the benefit would not be lost altogether. The likelihood of such occurrences may be increased by the desire of the executor to make initial distributions to those beneficiaries who are most in need, and, therefore, least able to pay the tax, even

44. INT. REV. CODE of 1954, Subch. J.

45. ADVISORY GROUP ON SUBCHAPTER J OF THE INTERNAL REVENUE CODE, 86TH CONG, 1ST., FINAL REPORT 90 (Comm. Print 1960) (statement of Kenneth Bergen and Lauren Williams).

though the others must ultimately receive amounts to which they are entitled by law. These persons may escape tax in a subsequent period of distribution.

The limited scope of section 663(a)(1) is singularly unfortunate for the recipient of stock in a closely held corporation: the intended recipient of a major voting interest may receive a disproportionately high fraction of the distributions in a given period, which may in turn necessitate a forced liquidation of the voting shares to raise cash.

The testator or settlor may chance to declare that X dollars be transferred out of corpus to a designated beneficiary each month for three years instead of creating a yearly payment of $12X$ dollars. In a given instance the fact that the beneficiary's tax bracket is lower than the estate's may yield tax benefits, but this potentiality offers no solace to the unwary for whom the reverse is true.

Even if the grantor and fiduciary are knowledgeable, they should be less hampered in pursuing the grantor's personal satisfaction. Among the considerations confronting them may be listed: the avoidance of taxable distributions to individuals in brackets which are steep, either absolutely or relatively to that of the estate or trust; optimum timing of payments which may be made in either of several periods; the immediate distribution of all assets, regardless of the present competence of beneficiaries, in a short initial taxable year in which little distributable net income has accrued, and the desirability of postponing property distributions until a short final taxable year in which little distributable net income has accrued. A narrow construction of section 663(a)(1) increases the number of assets for which such factors must be weighed.

These shortcomings have not gone unnoticed; numerous remedial proposals have been advanced, and in 1960 the House of Representatives passed a bill⁴⁶ encompassing several worthwhile alterations. However,

46. H.R. 9662, 86th Cong., 2d Sess. (1960). The House proposal extended section 663(c) to estates. That section provides that substantially separate and independent shares of different beneficiaries of a single trust are to be treated as separate trusts. Thus, the fact that one beneficiary receives no distribution of income accruing in a given period would not affect the recipient of corpus.

The bill also stated that, with respect to trusts, amounts which may be paid from either income or corpus and payments which must emanate solely from income, whether or not required to be distributed currently, should be placed in separate tiers so that the former distributions would be taxed only to the extent to which distributable net income exceeded the total distributions of the latter.

The Advisory Group of the Ways and Means Committee has suggested that for a period of thirty-six months following the testator's death a distribution by an executor of a portion of the residue would not be taxed to the beneficiary provided it were properly charged against corpus on the books of the estate. ADVISORY GROUP ON SUBCHAPTER J IN THE INTERNAL REVENUE CODE, 86TH CONG., 1ST SESS., FINAL REPORT 29-33 (Comm. Print 1960).

Other commentators have recommended that the law applicable to estates be physically dissociated from that necessarily more complex branch of doctrine surrounding

since these proposals have not become law, it becomes important to note that the Service is in a position to alleviate much of the present harshness without extensive revision of the Code by simply broadening the official interpretation of section 663(a)(1).

Moreover, even if some of the advocated amendments are enacted, section 663(a)(1) will continue needlessly to thwart several inventive estate planning devices. The preceivably narrow scope of section 663(a)(1), as currently aggravated by the practical infeasibility of probing its vague limits with litigation, suggests the desirability of congressional amendment or a recasting of the present Regulations.

The central focus in any alteration of section 663(a)(1) should be the fundamental distinction between corpus and income. The term specific sum serves some purpose only in so far as it denotes a lump sum payable without regard to the presence of income and is deplorable in so far as some of its connotations have inspired the present government interpretation. Choice of the term "specific" in modification of "property" seems still less justifiable given the likelihood that property other than money represents corpus.

Probably the Government's chief fear lies in the possibility that property other than money might be received as income or that funds comprising income might be converted into property, and this would seem to afford whatever justification which may exist for the Regulations' position that allowing the fiduciary discretion in making distributions makes the exclusion unavailable. In this respect the Regulations should at least allow exclusion from income where property is required by the terms of the instrument to be sold or exchanged before distribution even though the property or sum ultimately distributable cannot be identified instantly or with arithmetic precision.

An exclusion should also be allowed even though a trustee has freedom to select the beneficiaries' legacies from a fixed pool of assets. The situations discussed previously indicate that so long as the fiduciary's discretion merely enables him to choose among assets (or the directly traceable physical product of those assets) which were indentifiable as corpus at the date of creation of the trust or estate, section 663(a)(1) should apply. In addition the Regulations should state that the exclusion

trusts and be set out in a separate, brief section of the code for the benefit of the sizeable number of executors whose skills are unlikely to match those of professional trustees. See, e.g., Tomlinson, *Taxing the Estate as an Entity*, 77 BANKING L.J., Aug. 1960, at 1. From many other quarters has come the suggestion that payments to the beneficiary be ignored and that the estate be taxed as an entity. *Id.*

With the exception of this latter scheme, the defects of which have been widely publicized, all the above represent desirable solutions for at least some of the present inequities. See HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 1765-66 (Comm. Print 1959).

is available for variable lump sum dollar payments so long as the amount is determined by factors independent of income.

The recommended approach would adhere to the present policies of the 1954 Code and would in some respects placate those who espouse a readoption of the principles of the 1939 Code under which the trustee's characterization of a payment was dispositive.

William R. Piets