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The Use of Short-Term Trusts in Conjunction With Interests in Oil or Gas Properties: A Practitioner's Guide

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THE USE OF SHORT-TERM TRUSTS IN CONJUNCTION WITH INTERESTS IN OIL OR GAS PROPERTIES: A PRACTITIONER'S GUIDE

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INTRODUCTION

WITH THE ADVENT of the energy crisis and the consequent increases in the prices of oil and natural gas, there has been a great influx of investment into the oil and gas industry, and a correspondingly heightened interest in the field of taxation of oil and gas investments and certain tax saving devices associated with such investments. One such technique involves the use of a short-term trust. Although the use of such trusts is not of recent origin, their use in conjunction with oil or gas properties is a subject which has received relatively little attention in the context of tax planning. In light of recent changes in federal gift and estate taxation, an examination of the use of such trusts may prove valuable to the tax practioner.

This article will address the tax consequences of the funding of a short-term trust with an interest in oil or gas wells. At the end of this article there is set forth as Appendix I[1] a form of short-term trust which could be used for this purpose. Appendix II[2] contains an example of a situation where such use would be appropriate and a computation of the tax savings which can be generated by the use of such a trust.

I. SHORT-TERM TRUSTS

The following is a general outline of the attributes of short-term trusts.[3] In a trust of this type, the grantor retains a reversion, but the income of the trust is not taxable to the grantor because of section 673 of the Internal Revenue Code of 1954, as amended.[4] This section provides that the grantor will not be taxed on the income of a trust in which he has a reversion if (1) the reversion may not be reasonably expected to take effect within

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[1] *See* pp. 233-236 *infra.*

[2] *See* pp 237-238 *infra.*

[3] A more detailed discussion is beyond the scope of this article and would be repetitive of a number of other works dealing with this subject. *See generally,* Gilman, *Saving for College with a Clifford Trust,* 25 PRACTICAL LAWYER 11 (1979); Todd, *The Pros and Cons of Short-Term Trusts and Some Alternatives,* 57 TAXES 10 (1979); Smith, *Clifford Trusts Still Live,* 117 TRUSTS & ESTATES 488 (1978); Craven, *Practical Uses of Short-Term Trusts,* 16 N.Y.U. INST. FED. TAX. 903 (1958).

[4] Unless otherwise indicated, all section and regulation references in the text and footnotes are to the Internal Revenue Code of 1954, as amended to date, and the current regulations thereunder.

ten years, or (2) the reversion occurs upon the death of the income beneficiary.

The form of short-term trust attached as Appendix I provides that the trust will be terminated upon the expiration of ten years plus one month, the death of the grantor, or the death of the income beneficiary, whichever occurs first.[5] A provision of this type is permissible as long as the grantor's life expectancy is greater than ten years.[6] It should be emphasized that the 121-month period should be measured *from the date of the transfer of the property to the trust,* not the date the trust instrument is executed.[7]

The purpose of a short-term trust is to allow the grantor to transfer income to a beneficiary who will pay tax on the income at a reduced rate without divesting the grantor of ownership of the property generating the income. Short-term trusts are generally used by high income tax bracket taxpayers without substantial net worth to support needy relatives. Such taxpayers are reluctant to make a complete gift of the property, but they also desire to avoid paying tax on income which is being diverted to these relatives. The short-term trust enables such taxpayers to retain the security of a reversionary interest in the trust principal while avoiding the tax on the income generated by that principal.

If the income of the trust is for the benefit of a minor child of the taxpayer, such income must not be used to satisfy the grantor's legal obligation to support the child, or the income will be taxed to the grantor.[8] To avoid running afoul of these provisions, the trust form attached as Appendix I specifically prohibits the trustee from distributing any trust income in satisfaction of the grantor's legal obligation of support.[9] An examination of state law is required to determine the extent of the grantor's legal obligation of support.[10] In most states a child becomes an adult on his eighteenth birthday and the parents' obligation of support terminates at that time.[11] However, the age of majority is not in all cases determinative of when the legal obligation of support terminates. In Ohio, for example, the age of majority

[5] *See* App. I, Art. II, at p. 234 *infra.*

[6] Treas. Reg. § 1.673(a)-1(c) (1960). According to Rev. Rul. 73-251, 1973-1 C.B. 324, only male grantors under 70 and female grantors under 73 have the required life expectancy.

[7] *See* Bibby v. Commissioner, 44 T.C. 638 (1965).

[8] I.R.C. § 677(b).

[9] *See* App. I, Art. I, at p. 233 *infra. See* Letter Ruling 7851112 (1978).

[10] Treas. Reg. § 1.662(a)-4 (1960) provides that: "In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law."

[11] As of this writing, the legal age of majority was eighteen in all but six of the fifty states, as well as in the District of Columbia. It is nineteen in Alabama, Nebraska and Wyoming. *See* ALA. CODE § 26-1-1 (1977); NEB. REV. STAT. § 38-101 (1978); WYO. STAT. § 14-1-101 (1978). It is twenty-one in Colorado, Mississippi and Pennsylvania. *See* COLO. REV. STAT. § 2-4-401 (1980); MISS. CODE ANN. § 1-3-27 (1972); 1 PA. CONS. STAT. ANN. § 1991 (Purdon Supp. 1980).

is eighteen, but the Ohio Revised Code[12] provides further that "the parental duty of support . . . shall continue so long as the child continuously attends on a full-time basis any recognized and accredited high school, even when such child has attained the age of majority." Once the obligation of support has ceased under local law, however, parents can successfully employ a short-term trust to accumulate income for the college, graduate or professional education of their emancipated children. This is indeed the most popular reason for employing such a trust.

It should be noted that the Economic Recovery Tax Act of 1981[13] provides an exclusion from gift tax for any transfers made on behalf of an individual for education, training, or medical care.[14] In order to qualify for the exclusion the donor must make the payment for the items referred to above directly to the provider thereof, and not to the individual beneficiary. Although this will enable a parent to pay for his emancipated child's education without gift tax consequence, the parent will still be making such payments with dollars previously subjected to income tax in his high bracket. The trust arrangement discussed above will reduce significantly this income tax burden. Of course, the contributions to the trust will not qualify for this new gift tax exclusion, but, as will be discussed later in this article, the income tax savings will generally exceed the gift tax cost, if any.

II. TAX SAVINGS

As noted above, the principal advantage of a short-term trust is that it shifts income from the high income tax bracket grantor to the low income tax bracket trust beneficiary. Of course, an outright gift of income-producing property to a donee or to an irrevocable trust for the benefit of such donee would achieve similar results. But taxpayers frequently decide against these alternatives to short-term trusts because they result in the loss to the donor of the property gifted, and not merely of the income generated by the property. With an oil or gas property, however, this disadvantage is not significant. Oil and gas wells are wasting assets and and at the end of the short-term trust there is not likely to be any property left to revert to the grantor. The question thus becomes, why would a taxpayer use a short-term trust vehicle to accomplish the transfer of an oil and gas property rather than one of the other alternatives discussed above? There are three reasons why a short term trust might be preferable:

(a) preservation of the percentage depletion deduction with respect to the oil or gas property transferred;

(b) minimization of gift taxes on the transfer of the oil and gas property; and

[12] OHIO REV. CODE ANN. § 3103.03 (Page 1980).

[13] P.L. 97-34, 95 Stat. 172.

[14] *Id.* at § 441(b).

(c) the step-up in basis which may be availed of at the death of the grantor of the short-term trust.

A. *Percentage Depletion*

1. Background

Depletion is the analogue of depreciation in the context of mineral properties. There are two types of depletion, "cost" or "percentage," and the taxpayer is entitled to deduct the greater of the two with respect to each economic interest he owns in oil or gas properties.[15] Cost depletion for each year is determined by dividing the basis of the oil or gas property by the total units of gas or oil expected to be recovered and then multiplying the resulting quotient by the number of units actually sold during the year.[16] Thus, the aggregate cost depletion deductions claimed by the taxpayer cannot exceed his basis in the oil or gas property to which such deductions relate.

Percentage depletion is a statutorily defined percentage of the gross income attributable to a taxpayer's interest in oil or gas properties.[17] The deduction for percentage depletion with respect to a specific property cannot exceed 50% of the taxable income generated by such property (computed without regard to the depletion deduction).[18] In addition, the percentage depletion deduction for any year cannot exceed 65% of the taxpayer's total taxable income for such year computed with certain adjustments.[19] To the extent the percentage depletion deduction is disallowed on account of the 65% limitation, such disallowed deduction may be carried over indefinitely to future taxable years.[20]

Taxpayers generally prefer percentage depletion to cost depletion because percentage depletion deductions are not limited to the taxpayer's basis in the oil or gas property to which the deductions relate. The excess of the percentage depletion deduction over the taxpayer's adjusted basis in an oil or gas property constitutes a tax preference item, however, subject to the minimum tax on tax preferences.[21]

Percentage depletion with respect to oil or gas properties was repealed effective January 1, 1975, except for: natural gas regulated by the Federal Power Commission and purchased and sold before July 1, 1976; natural gas sold under a fixed contract in existence on February 1, 1975; and, in certain instances, natural gas produced from geopressurized brine.[22] In

[15] *See* I.R.C. §§ 611, 612, 613, 613A.
[16] Treas. Reg. § 1.611-2(a) (1960).
[17] *See* I.R.C. §§ 613, 613A.
[18] I.R.C. §§ 613A(c)(1); 613(a).
[19] I.R.C. § 613A(d)(1).
[20] *Id.*
[21] I.R.C. § 57(a)(8).
[22] I.R.C. § 613A(b).

addition, section 613A(c) creates a limited exemption from the repeal of percentage depletion for taxpayers who qualify as "independent producers" or "royalty owners."

In general, a taxpayer is an independent producer if neither he, nor any person related to him, engages in substantial refining or retail sales of oil or gas.[23] If a taxpayer qualifies for this exemption, he is entitled to a percentage depletion deduction with respect to up to 1,000 barrels of average daily production of oil or 6,000,000 cubic feet of average daily production of natural gas, known as the "depletable oil or natural gas quantity." If a particular well produces both oil and natural gas, the taxpayer must elect to split the production ceiling between the two types of minerals. The ceiling is convertible from barrels of oil to cubic feet of gas at the rate of one barrel equals 6,000 cubic feet.[24] The percentage depletion rate[25] for future tax years will be as follows:

1981	20%
1982	18%
1983	16%
1984 and thereafter	15%

Certain related taxpayers, including an individual and his spouse and minor children, share one depletable oil or gas quantity, and the production attributable to oil and gas properties owned by such related persons is aggregated for purposes of applying this limitation.[26]

The foregoing is only a very general discussion of percentage depletion and the exemptions from its repeal. A more detailed discussion is beyond the scope of this article.[27]

2. Preservation of Percentage Depletion Allowance

The independent producers and royalty owners exemption from the repeal of percentage depletion is lost if a transfer of the oil or gas property is made after it has become "proven," *i.e.*, "the principal value of the property has been demonstrated by prospecting or exploration or discovery work."[28] Transfers of proven oil or gas properties to certain persons related to the transferor, who share one depletable oil or gas quantity (as discussed above) will not result in disqualification for percentage depletion.[29] Unless

[23] I.R.C. §§ 613A(d)(2)-(4).

[24] I.R.C. §§ 613A(c)(1)-(4).

[25] I.R.C. § 613A(c)(5).

[26] I.R.C. § 613A(c)(8).

[27] For a more detailed treatment of this subject, *see, e.g.*, Dougherty, *Percentage Depletion Allowance: An Update*, 26 OIL & GAS TAX Q. 436 (1978); Linden, *Oil and Gas Depletion Regulations: Complexity Compounded*, 24 OIL & GAS TAX Q. 351 (1976).

[28] I.R.C. § 613(c)(9)(A).

[29] I.R.C. § 613A(c)(9)(B).

this exception applies, however, the transferee of an oil or gas property will be able to use only cost depletion. Failure to qualify for percentage depletion can be very disadvantageous, since oil and gas wells frequently generate percentage depletion deductions far in excess of the taxpayer's basis in the wells.

A short-term trust can be used to eliminate the risk that the gift of an interest in an oil or gas well will result in a loss of percentage depletion, if the trust instrument requires the trustee to establish a reserve for depletion equal to the taxpayer's share of the well's annual percentage depletion allowance for federal income tax purposes.[30] The rationale underlying this rule is that the short-term trust is a split-interest trust: the grantor retains a reversionary interest in the trust while the beneficiary enjoys a present interest in its income. If the trust instrument provides that the trustee is to accumulate as a reserve an amount of cash equal to the trust's annual percentage depletion deduction, the grantor cannot be said to have "transferred" his interest in the oil or gas property so as to invoke the provisions of section 613A(c)(9) which would otherwise deny the grantor the percentage depletion deduction. The Internal Revenue Service has employed the foregoing analysis in two recent private letter rulings.[31]

An important collateral advantage to the creation of a depletion reserve is that the grantor will be able to accumulate in the trust an income-tax-free amount of cash equal to the aggregate annual percentage depletion deductions. Section 677(a)(2) requires that the grantor be taxed on any income of the trust which is accumulated for eventual distribution to the grantor. Since the trustee will be accumulating for ultimate distribution to the grantor an amount of cash equal to the annual percentage depletion deduction, the grantor will be taxed on this amount of income each year.[32] The grantor will also, however, be entitled to a deduction for percentage depletion each year exactly equal to the amount of income taxed to him.[33]

B. *Minimization of Gift Tax*

The transfer of an oil or gas property generates a gift tax regardless of whether the transfer is made to an irrevocable trust, an individual or a short-term trust.[34] Depending upon the value of the property given, the amount of the gift tax may be so substantial as to outweigh the income tax savings discussed above. The use of a short-term trust can minimize the amount of this gift tax.

[30] *See* App. I, Art. VII(b), at p. 236 *infra*.

[31] Letter Rulings 8102027 (1980); 7938028 (1979).

[32] *Id.*

[33] Treas. Reg. § 1.611-1(c)(4) (1960). *See also* Rev. Rul. 60-47, 1960-1 C.B. 250; Letter Rulings 8102027, 7938028, *supra* note 31.

[34] I.R.C. § 2511 embraces any transfer, whether "in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." *See also* Treas. Reg. § 25.2511-1(a) (1958).

The grantor of a short-term trust is deemed to have made a gift to the trust beneficiary equal to the value of the property transferred to the trust, less the value of the interest retained by the grantor.[35] The value of both the grantor's retained interest and the income interest transferred to the beneficiary are determined in accordance with tables promulgated by the IRS which postulate a six percent return to the income beneficiary.[36] For a trust which will last ten years, these tables indicate that the value of the donor's gift will approximate only 44% of the value of the oil or gas property transferred.[37] These regulations control the computation of the value of the income beneficiary's interest even though the actual return may exceed the six percent assumption, as would frequently be the case with oil and gas properties.[38] Where the short-term trust may terminate in less than ten years upon the death of a person (such as the grantor or beneficiary of the trust), the IRS requires the use of a more sophisticated table known as Table XT6, "Trusts for Ten to Eleven Years, One Life Six Percent."[39]

The enactment of the Economic Recovery Tax Act of 1981[40] significantly reduces the amount of the gift tax payable with respect to gifts made after December 31, 1981, thereby enhancing the attractiveness of the income tax savings technique discussed herein.[41] In this regard, the changes made by the Act are significant in three respects. First, the gift tax payable with respect to gifts in excess of $2,500,000 is reduced on a phased-in basis from 1982-1985.[42] Secondly, the annual exclusion from taxable gifts has been increased from $3,000 to $10,000 per donee.[43] If the grantor's spouse joins in the gift, the annual exclusion can be increased to $20,000 per donee.[44] And finally, the unified credit against estate and gift taxes will be

[35] Treas. Reg. § 25.2512-9(a)(1) (1970).

[36] Treas. Reg. § 25.2512-9(d) (1970).

[37] Treas. Reg. § 25.2512-9(f) (1970), Table B indicates that the value of an income interest for 10 years is .441605.

[38] *See* Letter Ruling 7851112, *supra* note 9; McDaniel, *Estate Planning Problems Created by Oil and Gas Interests*, 15 OKLA. L. REV. 381, 404 (1962); Jewett, *Estate and Gift Tax Consequences of Oil and Gas Ventures*, 10 SW. LEGAL FOUNDATION INST. ON OIL & GAS L. & TAX. 389, 401-02 (1959).

[39] *See* IRS Publication 723A (12-70) *reprinted in* [1977] 2 FED. EST. & GIFT TAX REP. (CCH) ¶ 6441.50. If the trust term may be cut short upon the earliest to occur of the death of two or more persons (as is the case with the trust set forth in Appendix I), the valuation of the income interest requires the computation of a special valuation factor which is not available in published information. The calculation of this special factor is extremely difficult and, in most instances, will not be cost effective. The author suggests that the practitioner use the appropriate factor from Table XT6 using as the relevant life the individual who is older. Although this will result in an over-valuation of the interest subject to gift tax, the amount should not be significant. The author adopted this approach in the computation of the gift tax appearing as part of Appendix II.

[40] P.L. 97-34, 95 Stat. 172.

[41] *Id.* at §§ 401-03, 441-42.

[42] *Id.* at § 402.

[43] *Id.* at § 441(a).

[44] *Id.* at § 442(b)(2)(A).

increased annually to the amount set forth in the table below.[45] The table also reflects the size of gift which would generate tax equal to the various credits or, as tax practitioners are wont to refer to this number, "the exemption equivalent to the unified credit."

Year	Unified Tax Credit	Property Transfers Exempt From Tax
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
After 1986	192,800	600,000

The calculations set forth in Appendix II[46] indicate the maximum size gift which can be made to a short-term trust (assuming qualification for the increased annual exclusion and the election of gift-splitting) without incurring any gift tax. If larger gifts are made, the grantor will have to exhaust some of his unified credit against gift and estate taxes. This will not be a disincentive, however, to the many taxpayers whose assets at their death will not be sufficient to generate an estate tax. It has been estimated that the increase in the unified credit made by the Economic Recovery Tax Act of 1981 will reduce the number of estates subject to estate tax to less than .5% of the United States population.[47]

In order to preserve the annual exclusion and avoid or substantially reduce the gift tax payable on the transfer of property to the short-term trust, the trust instrument must be carefully drafted. The income of the trust must be paid to the beneficiary by the trustee on a current basis.[48] The income need not actually be paid to the beneficiary so long as he has the right to withdraw it.[49]

It has been held that a trust of the type described above will not qualify for the annual exclusion where the corpus of the trust consists of property which is not income-producing.[50] The trustee of any trust holding oil or gas property must be authorized to hold non-income producing assets as investments, not because of a desire to deprive the trust beneficiary of income but, rather, because oil and gas properties by their nature are unproductive during the drilling and development stages. Recognizing this

[45] *Id.* at §§ 401(a)-(c).

[46] *See* pp. 237-238 *infra.*

[47] ECONOMIC RECOVERY TAX ACT OF 1981, 12 (Arthur Anderson & Co. 1981).

[48] Treas. Reg. § 25.2503-3(b) (1958). *See* App. I, Art. I, at p. 233 *infra.*

[49] Rev. Rul. 73-405, 1973-2 C.B. 321, states that if "the minor donee has a right to demand distribution, the transfer is a gift of a present interest that qualifies for the annual exclusion."

[50] Phillips v. Commissioner, 12 T.C. 216 (1949). *See* Rev. Rul. 69-344, 1969-1 C.B. 225.

unique aspect of oil and gas properties, the IRS has ruled that the transfer of such properties to a short-term trust which has mandatory income distribution provisions, but which allows the trustee to hold unproductive property as a trust asset, will nonetheless qualify for the annual exclusion.[51]

C. *Basis Step-Up*

If an oil or gas property is given outright to an individual or to an irrevocable trust, the donor's basis in such property carries over to the transferee, as long as the fair market value of the property exceeds its basis on the date of transfer.[52] This same rule applies with respect to a short-term trust, except that if the trust terminates at the death of the grantor,[53] the property contained in the trust will pass through the grantor's estate and will receive a step-up in basis equal to its fair market value on the date of the grantor's death, or the alternate valuation date.[54]

This step-up in basis will result in a larger amount of cost depletion, perhaps more than percentage depletion, which would be advantageous to the beneficiaries of the grantor's estate. The step-up in basis will also be helpful if the oil or gas property is subsequently sold by the beneficiaries of the grantor's estate, since it will reduce the gain, or increase the loss, as the case may be, recognized by them on the sale.[55]

III. TYPE OF OIL OR GAS PROPERTY INTEREST TO BE TRANSFERRED

Conveyances of only certain types of interests in oil or gas properties will effectively shift the incidence of taxation with respect to the income generated by such properties. Definitions of the relevant types of property interests with which this article is concerned are set forth below:

Royalty. A royalty entitles its owner to a specified fraction of the total production of the oil or gas well before deduction of any of the costs of development or operation of the well.[56]

Working Interest. A working or operating interest (hereinafter referred to as a "working interest") is the interest remaining in an oil or gas property after the conveyance of a royalty interest. This interest is burdened with the costs of development and operation of the oil or gas property.[57]

Overriding Royalty. An overriding royalty is identical to a royalty in

[51] *See* Letter Ruling 7851112, *supra* note 9.
[52] I.R.C. § 1015.
[53] *See, e.g.,* App. I, Art. II, at p. 234 *infra.*
[54] I.R.C. §§ 1014(a), (b).
[55] *See* C. BREEDING, F. BURKE & A. BURTON, [1981] INCOME TAXATION OF NATURAL RESOURCES (P-H) ¶ 6.08.
[56] *Id.* at ¶ 2.03. *See also* Getty Oil Co. v. United States; 399 F.2d 222 (Ct. Cl. 1968).
[57] BREEDING, BURKE & BURTON, *supra* note 55, at ¶ 2.03. *See also* Brooks v. Commissioner, 424 F.2d 116 (5th Cir. 1970); Miller v. United States, 78-1 U.S. TAX CAS. (CCH) ¶ 9127 (D.C. Cal. 1977); Standard Oil Co. v. Commissioner, 68 T.C. 325 (1977).

that it entitles the owner to a specified fraction of the gross production of the well, except that the overriding royalty is carved out of the working interest.[58]

Net Profits Interest. This interest is also created out of the working interest and resembles it in that the income accruing to the owner is reduced by development and operating expenses. A net profits interest differs from a working interest, however, because the owner's liability for such expenses cannot exceed his share of the income produced by the oil or gas property.[59]

Production Payment. A production payment is similar to an overriding royalty. It is created from the working interest and entitles the owner to a specific fraction of the gross production of the well. It is distinguishable from an overriding royalty, however, because it is limited by time or by a specified amount of production, defined in terms of dollars or units of production.[60]

The goal of a grantor who transfers an oil or gas property to a short-term trust is to assign income, not deductions. Thus, the preferred property interest to be transferred to such a trust is a royalty or an overriding royalty. The only deduction associated with these types of property interests is the depletion allowance and, as discussed above, that deduction is retained by the grantor of a short-term trust. A working interest or net profits interest may also be used to fund a short-term trust, but, because of the loss to the grantor of the deductions for development and operating expenses, they do not result in as significant an income tax savings as do royalty interests. With respect to the transfer of a working interest, this problem may be ameliorated by delaying the transfer until after the well has been completed, thus enabling the grantor to claim and deduct all intangible drilling and development costs.[61] Of course, the completion of the well will also increase its value, thereby increasing the possibility that a gift tax will be imposed on the transfer to a short-term trust of an interest in such a well.[62]

There is one type of oil or gas property interest which should not be conveyed if the donor desires to shift the incidence of income taxation. The United States Supreme Court has held that the transfer of a production payment is merely an assignment of income which does not effectively transfer the incidence of taxation with respect to the income produced by such

[58] BREEDING, BURKE & BURTON, *supra* note 55, at ¶ 2.05. *See also* Rev. Rul. 67-118, 1967-1 C.B. 163.

[59] BREEDING, BURKE & BURTON, *supra* note 55, at ¶ 2.06.

[60] *Id.* at ¶ 2.07. *See, e.g.,* Christie v. United States, 436 F.2d 1216 (5th Cir. 1971); United States v. Morgan, 321 F.2d 781 (5th Cir. 1963); Landreth v. Commissioner, 50 T.C. 803 (1969); Brooks v. Commissioner, 50 T.C. 927 (1968); Flewellen v. Commissioner, 32 T.C. 317 (1959). *See also* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

[61] I.R.C. § 263(c).

[62] *See* text accompanying notes 34-51 *supra*.

property to the transferee.[63] In *Commissioner v. P.G. Lake, Inc.*, the assignment of income doctrine was applied to this type of property interest because the donor did not convey its entire interest, or an undivided fraction thereof, to the donee. The transferee was assigned a right to receive an amount of income in the oil property equal to $600,000 plus interest at three percent per annum on the unpaid balance remaining from month to month.[64] This assignment of income doctrine does not apply to the other transfers of property interests described above because the terms of such property interests are coextensive with the terms of the interest from which they were created.[65]

IV. Avoidance of Taxation as a Corporation

Some commentators have suggested that a trust which holds an interest in oil or gas properties, particularly a working interest, assumes a risk that it will be taxed as a corporation.[66] Such an occurrence would have disastrous consequences, since it would result in double taxation of the trust's income, as well as loss of the percentage depletion allowance to the grantor and, perhaps, to the trust as well.[67]

The treasury regulations set forth six characteristics which distinguish a corporation from other organizations: associates, an objective to carry on business and divide the gains therefrom, continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests.[68] "An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust."[69] The regulations provide further, however, that since the last four of the six characteristics are "generally common to trusts and corporations," the determination of whether a trust is to be taxed as a trust or a corporation "depends on whether there are associates and an objective to carry on business and divide the gains therefrom."[70] These guidelines clearly indicate that a trust will be taxed as a corporation or association only if it has both associates and an objective to carry on a business for profit. The other corporate characteristics are not relevant because they are common to both

[63] Commissioner v. P.G. Lake, Inc., 356 U.S. at 260; *accord,* Flewellen v. Commissioner, 32 T.C. at 317.

[64] 356 U.S. at 262.

[65] Rev. Rul. 67-118, 1967-1 C.B. 163. *See* Breeding, Burke & Burton, *supra* note 55 at ¶ 6.11; Wilson, *The Use of Mineral Interests in Short-Term Trusts - A New Tax Problem,* 14 Sw. L.J. 495 (1960). *See also* [1975] Oil & Gas/Natural Resources Taxes (P-H) ¶ 4001.4; Rev. Rul. 71-130, 1971-1, C.B. 28; Letter Rulings 8102027, 7938028, *supra* note 31.

[66] *See* McDaniel, *supra* note 38, at 406-07; Bruen, *Federal Income Tax Aspects of Oil and Gas Ventures—A Summary for the Investor,* 14 Tax L. Rev. 353, 364 (1959).

[67] I.R.C. § 613A(c)(9).

[68] Treas. Reg. § 301.7701-2(a)(1) (1967).

[69] *Id., citing* Morrissey v. Commissioner, 296 U.S. 344 (1935).

[70] Treas. Reg. § 301.7701-2(a)(2) (1967).

corporations and trusts. However, some of the decided cases have overlooked this aspect of the regulations and have examined all six corporate characteristics to determine if a majority was present in a given situation.[71]

Notwithstanding the foregoing inconsistency, virtually all authorities agree that association status may not be found if the first two corporate characteristics are not present. This rule derives directly from the United States Supreme Court decision in *Morrissey v. Commissioner*,[72] the opinion which established the foundation for the association regulations:

> "Association" implies associates. It implies the entering into a joint enterprise, and as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust - whether created by will, deed, or declaration - by which particular property is to be conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere *cestuis que trust*, plan a common effort or enter into a combination for the conduct of a business enterprise.[73]

Although the authorities are in agreement that the "associates" and "business objective" tests are critical in determining whether a trust is to be treated as a corporation, there is disagreement over the interpretation of these tests. Two major issues have been raised in the decided cases: (1) Must there be more than one participant in a trust before it can be taxed as a corporation?[74] (2) Is the existence of a power to conduct business in the trust instrument dispositive of whether a business objective exists, or must inquiry be made into the actual purposes and actions of the parties?[75]

The chief rationale for the requirement of more than one participant for an organization to be treated as a corporation is a literal reading of the reference to "associates" in the regulations and the *Morrissey* case.[76] One-man corporations are taxed as associations and there appears to be no reason why other entities resembling corporations and having only one participant should not be similarly taxed.[77]

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[71] *See, e.g.*, Outlaw v. United States, 494 F.2d 1376 (Ct. Cl. 1974), *cert. denied*, 419 U.S. 844 (1974); Hynes v. Commissioner, 74 T.C. 1266 (1980).

[72] 296 U.S. at 344.

[73] *Id.* at 356-57.

[74] *Compare* Outlaw v. United States, 494 F.2d at 1376, *with* Lombard Trustees Ltd. v. Commissioner, 136 F.2d 22 (9th Cir. 1943); Hynes v. Commissioner, 74 T.C. at 266; and Knoxville Trust Sales & Services, Inc. v. Commissioner, 10 T.C. 616 (1948), *acq.* 1948-2 C.B. 3.

[75] *Compare* Elmstreet Realty Trust v. Commissioner, 76 T.C. 68 (1981); Curt Teich Trust No. One v. Commissioner, 25 T.C. 884 (1956); Lyman v. Commissioner, 36 B.T.A. 161 (1937) *with* Helvering v. Coleman-Gilbert Assocs., 296 U.S. 369 (1935); Abraham v. United States, 406 F.2d 1259 (6th Cir. 1969).

[76] 296 U.S. at 356-57; Treas. Reg. 301-7701-2(a) (1967).

[77] *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.07 (3d Ed. 1971).

To determine the existence of a "business objective," it would appear that a mere inspection of the trust instrument without an inquiry into the motives and actions of the parties would result in an exaltation of form over substance. A court would be unlikely to cause an ordinary trust of the type described in treasury regulation 301.7701-4(a) to be taxed as a corporation merely because the trustee had the power to operate a business. If this practice were followed, it would certainly place in jeopardy a great number of trusts drafted by practitioners, including those of the author. It is important to note in this regard that in none of the cases where courts have emphasized the importance of the trust instrument was this type of ordinary trust arrangement involved.[78]

Of course, from a planning point of view, which is the perspective of this article, the practitioner should draft the short-term trust instrument so as to minimize the risk of association status. Accordingly, the trustee's authority should be circumscribed so that its powers are limited to investment of the trust property, collection and disbursement of income, payment of expenses and actions incident thereto. The trustee should be prohibited from conducting a business or directly developing or operating oil or gas wells.[79] These tasks should be performed by independent contractors who would enter into agreements with the trustee.[80]

It is virtually impossible for the practitioner to avoid the corporate attributes of limited liability and centralized management because they are inherent in any trust arrangement. The attribute of continuity of life will not exist with respect to a short-term trust, however, because the trust will terminate within a defined term.[81] Similarly, the corporate characteristic of free transferability of interest can be avoided by prohibiting the beneficiaries from transferring their interest in the short-term trust.[82] Such a provision will impose no undue burden upon the beneficiaries and will in all likelihood be consistent with the grantor's intent.

If all of the foregoing recommendations are followed, there appears to be no significant risk that an ordinary short-term trust would be characterized as an association for tax purposes.

V. CRUDE OIL WINDFALL PROFITS TAX

A detailed analysis of the Crude Oil Windfall Profit Tax Act of

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[78] *See, e.g.*, Helvering v. Coleman-Gilbert Assocs., 296 U.S. at 369; Abraham v. United States, 406 F.2d at 1259.

[79] *See* Helvering v. Coleman-Gilbert Assocs., 296 U.S. at 369; Abraham v. United States, 406 F.2d at 1259; Rev. Rul. 57-112, 1957-1 C.B. 494; Letter Ruling 7937014 (1979). *But see* Rev. Rul. 79-77, 1979-1 C.B. 448; Letter Ruling 8047016 (1980); BREEDING, BURKE & BURTON, *supra* note 55, at § 9.10.

[80] *See* App. I, Art. V, at p. 235 *infra*. *See also* McDaniel, *supra* note 38, at 407.

[81] *See* App. I, Art. II, at p. 234 *infra*.

[82] *See* App. I, Art. I, at p. 233 *infra*.

1980[83] is beyond the scope of this article, but a summary of the provisions of the act and a discussion of their impact upon the income tax savings device which is the subject of this article seems appropriate.

The windfall profit tax[84] is a federal excise tax on domestically produced oil. The tax is imposed on the "windfall profit" derived from the production and sale of oil, which is defined as the difference between (a) a defined base price for crude oil (adjusted quarterly for inflation) plus an adjustment for severance taxes and (b) the actual selling price of the crude oil.[85] The amount of the tax depends upon whether the oil is characterized as tier 1, tier 2, tier 3, newly discovered, or independently produced oil.[86] Oil is considered to be "newly discovered" if it is produced from an area from which there was no production in 1978.[87] Tier 3 oil includes newly discovered oil, heavy oil, and incremental tertiary oil.[88] Tier 2 oil is oil which is not included in tier 3 and which is produced from a stripper well or is attributable to an economic interest in a National Petroleum Reserve held by the United States.[89] In general, a stripper well is a well which produces less than ten barrels of oil per day.[90] Tier 1 oil is any oil which is not included in tiers 2 or 3.[91] As a general rule, tier 1 oil is any oil produced from a property which began production prior to January 1, 1979, and which does not fall into one of the special categories discussed above.

Tier 1, tier 2, and tier 3 oil are subject to windfall profit tax rates of 70%, 60%, and 30% respectively.[92] For taxable years beginning in 1982, tier 3 oil which is newly discovered will be subject to the reduced tax rates set forth below.

1982	27.5%
1983	25.0%
1984	22.5%
1985	20.0%
1986 and thereafter	15.0%

Tier 1 and tier 2 oil which is "independently produced" will be taxed at lower rates of 50% and 30% respectively[93]

The concept of independent production for purposes of determining

[83] P.L. 96-223, 94 Stat. 230.
[84] I.R.C. §§ 4986-4998.
[85] I.R.C. § 4988(a).
[86] I.R.C. § 4987.
[87] I.R.C. § 4991(e)(2); 10 C.F.R. § 212.79 (1981).
[88] I.R.C. § 4991(e)(3).
[89] I.R.C. § 4991(d).
[90] I.R.C. § 4991(d)(1)(A).
[91] I.R.C. § 4991(c).
[92] I.R.C. § 4987(b).
[93] I.R.C. § 4987(b)(2).

whether tier 1 or tier 2 oil qualifies for a lower tax rate is similar to that employed in the independent producers and royalty owners exemption from the repeal of percentage depletion.[94] Tier 1 or tier 2 oil is considered to be independently produced if it is attributable to a working interest (including an overriding royalty interest in certain situations), and if neither the taxpayer, nor any party to whom he is related, is a retailer or refiner.[95] There is an annual 1,000 barrel limitation on the amount of tier 1 or tier 2 oil which will qualify for the reduced tax rate.[96] This limitation must be shared by certain related persons, including an individual taxpayer and his spouse and minor children.[97] Similar to the disqualification from the percentage depletion allowance for transfers of proven oil or gas properties by independent producers, the benefit of the lower independent producers windfall profit tax rate can be lost if transfers of oil properties are made after January 1, 1980.[98] This rule will not be applicable, however, if the transferred property was never held by a person after September 30, 1979, who was not an independent producer or who received oil production in excess of the 1,000 barrel limitation.[99] A transferee will also not be disqualified from the favorable tax rates if he is a person related to the taxpayer who must share a 1,000 barrel ceiling as discussed above (*e.g.*, a minor child of the taxpayer or a trust for the benefit of such a person).

Section 603 of the Economic Recovery Tax Act of 1981[100] creates a complete exemption from the windfall profit tax for "exempt independent producer stripper well oil." This exemption is for oil produced after December 31, 1982, which is attributable to an independent producer's working interest in a stripper well, which property was at no time after July 22, 1981, owned by a person who could not qualify as an independent producer.

The Act also creates a $2,500 credit against the windfall profit tax for qualified royalty owners.[101] For 1982 through 1984, the Act converts the credit into an exemption for up to two barrels of production per day. Beginning in 1985, this exemption is increased to three barrels per day.[102] The credit and exemption can be claimed only by individuals, estates, and qualified farm family corporations and only with respect to royalty interests.[103] Trusts do not qualify,[104] nor does production attributable to an

94 I.R.C. §§ 613A(c), 4992.
95 I.R.C. §§ 4992(b), (d).
96 I.R.C. § 4992(c).
97 I.R.C. § 4992(e).
98 I.R.C. § 4992(d)(3).
99 I.R.C. § 4992(d)(3)(B).
100 P.L. 97-34, 95 Stat. 172.
101 *Id.* at § 601(a).
102 *Id.* at § 601(b).
103 I.R.C. § 6429(d); Economic Recovery Tax Act, P.L. 97-34, 95 Stat. 172, § 601(b) (1981).
104 I.R.C. § 6429(d).

overriding royalty, a production payment, or a net profits interest.[105] Although there are exemptions from the windfall profit tax other than described above,[106] they are of limited relevance to the subject of this article.

The windfall profit tax is a temporary tax which will be phased out over a thirty-three month period beginning January 1, 1988, or at such time as the cumulative revenues raised by the tax reach $227.3 billion, whichever is later. In no event, however, will the phaseout begin any later than January 1, 1991.[107]

As the foregoing discussion indicates, additional considerations may come into play as a result of these provisions for the practitioner who wishes to utilize the short-term trust tax savings device which is the focus of this article. Clearly, a taxpayer who is an independent producer should be careful when transferring interests in oil wells producing tier 1 or tier 2 oil. Such a transfer may result in loss of the advantage of the lower windfall profit tax rates enjoyed by independent producers.[108] However, the exceptions to this rule discussed above should, in most situations, prevent any such loss of the favorable tax rates|[109] Moreover, it should be remembered that this risk will not be present with respect to any well producing tier 3 oil, including newly discovered oil, or exempt independent producer stripper well oil.

CONCLUSION

Although the new Act has significantly reduced the rate of income tax on individuals and has indexed the rates for inflation after 1983, the burden of such tax will still be substantial for high-income individuals. In 1984, the marginal rate for taxpayers filing joint returns with income over $162,400 will be 50%. If those taxpayers must support needy relatives (*e.g.*, minor children, incapacitated children or parents), a significant savings can be derived from providing for such relatives with monies taxed at the relatives' lower tax rate.

The taxpayer could accomplish this goal by gifting any income-producing property to such relatives, either outright or in trust, but, as we have seen, there are several unique advantages to the use of short-term trusts funded with an oil or gas property created by the taxpayer for the benefit of the needy relative.

In order to maximize these advantages, the practitioner should draft the trust instrument carefully, allowing only certain types of interests in oil or gas properties to be transferred into the trust. The transfer of a roy-

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[105] Economic Recovery Tax Act, P.L. 97-34, 95 Stat. 172, §§ 601(a)(4), (b)(3) (1981).
[106] *See* I.R.C. § 4991(b).
[107] I.R.C. § 4990.
[108] I.R.C. § 4992(d)(3).
[109] *Id.*

alty or overriding royalty will maximize the tax savings because the only deduction associated with such interests, the depletion deduction, will be retained by the grantor. The working or net profits interest will also generate the desired tax savings, but to a lesser degree, because the grantor will be losing the benefits of the development and operating expenses which will be applied in reduction of the income to be reported by the beneficiary of the short-term trust. Of course, if the transfer of these property interests is delayed until after the well has been completed, this disadvantage can be ameliorated in that the development costs will already have been claimed by the grantor. A production payment should never be gifted, because a transfer of this type is ineffective to convey the incidence of income taxation from the grantor to the beneficiary of the short-term trust. It must also be kept in mind that taxpayers who qualify as independent producers obtain a lower windfall profits tax rate on tier 1 and tier 2 oil. Such taxpayers should be careful when transferring interests in wells producing such oil that they do not disqualify themselves from this lower tax rate.

In the final analysis, the short-term trust instrument is relatively simple to draft. Where used in conjunction with an oil or gas property, it should contain the special provisions enumerated in this article, including a requirement that the trustee establish a depletion reserve. The trustee must be granted special powers to enable him to deal effectively with the oil or gas properties, but his powers must also be limited to avoid possible classification of the trust as an association for federal income tax purposes. As an examination of Tables II and III[110] makes abundantly clear, the tax savings resulting from the use of such a trust can be quite significant.

APPENDIX I

SHORT TERM TRUST

This Trust Agreement is entered into this .... day of ...., 1981 by .... as GRANTOR and .... as TRUSTEE to show that GRANTOR has delivered to TRUSTEE the property described on *Exhibit A* attached hereto, such property to be held and disposed of with all other property received by TRUSTEE from any source upon the following terms and conditions.

ARTICLE I

Trust Beneficiary

TRUSTEE shall hold the corpus of this trust for the benefit of .... (BENEFICIARY). TRUSTEE shall annually pay to or apply for the benefit of BENEFICIARY all of the net income of the trust. Notwithstanding the foregoing, TRUSTEE is prohibited from distributing the net income in satisfaction of GRANTOR'S legal obligation to support BENEFICIARY. BENEFICIARY is prohibited from transferring his interest hereunder.

110 *See* App. II at pp. 239-240 *infra*.

ARTICLE II

Trust Term

This trust shall commence as of the date of execution of this instrument and shall continue until the earliest to occur of the following events:

(1) the expiration of the last day of the 121st month after the execution of this Trust Agreement; or

(2) the death of BENEFICIARY; or

(3) the death of GRANTOR.

Upon the termination of the trust, TRUSTEE shall distribute the principal of the trust to GRANTOR, or if GRANTOR is deceased, GRANTOR'S estate. GRANTOR shall have the right to assign the reversionary interest hereunder, and if GRANTOR should make such an assignment, TRUSTEE shall distribute the trust principal to the designated assignee. All of the undistributed income of the trust as of the date of termination shall be distributed to BENEFICIARY, or if BENEFICIARY is deceased, BENEFICIARY'S estate. GRANTOR reserves the right to contribute additional property to the trust and to extend its term.

ARTICLE III

Irrevocability of Trust

This trust shall be irrevocable and GRANTOR relinquishes all power to amend, revoke or terminate this trust during its term except for the sole purpose of postponing the termination date.

ARTICLE IV

Trustee Powers

Subject to the limitations contained in ARTICLE V, TRUSTEE shall have the following powers, without giving bond and without prior approval or subsequent confirmation by any court:

(a) to sell or exchange any of the property in the trust estate for cash or on such other terms as may seem advisable;

(b) to borrow money and renew or refinance existing debts and to make such security arrangements in conjunction therewith as may be reasonably necessary regardless of whether such loans or security arrangements may extend beyond the trust term;

(c) to hold the trust estate in any form and to invest and reinvest in any type of property, including interests in oil or gas wells, without regard to any statute or rule otherwise restricting investments by fiduciaries;

(d) to settle or compromise all claims against the trust or those the trust may have against others;

(e) to make distributions either in cash or kind at fair market value;

(f) to enter into leases or farm-out, unitization, pooling, or operating agreements;

(g) to enter into contracts to drill or otherwise develop or rework an oil and gas property, including contracts with respect to secondary or tertiary recovery methods and contracts with respect to marketing any production obtained from any mineral properties;

(h) to enter into any agreements of the type authorized herein for periods extending beyond the trust term;

(i) to exchange undivided interests in oil or gas properties for interests in other properties;

(j) to participate in joint ventures and partnerships, including limited partnerships;

(k) to make distributions to BENEFICIARY directly or to any person or institution for the benefit of BENEFICIARY including a custodian under the Uniform Gifts to Minors Act and to, in all respects, deal with oil and gas properties as if the trustee were the individual owner of such properties; and

(l) to hire agents and employees to assist TRUSTEE in managing the property held by TRUSTEE or in exercising any of the foregoing powers.

ARTICLE V

Limitation of Powers

All powers given to TRUSTEE by this instrument are exercisable by TRUSTEE only in a fiduciary capacity and, no power given to TRUSTEE hereunder shall be construed to enable GRANTOR or any person other than BENEFICIARY to purchase, exchange, or otherwise deal with or dispose of the principal or income hereof for less than an adequate consideration in money or money's worth or to borrow funds from the trust without interest or security. TRUSTEE shall not use the income or principal of the trust to pay premiums on insurance on the life of GRANTOR or any other contributor to the trust. TRUSTEE shall not carry on any business directly, including the development or operation of oil and/or gas wells, but shall hire independent contractors to perform such tasks. No person, other than TRUSTEE, shall have the power to:

(a) vote or direct the voting of any stock or securities held by the trust;

(b) control the investment of the trust funds; or

(c) reacquire trust corpus by substituting other property of an equivalent value.

ARTICLE VI

Successor Trustees/Compensation

GRANTOR shall have the power to remove TRUSTEE and appoint Successor Trustees. If GRANTOR should become incapacitated and if the original TRUSTEE named herein should become unable or unwilling to continue to act as TRUSTEE, ... shall thereafter serve as Successor Trustee. TRUSTEE shall receive compensation for services rendered in conjunction with the administration of the trust, which shall be charged against income. TRUSTEE shall keep full books of account showing the operations and financial conditions of the trust and TRUSTEE shall render periodic accountings not less frequently than annually to the GRANTOR and to BENEFICIARY or BENEFICIARY'S guardian or agent.

ARTICLE VII
Interpretation

This instrument shall be interpreted consistent with the following statements of GRANTOR's intentions:

(a) where necessary or appropriate to the meaning hereof, the singular and plural shall be interchangeable and the words of any gender shall include any one or all genders;

(b) the term "net income" as used throughout this trust instrument shall be construed to mean income received from all sources including proceeds received from the sale of oil and/or gas, but exclusive of stock dividends, capital gains distributions from regulated investment companies, capital gains from the sale or exchange of assets comprising the principal of the trust estate, or extraordinary dividends; and such income shall be decreased by all expenses incurred in conjunction with the administration of the trust, and by reserves for depletion and depreciation which shall equal the amount deductible in each taxable year of the trust for federal income tax purposes as depletion and depreciation; such amounts set aside as reserves shall be allocated to principal;

(c) this instrument shall be construed under the laws of the State of Ohio;

(d) the word "TRUSTEE" where used herein refers to such then acting TRUSTEE as the context requires including the initial TRUSTEE and any successors.

IN WITNESS WHEREOF, the parties have executed this Trust Agreement the day and year first above written.
Signed in the Presence of:

....
"GRANTOR"

....
"TRUSTEE"

APPENDIX II

Grantor is a male age 40 who is married and has one daughter named Beneficiary, age 8. Grantor proposes to execute a trust instrument identical to Appendix I on December 31, 1983, for the benefit of Beneficiary which will terminate 121 months from the date of execution or upon the earlier death of Beneficiary or Grantor. Grantor will assign a royalty interest to the trustee on December 31, 1983, which will be valued at $46,053. On January 1, 1984, Grantor will assign a second royalty interest to the trustee in the same well which is also valued at $46,053. Grantor is an independent producer who qualifies for percentage depletion, and the oil produced from this well qualifies as exempt independent producer stripper well oil which is not subject to the crude oil windfall profits tax.

Grantor will split the gifts made in 1983 and 1984 with his spouse and will take full advantage of the $10,000 annual exclusion available to each.

Grantor will file a joint income tax return along with his spouse and will be in the 50% marginal income tax bracket. In 1984, this would require a taxable income in excess of $162,400. Beneficiary will have no income other than that received from the short-term trust.

Any cash received from the sale of oil or gas will be held by the trustee and reinvested in bonds paying 10% interest. This reinvested cash will include both that accumulated as a depletion reserve for ultimate distribution to Grantor, and that which will constitute income which, although required to be distributed to Beneficiary, will not be, but will be held by the trustee until the trust terminates.

Table I indicates that the Grantor will incur no gift tax as a result of the transfer of the two oil and gas properties referred to above to the short-term trust. Table II reflects the income, income tax, and cash flow which would result if the Grantor assigns these oil and gas properties to a short-term trust as described herein. Table III reflects the same information if the Grantor retains possession of these properties. Table IV summarizes and compares Tables II and III thereby quantifying the tax savings to be derived from the use of the short-term trust.

For the sake of simplicity, the income calculations in Tables II and III assume that income is distributed only once a year, on the last day of the year. It is assumed that the well in this hypothetical will produce sufficient amounts of oil and gas to generate the income reflected in Column 1 of the Tables II and III, and that the well will be completely exhausted at the end of the term of the trust ten years and one month from the date of execution.

Column 2 of Tables II and III represents the annual depletion deduction which equals, for 1984 and thereafter, 15% of gross income. With respect to

Table II, this column also shows the amount of cash that will be accumulated each year for ultimate distribution to the Grantor at the time the trust terminates.

Column 3 is the net income of the well after subtraction of the depletion deduction. Column 4 is the 10% return received from investment of the prior year's accumulated cash flow. Column 5 is the total of Columns 3 and 4, and Column 6 is the tax payable on the total income reflected in Column 5. Column 6 indicates different amounts in Tables II and III to reflect the varying tax rates of Grantor and Beneficiary.

Column 7 is the after-tax income each year, which in the case of Table II, is the amount required to be distributed to Beneficiary, but which Trustee will retain and reinvest at the 10% rate referred to above. Column 8 reflects the after-tax cash flow generated with or without the use of the short-term trust, and Column 9 is the accumulation of this cash flow.

TABLE I
Gift Tax

Valuation factor for income interest for 10 year term or earlier death of male aged 40 per Table XT6	.431810	
Add factor for additional month	.002467	
Required factor	.434277	
Value of property transferred 12/31/83	46,053	
Required factor	× .434277	
Value of gift		20,000
Less: annual exclusions		(20,000)
Taxable gift		0
Value of property transferred 11/1/84	46,053	
Required factor	× .434277	
Value of Gift		20,000
Less: annual exclusions		(20,000)
Taxable gift		0

TABLE II

Income Tax If Short-Term Trust Utilized

Year	Gross Income From Well	Depletion Reserve	Net Income From Well	Other Income	Total Income	Tax	After Tax Income	Cash Flow	Accumulated Cash Flow
1	23,000	3,450	19,550	-0-	19,550	3,426	16,124	19,574	19,574
2	13,800	2,070	11,730	1,957	13,687	1,998	11,689	13,759	33,333
3	9,200	1,380	7,820	3,333	11,153	1,501	9,652	11,032	44,365
4	8,280	1,242	7,038	4,437	11,475	1,559	9,916	11,158	55,523
5	7,360	1,104	6,256	5,552	11,808	1,623	10,185	11,289	66,812
6	6,440	966	5,474	6,681	12,155	1,692	10,463	11,429	78,241
7	5,520	828	4,692	7,824	12,516	1,764	10,752	11,580	89,821
8	3,680	552	3,128	8,982	12,110	1,683	10,427	10,979	100,800
9	3,680	552	3,128	10,080	13,208	1,903	11,305	11,857	112,657
10	3,680	552	3,128	11,266	14,394	2,161	12,233	12,785	125,442
11*	307	46	261	1,045	1,306	34	1,272	1,318	126,760
Totals	84,947	12,742	72,205	61,157	133,362	19,344	114,018		

*One-month's production

TABLE III

Income Tax If Short-Term Trust Not Utilized

Year	Gross Income From Well	Depletion Reserve	Net Income From Well	Other Income	Total Income	Tax	After Tax Income	Cash Flow	Accumulated Cash Flow
1	23,000	3,450	19,550	-0-	19,550	9,775	9,775	13,255	13,255
2	13,800	2,070	11,730	1,326	13,056	6,528	6,528	8,598	21,853
3	9,200	1,380	7,820	2,185	10,005	5,003	5,002	6,382	28,235
4	8,280	1,242	7,038	2,824	9,862	4,931	4,931	6,173	34,408
5	7,360	1,104	6,256	3,441	9,697	4,849	4,848	5,952	40,360
6	6,440	966	5,474	4,036	9,510	4,755	4,755	5,721	46,081
7	5,520	828	4,692	4,608	9,300	4,650	4,650	5,478	51,559
8	3,680	552	3,128	5,156	8,284	4,142	4,142	4,694	56,253
9	3,680	552	3,128	5,625	8,753	4,377	4,376	4,928	61,181
10	3,680	552	3,128	6,118	9,246	4,623	4,623	5,175	66,356
11*	307	46	261	553	814	407	407	453	60,809
Totals	84,947	12,742	72,205	35,872	108,077	54,040	54,037		

*One-month's production

TABLE IV

Summary and Comparison of Tables II and III

	Grantor's Accumulated Cash Flow After-Tax	Beneficiary's Accumulated Cash Flow After-Tax	Total Accumulated Cash Flow After-Tax
TABLE II	12,742	114,018	126,760
TABLE III	60,809	-0-	60,809
SAVINGS			65,951