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## SHIFTING OF INCOME WITHIN THE FAMILY: WILL 1986 I.R.C. CHANGES BRING SIGNIFICANT REFORM?

*John A. Lynch, Jr.\**

### I. INTRODUCTION

In challenging Congress and the citizenry to embrace tax reform, President Reagan stated:

While most Americans labor under excessively high tax rates that discourage work and cut drastically into savings, many are able to exploit the tangled mass of loopholes that has grown up around our tax code to avoid paying their fair share—sometimes to avoid paying any taxes at all.<sup>1</sup>

Fairness and simplicity were clearly overriding objectives of the tax reform movement that culminated in the Tax Reform Act of 1986.<sup>2</sup>

From the perspectives of both fairness and simplicity, one of the most egregious features of prior law was the ability of taxpayers with accumulated wealth to thwart the effects of the progressive taxation by shifting income from such accumulated wealth from the accumulator of such wealth to family members in lower tax brackets. Often, such shifting of income has been accomplished through the use of trusts, which since the earliest days of federal income taxation have been recognized as separate taxpayers.<sup>3</sup>

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1. President's Message to Congress Transmitting Proposed Tax Reform Legislation, 21 WEEKLY COMP. PRES. DOC. 707-08 (June 3, 1985).

2. Pub. L. No. 99-514, 100 Stat. 2085.

3. See Revenue Act of 1916, ch. 271, § 2(b), 39 Stat. 756, 757 (1916), which provided: [I]ncome of estates or any kind of property held in trust, . . . for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator or trustee, as the case may be: *Provided*, That where the income is to be distributed annually or regularly between existing heirs or lega-

The tax law has favored shifting of income from accumulated wealth over shifting of income from services because, early on, the law had developed sophistication sufficient to thwart the latter.<sup>4</sup> The law has permitted shifting of income from property even when the owner has not completely given the property away. This has easily been accomplished through the use of trusts. To be sure, Congress provided that retention of too much control by the grantor of a trust will result in taxation to the grantor of income from the portion controlled.<sup>5</sup>

Nevertheless, as vexing to the taxpayer as these restrictions have seemed, they might best be described as safe harbors; if they were followed, trust income would be taxable to a beneficiary<sup>6</sup> or to the trust.<sup>7</sup> The Tax Court has rather bluntly noted that Congress, in respecting the separateness of the trust as a taxpayer, sanctioned tax avoidance: "[I]t must be noted that while Congress has carefully delineated certain areas in which tax-avoidance . . . is the touchstone of tax liability, it has enacted no such provisions in the trust area."<sup>8</sup>

In a complex trust,<sup>9</sup> a grantor has the ability either to distribute income to a beneficiary or to have it accumulated by and taxed to the

tees, or beneficiaries the rate of tax and methods of computing the same shall be based in each case upon the amount of the individual share to be distributed.

There was no means of taxing the grantor of a revocable trust on the income thereof until 1924. 3 B. BITTKER, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 80.1.1 (1981).

4. See *Lucas v. Earl*, 281 U.S. 111 (1930), in which the Court held:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.

*Id.* at 114-15.

5. *Id.* at 114-15. Such "forbidden" controls include retention by the grantor of a reversionary interest in excess of five percent of the value of any portion of the trust at its inception, see I.R.C. § 673(a) (1988); possession of a power, exercisable by the grantor or a nonadverse party or both, to dispose of the beneficial enjoyment of the corpus or income of any portion of the trust, see *id.* § 674(a); the ability to exercise certain administrative powers such as borrowing trust corpus or income without adequate security, see *id.* § 675(2); the power to revest any portion of the trust exercisable by the grantor or a nonadverse party, see *id.* § 676(a); the ability to have the income of any portion of the trust, without consent of an adverse party, distributed to the grantor or the grantor's spouse, held for future distribution to the grantor or the grantor's spouse, or applied to payment of premiums on policies of insurance on the life of the grantors or the grantor's spouse, see *id.* § 677(a); or the application of income for the support or maintenance of a beneficiary whom the grantor is legally obligated to support, see *id.* § 677(b).

6. See I.R.C. § 61(a)(15) (1988); see also *id.* §§ 651, 662.

7. See *id.* § 641.

8. *Morris Trusts v. Comm'r*, 51 T.C. 20, 39 (1968) (footnote omitted), *aff'd*, 427 F.2d 1361 (9th Cir. 1970).

9. A complex trust is any trust that is not a simple trust. See generally I.R.C. §§ 661-662 (1988). Under § 651, a simple trust is a trust that does not require that its income be distributed currently and that does not provide that its income may be paid, permanently set aside, or used for charitable purposes under § 642(c).

trust.<sup>10</sup> In the past, this option could be used to avoid distributions to a child of the grantor that might have been taxable to a grantor because they were in fulfillment of a legal obligation of support.<sup>11</sup>

Under former law, if the income from a trust could be distributed to a child or other family member of the grantor without fulfilling an obligation of support, such income could be offset by the \$1,000 personal exemption of the beneficiary.<sup>12</sup>

Although the landmark Supreme Court decision in *Helvering v. Clifford*<sup>13</sup> was aimed at "temporary reallocation of income within an intimate family group,"<sup>14</sup> in the public mind, *Clifford* became associated with the so-called "Clifford trust," a popular means of avoiding taxes on income from income-producing property.<sup>15</sup>

The recognition of the trust for tax purposes and the safe harbors of the grantor trust rules created unfair tax advantages for affluent and sophisticated taxpayers. Use of trusts, like resort to tax shelters, provided inappropriate relief from the progressivity of income tax rates.

Not surprisingly, then, as the drive for tax reform heated up in the mid-1980's, use of the trust as an income-shifting device within the family came under attack. The Tax Reform Act of 1986 was the product of four comprehensive tax reform proposals: the Treasury Department proposal of November 1984,<sup>16</sup> President Reagan's May 1985 pro-

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10. In a simple trust, the income required to be distributed is taxable to the beneficiary and deductible by the trust up to the amount of the distributable net income of the trust. *Id.* § 651-652. Distributable net income is defined *id.* § 643(a).

The complex trust provisions are found in §§ 661-662. Section 661 contemplates both distributions that are *required* to be paid to a beneficiary and distributions that *may* be made, whereas section 662 requires a beneficiary to include such mandatory or permitted distributions as income to the extent of his or her share of the trust's distributable net income. If trust income is not *required* to be distributed currently, the trustee may determine whether it is taxable to the trust or the beneficiary by distributing it to the beneficiary or accumulating it in the trust. *Id.* § 661-662.

11. *See id.* § 677(b). The so-called throwback rule, §§ 665-668, is designed to thwart tax avoidance via accumulation of income by taxing distributions of accumulated income to beneficiaries "as though they had been distributed to the beneficiaries in earlier years." 3 B. BITTKER, *supra* note 3, ¶ 81.5.1. This device discourages accumulation only if the beneficiary is in a higher tax bracket in the years of accumulation than he or she is in the year of distribution.

12. I.R.C. § 151(b) (1985) (amended 1986). As of 1987, however, the personal exemption is denied for an individual who may be claimed as a dependent for purposes of the exemption on the return of another. *Id.* § 151(d)(2) (1987).

13. 309 U.S. 331 (1940).

14. *Id.* at 335.

15. I.R.C. § 673(a) (1954). A grantor could retain a reversionary interest in property placed in trust as long as the reversion would not reasonably be expected to take effect within 10 years. *Id.*

16. U.S. DEPT. OF TREAS., OFFICE OF THE SECY., TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984) [hereinafter TREASURY PROPOSAL].

posal,<sup>17</sup> the bill passed by the House of Representatives in December 1985,<sup>18</sup> and the bill passed by the Senate on May 29, 1986.<sup>19</sup> The first three of those proposals would have effectively nullified the separate identity of a trust as a taxpayer for income-shifting purposes. The latter, the Senate bill, which was closest to what ultimately became law, did not do so as completely as the others.

All reform proposals included a dramatic new provision that would tax the income of children under fourteen as if it had been received by one or both of their parents.<sup>20</sup> This provision, which was adopted,<sup>21</sup> and

17. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY (1985) [hereinafter REAGAN PROPOSAL].

18. H.R. 3838, 99th Cong., 1st Sess. (1985), accompanied by H.R. REP. NO. 426, 99th Cong., 1st Sess. (1985) [hereinafter House Bill].

19. H.R. 3838, 99th Cong., 2d Sess. (1986), accompanied by S. REP. NO. 313, 99th Cong., 2d Sess. (1986) [hereinafter Senate Bill].

20. See 2 TREASURY PROPOSAL, *supra* note 16, at 93-94; REAGAN PROPOSAL, *supra* note 17, at 85; H. REP. NO. 426, *supra* note 18, at 801; S. REP. NO. 313, *supra* note 19, at 863.

21. I.R.C. § 1(i) provides:

(i) Certain unearned income of minor children taxed as if parent's income.—

(1) In general.—In the case of any child to whom this subsection applies, the tax imposed by this section shall be equal to the greater of—

- (A) the tax imposed by this section without regard to this subsection, or
- (B) the sum of—

- (i) the tax which would be imposed by this section if the taxable income of such child for the taxable year were reduced by the net unearned income of such child, plus

- (ii) such child's share of the allocable parental tax.

(2) Child to whom subsection applies.—This subsection shall apply to any child for any taxable year if—

- (A) such child has not attained age 14 before the close of the taxable year, and

- (B) either parent of such child is alive at the close of the taxable year.

(3) Allocable parental tax.—For purposes of this subsection—

- (A) In general.—The term "allocable parental tax" means the excess of—

- (i) the tax which would be imposed by this section on the parent's taxable income if such income included the net unearned income of all children of the parent to whom this subsection applies, over

- (ii) the tax imposed by this section on the parent without regard to this subsection.

For purposes of clause (i), net unearned income of all children of the parent shall not be taken into account in computing any deduction or credit of the parent.

(B) Child's share.—A child's share of any allocable parental tax of a parent shall be equal to an amount which bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the aggregate net unearned income of all children of such parent to whom this subsection applies.

(4) Net unearned income.—For purposes of this subsection—

- (A) In general.—The term "net unearned income" means the excess of—

- (i) the portion of the gross income for the taxable year which is not earned income (as defined in section 911(d)(2)), over

- (ii) the sum of—

which will be referred to herein as the parental tax, will diminish the usefulness of trusts for income-shifting purposes. Under this provision, in most instances, only the first \$1,000 of unearned income will be taxed at the child's rate.<sup>22</sup> It will have an impact on income shifting outside of the trust context as well. Nevertheless, the reform proposal adopted, which largely respects the separate tax identity of trusts, may, to some extent, permit the use of trusts to serve as an escape hatch for the parental tax.

Perhaps the most significant vice of the former grantor trust provisions was that they permitted "parking" of income-producing property in trust for tax purposes. The legislation ultimately enacted restricts but does not prevent this. On the other hand, of all four proposals for a parental tax, only the Senate bill would have taxed the unearned income of minors under fourteen that is *not* attributable to parental sources at the marginal rate of one or both of the parents.

This article explores the effects of the provisions of the Tax Reform Act of 1986 aimed at income shifting within the family. The article first examines in detail changes that will affect income shifting. Second, the article compares these changes with parallel provisions of the various tax reform proposals to evaluate whether the most effective solutions to past abuses were selected. Third, the article examines the potential effects of existing law upon the Act. Finally, the article in-

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(I) the amount in effect for the taxable year under section 63(c)(5)(A) (relating to limitation on standard deduction in the case of certain dependents), plus

(II) the greater of the amount described in subclause (I) or, if the child itemizes his deduction for the taxable year, the amount of the deductions allowed by this chapter for the taxable year which are directly connected with the production of the portion of gross income referred to in clause (i).

(B) Limitation based on taxable income.—The amount of the net unearned income for any taxable year shall not exceed the individual's taxable income for such taxable year.

(5) Special rules for determining parent to whom subsection applies.—For purposes of this subsection, the parent whose taxable income shall be taken into account shall be—

(A) in the case of parents who are not married (within the meaning of section 7703), the custodial parent of the child, and

(B) in the case of married individuals filing separately, the individual with the greater taxable income.

22. *Id.* § 1(i)(4)(A)(ii)(I)–(II); see also Treas. Reg. § 1.1(i)-1T, A-1 (1987). In the parlance of the statute, the net unearned income of the child under 14 is taxable at the tax rate of the parent. This net unearned income is the amount by which unearned income exceeds \$500, the child's standard deduction under § 63(c)(5)(A), if the child may be claimed for a dependency exemption by another taxpayer and such child does not have earned income in a greater amount, plus the greater of the standard deduction or the portion of itemized deductions directly connected with the production of the child's unearned income.

cludes a discussion of the effects of the Act outside the sphere of the use of trusts to shift income—most prominently, the Act's effects on family partnerships and S corporations.

## II. WHAT CONGRESS DID: INCOME SHIFTING AND THE TAX REFORM ACT OF 1986.

The attacks of the Tax Reform Act of 1986 on income shifting within a family are two-fold: several modifications were made to the trust provisions of the Code and the marginal rate applicable to the income of minor children under fourteen has been changed to that of the parents.

### A. Changes in Code Provisions Affecting Trusts

#### 1. Increase in Tax Rates Applicable to Trusts

Several changes were made in provisions of the Code pertaining to trusts that either directly restrict income shifting or indirectly make it less attractive. Perhaps the most dramatic in the long run, if the most mundane, was a significant increase in the rates applicable to trusts and estates.<sup>23</sup> The new rates, of course, must be viewed in the context of the entire Act. The maximum tax rate on trust income, twenty-eight percent, will apply for taxable years beginning 1988 to taxable income over \$5,000. Under rates applicable for 1986, the twenty-eight percent bracket was not reached until a taxable income in excess of \$14,300.<sup>24</sup>

The new tax rates on trusts tend to discourage resort to trusts to avoid taxation because the rates are higher than those upon individuals. For married taxpayers filing jointly, the twenty-eight percent bracket begins at taxable income of \$29,750;<sup>25</sup> for unmarried individuals other than surviving spouses or heads of households, it begins at \$17,850;<sup>26</sup> and for married individuals filing separately, the highest rate begins at taxable income of \$14,875.<sup>27</sup> Clearly, much less income of a trust is subject to the lower fifteen percent bracket than the incomes of other

23. See *id.* § 1(e). This section provides:

(e) Estates and trusts.—There is hereby imposed on the taxable income of—

(1) every estate, and

(2) every trust,

taxable under this subsection a tax determined in accordance with the following table:

*If taxable income is:*

*The tax is:*

Not over \$5,000 . . . . . 15% of taxable income

Over \$5,000 . . . . . \$750, plus 28% of the excess over \$5,000

24. See 1 STAND. FED. TAX REP. (CCH) § 1116 (1987).

25. I.R.C. § 1(a) (1988).

26. *Id.* § 1(c).

27. *Id.* § 1(d).

noncorporate taxpayers. Further, under the Act the benefit of the fifteen percent bracket begins to phase out at a much lower level of income, \$13,000, than it does for married taxpayers filing jointly, for whom such phaseout begins at taxable income of \$71,900.<sup>28</sup>

The decrease in the progressivity of rates applicable to individuals reduces the incentive to attempt to shift income to or through a trust. Nevertheless, up to a taxable income of \$13,000, a trust retains the benefit of the fifteen percent bracket for its first \$5,000 of income. Furthermore, to the extent an individual taxpayer can shift income to a trust, he or she may avoid a phaseout of the benefit of the fifteen percent bracket and personal exemptions on his or her own return. Given the significant increase in the amount of the personal exemption to \$2,000, effective in 1989,<sup>29</sup> high-income taxpayers who have a significant number of personal exemptions might have an incentive to place income-producing assets in trust in order to avoid phaseout of the fifteen percent bracket and personal exemptions.<sup>30</sup>

## 2. Changes in the Effects of the Grantor's Retention of a Reversionary Interest

A second significant modification in the Code provisions pertaining to trusts, and one that more directly restricts the shifting of income through the use of trusts, is the change to I.R.C. § 673. New section 673 provides:

The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of

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28. Under § 1(g), the tax is increased 5%, above the maximum rate of 28% upon the excess of the taxable income over the applicable dollar amount, i.e., the beginning of the phaseout. *See id.* § 1(g)(3). This surcharge applies to an amount of taxable income up to the sum of 13% of the income to which the 15% bracket applies and 28% of the amount of the deductions for personal exemptions. *See id.* § 1(g)(2)(A)-(B). The applicability of what amounts to a 33% rate of taxation results in a complete phaseout of the benefit of the 15% bracket for trusts at an income level of \$13,950 or \$13,750, depending upon the amount of the personal exemption available to the trust. *See id.* § 642(b) (providing that a trust required to distribute all of its income currently is allowed a personal exemption of \$300, while all other trusts are allowed a personal exemption of \$100).

29. *See id.* § 151(d)(1)(C).

30. Such a maneuver might also be helpful in avoiding phaseout of the \$25,000 exemption from the disallowance of losses in passive activities under § 469(i), which begins at an adjusted gross income of \$100,000. *Id.* § 469(i)(3)(A). The IRS has provided in temporary regulations that a child's tax under the parental tax is affected by the parent's phaseout of the 15% bracket and personal exemptions, *Treas. Reg.* § 1.1(i)-1T, A-20 (1987), but the parent's phaseout of the passive loss allowance is not affected by addition of the child's net unearned income for purposes of the parental tax. *Id.* at Q-21.

Such taxpayers, however, must not retain a reversionary interest the value of which exceeds five percent of the value of the trust property. *Id.* § 673(a).



such interest exceeds 5 percent of the value of such portion.<sup>31</sup>

Former section 673(a) treated the grantor as the owner of any portion of the trust in which he or she had a reversionary interest in either corpus or income, if at the inception of such portion of the trust, such interest might reasonably have been expected to take effect within ten years.<sup>32</sup>

Former section 673 was the basis of the "Clifford trust," which, in the argot of tax avoidance, was a trust in which the corpus could not revert to the grantor for a minimum period of ten years. During that period the income could be accumulated for purposes such as college expenses without tax consequences to the grantor. The ability of the grantor to get the corpus back after a definite period while shifting tax consequences from such corpus in the interim provided significant flexibility to taxpayers with accumulated property.

As discussed above, even with lower tax rates for individuals and higher rates for trusts under the Act, taxpayers might still have an incentive to shift income to trusts. With the elimination of the ten year safe harbor, however, a grantor has less flexibility in planning to get the corpus back.

New section 673 does carve out an exception to the rule that a reversionary interest valued in excess of five percent of the corpus will result in the grantor being treated as owner of such portion. The section provides that the grantor will not be treated as the owner of any portion in which he or she has a reversionary interest if the beneficiary of such portion is a lineal descendant of the grantor and holds all present interest in such portion and such reversionary interest takes effect only upon the death of such beneficiary before such beneficiary reaches the age of twenty-one.<sup>33</sup>

The safe harbor of the Act allows, at best, only a modicum of doomsday planning. It allows the grantor to regain control of the corpus in the relatively unlikely event of the death of a child or grandchild beneficiary before such beneficiary reaches the age of twenty-one. It permits the grantor to keep such corpus subject to his or her control and perhaps within the family, rather than permitting it to

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31. *Id.* § 673(a). Neither the statute nor the committee reports indicate how a reversionary interest is to be valued. Presumably such valuation will be made in a manner similar to that for purposes of the gross estate under § 2031. Treas. Reg. § 20.2031-10(d) (as amended T.D. 7955, 1984-1 C.B. 40) provides a reference to an actuarial table at § 20.2031-10(f). However, if the reversion is dependent upon the continuation or termination of more than one life, a special factor (multiplier) must be used which, in some instances, may be obtained directly from § 20.2031-10(e).

32. I.R.C. § 673(a) (1954).

33. *Id.* § 673(b) (1988).

become part of the estate of the beneficiary.

Obviously, new section 673 provides no ability for shifting income to a beneficiary older than the grantor while the grantor retains a reversionary interest; in contrast, former section 673(c) did contain such a safe harbor.<sup>34</sup> With America's population aging, it is unfortunate that Congress eliminated former section 673(c), a provision that facilitated support of elderly relatives by taxpayers. However, the curtailment of tax benefits from the use of trusts in which the grantor retained a reversionary interest was an important objective of Congress with respect to the Act.<sup>35</sup>

### 3. Changes Affecting Deferral of Income and Payment of Tax

Congress made two other changes in the tax treatment of trusts that might affect the desirability of resort to a trust: under new section 645, trusts are generally required to adopt the calendar year as a taxable year; and under section 6654(l), trusts are now required to make estimated tax payments, a requirement for individuals since 1944.<sup>36</sup>

The requirement that trusts adopt a calendar year removes an opportunity for deferral of the reporting of trust income by a calendar year beneficiary through selection for the trust of a fiscal year ending in January. If distributions by the trust were delayed until the end of such a fiscal year, they would be reported by the beneficiary in a taxable year that would not end until eleven months after the trust's taxable year. Significant deferral of taxation of trust income could be achieved in this way. The income taxed to the beneficiary might have pertained to a period twenty-three months before the end of the taxable

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34. *Id.* § 673(c) (1954) (repealed 1986). Under former § 673(c), a former grantor was not treated as owner of any portion of a trust when his reversionary interest in such portion would not take effect in possession or enjoyment until the death of an income beneficiary. This permitted a grantor to shift income to an elderly beneficiary for life regardless of such beneficiary's life expectancy. See *Treas. Reg.* § 1.673(a)-1(b) (1956).

35. STAFF OF JOINT COMMITTEE ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1248 (Comm. Print 1987).

Under the Act, § 674(b)(2) was amended to provide that the possession of a reversionary interest by the grantor that does not subject the grantor to taxation under § 673(b) until a particular event occurs will also not subject the grantor to taxation under § 674(a). A similar confirming amendment was made to § 676(b) concerning a power in the grantor to revoke a beneficial interest in the income of a trust. Both § 674 and § 676, in their references to § 673, now reflect § 673's new emphasis upon the likelihood of an event rather than the expiration of a period of time in determining whether a grantor will be taxed.

36. See *Individual Income Tax Act of 1944*, ch. 210, 58 Stat. 315.

Since income tax withholding under I.R.C. § 3402 is only against wages of employees, and since under *id.* § 6654(k) (1954) (amended 1986) (current version at I.R.C. § 6654(l)), trusts were not required to make estimated tax payments, trusts enjoyed the privilege of paying taxes only at the end of the year—a privilege long denied other taxpayers.

year of the beneficiary.<sup>37</sup> Since it is quite likely that many taxable beneficiaries will be unsophisticated taxpayers who do not keep formal books and are therefore required to report on a calendar year,<sup>38</sup> they will not be in a position to achieve tax deferral through variation in the taxable year between trust and beneficiary.

### *B. What Congress Might Have Done, but Did Not Do, to Income Shifting*

The ultimate changes to the rules for taxation of trusts seem modest when compared to the criticism of the role of the trust in tax avoidance contained in the 1984 Report of the Treasury Department to the President:

No discernible social policy is served by [the] tax incentive for the creation of trusts and the accumulation of income within them . . . . [C]urrent tax policy has not only sacrificed tax revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property.<sup>39</sup>

The criticism of President Reagan's proposal for tax reform of resort to the trust device to avoid taxes was also quite pointed:

During the lifetime of the grantor, there is no persuasive justification for taxing a trust under its own graduated rate schedule. Permitting a grantor to create trusts and thereby obtain the benefit of multiple graduated rate schedules is inconsistent with the principle that all income of an individual taxpayer should be subject to tax under the same progressive rate structure.<sup>40</sup>

The report of the House Ways and Means Committee accompanying its version of the Act was perhaps not quite as sweeping in its criticism of use of the trust device but did express concern about "the inherent tax benefits arising under the present rules governing the taxation of trusts."<sup>41</sup> The House Report viewed such problems as arising "because

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37. This change was probably long overdue, as it has already been visited upon other conduit-taxpayers. Partnerships are quite restricted in their ability to select a taxable year that permits deferral of income, see I.R.C. § 706(b), and S corporations must generally select a calendar year. See *id.* § 1378(b).

38. See *id.* § 441(g).

39. 2 TREASURY PROPOSAL, *supra* note 16, at 98-99.

40. REAGAN PROPOSAL, *supra* note 17, at 90.

41. H.R. REP. NO. 426, *supra* note 18, at 811.

The Committee saw the benefits to taxpayers from the taxation of trusts as four-fold: 1) creation of separate taxpayers entitled to separate rate structures and exemptions through creation of trusts, 2) deferral of tax on trust income through selection of taxable years that do not coincide with those of the beneficiaries, 3) separation of taxation of the stream of income from assets from the ownership of those assets through trusts, and 4) minimization of taxes by spraying of income through discretionary trusts to beneficiaries with the lowest taxable incomes.

present law provides separate tax rates to trusts or estates and taxes beneficiaries on distributions from the trust or estate."<sup>42</sup>

The tax reform proposals other than that of the Senate essentially eliminated the separate tax identity for trusts. The Treasury and the Reagan plans, which were not accompanied by draft legislation, proposed to distinguish between grantor-owned and non-grantor-owned trusts. The income of grantor-owned trusts<sup>43</sup> would have been taxed to the grantor.<sup>44</sup> Under the Treasury and Reagan proposals, income from non-grantor-owned trusts would have been taxed at the same rate as if it had been added to the grantor's other income.<sup>45</sup> In arriving at the taxable income of such trusts, both proposals would have allowed deductions for mandatory distributions. A distribution would have been considered mandatory only if a fixed or ascertainable amount of trust income or property were required to be distributed to a specific beneficiary or beneficiaries.<sup>46</sup> Under both proposals a beneficiary of a trust would have been taxed on income from property irrevocably set aside for such beneficiary.<sup>47</sup> The net effect of this scheme would have been that the income from a trust would have been taxable either to the trust, at the same rate as if it had been added to the income of the grantor, or to the beneficiary. The trust itself would have had no significance in determining the rate of taxation. Since, under both proposals, beneficiaries under age fourteen would have been taxed on their unearned income at the marginal rates of their parents,<sup>48</sup> it would not have been possible to use the trust device as a separate taxpayer or as a means of diverting income to or for young children in order to avoid

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42. *Id.*

43. Under both provisions, trusts were treated as owned by the grantor if (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year.

2 TREASURY PROPOSAL, *supra* note 16, at 99; REAGAN PROPOSAL, *supra* note 17, at 91.

44. 2 TREASURY PROPOSAL, *supra* note 16, at 100; REAGAN PROPOSAL, *supra* note 17, at 100.

45. 2 TREASURY PROPOSAL, *supra* note 16, at 102; REAGAN PROPOSAL, *supra* note 17, at 94.

46. 2 TREASURY PROPOSAL, *supra* note 16, at 101; REAGAN PROPOSAL, *supra* note 17, at 92-93.

47. 2 TREASURY PROPOSAL, *supra* note 16, at 101; REAGAN PROPOSAL, *supra* note 17, at 93.

48. 2 TREASURY PROPOSAL, *supra* note 16, at 94; REAGAN PROPOSAL, *supra* note 17, at 85.

taxing income from property from a grantor at the marginal rate of the grantor.

The House proposal would have achieved largely the same end through different means. Under that proposal, non-grantor-owned trusts<sup>49</sup> would have been taxed during the lifetime of the grantor at the top marginal rate of the grantor, generally without deduction for distributions to beneficiaries.<sup>50</sup> This would have been accomplished through a convoluted scheme of allowing a grantor to allocate his or her unused rate brackets to the trust for the purpose of determining the trust's tax rate.<sup>51</sup> The House bill provided two exceptions to the rule that trust income was to be taxed at the marginal rates of the grantor. In the case of a qualified beneficiary trust,<sup>52</sup> the income would have been taxed at the marginal rates of the beneficiary. In the case of a qualified children's trust,<sup>53</sup> the income would have been taxed at the unused tax brackets of the children.<sup>54</sup>

Neither of these exceptions to the general rule of taxation at the grantor's highest marginal rate would have permitted use of the trust to avoid this general rule if the beneficiary were a child of the grantor under age fourteen. In such a case, the beneficiary's unused rate brackets would not have been permitted to be allocated to the trust.<sup>55</sup>

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49. The House proposal would have treated the grantor as owner of a trust in fewer instances than the Treasury or Reagan proposals or than under former law. *See supra* note 5. The grantor would have been treated as owner of the trust if: 1) the grantor or the grantor's spouse retained the power to deal with the trust for less than adequate and full consideration, to borrow without adequate interest or security, or had borrowed from the trust and had not repaid such amount before the beginning of the taxable year, 2) the trust was subject to a power to revoke that enables the grantor or the grantor's spouse to revest part or all of the trust in the grantor or the grantor's spouse, or 3) any portion of the trust was required to be or might have been, in the discretion of the grantor or the grantor's spouse, held for distribution to the grantor or the grantor's spouse, or applied to the payment of premiums on life insurance policies on the grantor or the grantor's spouse. H.R. REP. NO. 426, *supra* note 18, at 817-18.

50. *Id.* at 812.

51. Under the House bill there were four tax rate brackets: 15%, 25%, 35% and 38%. *Id.* at 4. To the extent that the taxable income of a married grantor filing jointly was less than \$43,000, he or she would have been able to allocate his or her 25% bracket to the taxable income of the trust; to the extent his or her taxable income was less than \$100,000, he or she would have been able to allocate his or her 35% bracket to the taxable income of the trust. *Id.* at 813-14.

52. A qualified beneficiary trust is a trust in which all of the income or principal would be irrevocably allocated to a particular individual or his estate at all times during a taxable year and thereafter. *Id.* at 816.

53. A qualified children's trust is a trust in which all of the principal and income must have been irrevocably devoted for the taxable year and all subsequent years to the children of the grantor. *Id.* at 816-17.

54. The primary difference between the qualified beneficiary trust and the qualified children's trust appears to have been that in a qualified children's trust the irrevocable commitment of income and corpus could have been to a group of beneficiaries, the grantor's children, rather than to a single beneficiary and his or her estate. *Id.*

55. *Id.*

Like the Treasury and the Reagan proposals, the House bill would not have permitted taxpayers to accumulate income in a trust in order to avoid taxation of the child's income at the marginal rate of the parent. As discussed above, the Act, as did former law, treats non-grantor trusts as separate taxpayers, taxable at their own rates. Unless income ultimately distributable to a child of the grantor is distributed to the child in the taxable year, it is taxable to the trust at the trust's rate.<sup>56</sup> A trust may thus be used to accumulate income for a child until such child is fourteen, thereby avoiding the parental tax of I.R.C. § 1(i). Just how much of an opportunity for avoidance this creates, particularly in light of the new tax rates applicable to trusts under the Act and the general flattening of rates, shall be discussed shortly.

As to trust beneficiaries other than the children of the grantor under age fourteen, the Act provides for more flexibility than alternative proposals in accumulating income while avoiding taxation of trust income at the grantor's rate. As noted above, the Treasury<sup>57</sup> and Reagan proposals<sup>58</sup> and the House bill<sup>59</sup> would have required that property and income be irrevocably set aside for a beneficiary (or his or her estate) in order for the trust income not distributed to a beneficiary to be taxed to such beneficiary rather than to the grantor. The Act does not require such an irrevocable commitment. As long as the grantor does not provide for a reversionary interest worth more than five percent of the trust corpus, or portion thereof, a grantor may provide for alternative ultimate dispositions of the trust corpus and still have income taxed to the trust or beneficiaries rather than the grantor. By not requiring an irrevocable commitment of income to particular beneficiaries the Act permits "spraying" of corpus among beneficiaries.<sup>60</sup> Further, unless a grantor retains a reversionary interest that would make income of the trust taxable to him or her under new section 674(b), the Act contains no new limitations on the ability of a grantor to use a trust to shift income to a beneficiary who is *not* a minor child

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56. H.R. REP. NO. 841, 99th Cong., 2d Sess. (1986).

57. TREASURY PROPOSAL, *supra* note 16, at 101; *see also supra* note 47 and accompanying text.

58. REAGAN PROPOSAL, *supra* note 17, at 93; *see also supra* note 47 and accompanying text.

59. H.R. REP. NO. 426, *supra* note 18, at 816-17; *see also supra* notes 52-53 and accompanying text.

60. In order not to cause such income to be taxed to the grantor, power to allocate corpus to different beneficiaries must be limited in the manner provided by I.R.C. § 674(b)(5) (1988) if it is exercisable by the grantor, or by *id.* § 674(c) if it is exercisable only by independent trustees. Section 674(b)(5) requires that such distributions of corpus to current income beneficiaries be chargeable against the proportionate share of corpus held in trust for such beneficiaries and that distributions for other beneficiaries be limited by a "reasonably definite standard." Corpus distributions by independent trustees under § 674(c) are not similarly restricted.

under the age of fourteen.

Nevertheless, it appears that the most significant tax avoidance device permitted by the Act that was not permitted by the alternative tax proposals is the ability to sidestep the parental tax by having trust income taxed to a trust at a trust's own tax rate.

### *C. Use of Trusts for Tax Avoidance Under the Act: How Significant a Loophole?*

All of the reform proposals discussed herein sought to make the tax law fairer by restricting income-shifting devices within a family. Under proposals other than the Senate bill, the only way to avoid taxation of trust income at the grantor's tax rate would have been to distribute the income, actually or constructively, to particular beneficiaries. If such beneficiaries were children of the grantor under fourteen, all proposals, including the Senate bill, would have taxed the income at the grantor's rate. Under the Act, however, it is not necessary for a trust to make a distribution or a set aside in order to avoid taxation of income at the tax rate of the grantor. A parent has an incentive to accumulate income in a trust for a minor child until the child is fourteen and to provide then for distribution from the trust, taxable to the child.<sup>61</sup>

Such a two-step process flies in the face both of the reformist notion that the artifice of the trust should not be used to avoid taxes, and the more concrete restriction of shifting of income to children of the grantor under fourteen. Such a scheme may be useful where the amount of income generated by trust property is small enough, when the eventual child-beneficiary is under fourteen, to be taxed to the trust at the fifteen-percent rate.<sup>62</sup> Two important income shifting restrictions of prior law may present difficulties for this two-step avoidance process: Section 643(f), the multiple-trust rule; and section 677(b), which provides for taxation to the grantor trust of income used to discharge an obligation of support of the grantor.

#### 1. The Multiple-Trust Rule

The relatively low level of income at which the twenty-eight percent bracket becomes effective for trusts would ostensibly encourage a grantor to put into as many trusts as possible property as to which he or she wishes to shift income. For example, if a grantor has five chil-

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61. Accumulation in a trust *vis à vis* distribution to a child is also made more attractive by substitution in the Act of a \$500 standard deduction for the unearned income of a child, *see id.* § 63(c)(5)(A), for the personal exemption available under prior law. *See id.* § 151 (1954) (current version at I.R.C. § 151(d)(2)).

62. *See supra* notes 22-30 and accompanying text.

dren under fourteen, he or she would be encouraged to set up at least five separate trusts. In 1984, Congress enacted section 643(f)<sup>63</sup> to address the problem of avoidance of taxes through multiple trusts. Aggregation of trusts, of course, can result in the total income being taxed at a higher rate. The incentive to use trusts to avoid the new parental tax will undoubtedly lead to scrutiny of the efficacy of section 643(f) to thwart avoidance through multiple trusts. That is ironic because the Treasury reform proposal decried prior law as creating the necessity for a multiple-trust rule.<sup>64</sup>

The multiple-trust rule of section 643(f) permits the IRS to treat two or more trusts as one if the trusts have substantially the same primary beneficiary or beneficiaries and a principal purpose of such trusts is tax avoidance. This provision was enacted in the wake of the decision of the Tax Court in *Stephenson Trust v. Commissioner*,<sup>65</sup> which invalidated regulations that were quite similar to section 643(f).<sup>66</sup>

The Tax Court's invalidation of the consolidation regulations involved a broad sanctioning of the use of trusts to shift income as long as proper trust form was respected. The trust arrangement given effect therein involved two simple trusts that could "pour over" into companion accumulation trusts. In both cases, the beneficiaries of both trusts were the same or nearly the same.

In its report accompanying passage of section 643(f), the House stated its belief that rules similar to those that had been imposed in the invalidated IRS regulations were necessary to prevent significant reduction of taxation of investment income through use of multiple

63. I.R.C. § 643(f) (originally enacted as I.R.C. § 643(e)) provides:

For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

64. 2 TREASURY PROPOSAL, *supra* note 16, at 100; *see also* REAGAN PROPOSAL, *supra* note 17, at 90-91.

65. 81 T.C. 283 (1983).

66. Treas. Reg. § 1.641(a)-0(c) (1972), invalidated by the Tax Court in *Stephenson Trust*, provided:

Multiple trusts that have—

(1) No substantially independent purposes (such as independent dispositive purposes),

(2) The same grantor and substantially the same beneficiary, and

(3) The avoidance or mitigation of (a) the progressive rates of tax (including mitigation as a result of deferral of tax) or (b) the minimum tax for tax preferences imposed by section 56 as their principal purpose,

shall be consolidated and treated as one trust for the purposes of subchapter J.



trusts.<sup>67</sup> Under section 643(f), the IRS may aggregate multiple trusts when two requirements are met: when such trusts have substantially the same grantors and beneficiaries and a principal purpose of tax avoidance.

The effectiveness of section 643(f) in combating avoidance of the parental tax through resort to multiple trusts will depend upon the construction given the terms "substantially the same grantors and beneficiaries" and "a principal purpose of tax avoidance." The statute contemplated promulgation of regulations, but none have yet been proposed by Treasury. For the time being, the only interpretive guidance is the House report,<sup>68</sup> which discusses when the committee would expect trusts to be treated as having different or the same grantors or beneficiaries.

The committee stated that "trusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries."<sup>69</sup> The report provides two examples, one involving trusts that the committee stated should be aggregated and one involving trusts that it stated should not be aggregated.

In the first example, a grantor set up four trusts, the beneficiaries of which were the grantor's two brothers and two sisters. Each trust had two beneficiaries; each of the group of four beneficiaries was not a beneficiary of at least one of the trusts. The report stated that these trusts should have been treated as one trust.<sup>70</sup>

This example is an extreme case. Two-thirds of the beneficiaries of each trust were identical to two-thirds of the beneficiaries of each other trust. It is not clear that this degree of overlap of beneficiaries will be necessary to permit the IRS to aggregate multiple trusts.

The second example provided by the committee demonstrates how a purpose independent of tax considerations may prevent aggregation. In that example a grantor set up two trusts. The grantor's son was the income beneficiary of the first trust and the grantor's daughter was the remainder beneficiary. The daughter was an income and remainder beneficiary of the second trust; the trustee of the second trust was permitted to use income for her education, support and maintenance. The trustee of the second trust was also permitted to pay income or corpus for the son's medical expenses.<sup>71</sup>

The two trusts had a significant overlap of beneficiaries, although the daughter was not an income beneficiary of the first trust. Aggrega-

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67. H.R. REP. NO. 432, Supplemental Report, 98th Cong., 2d Sess., pt. 2, at 1239 (1984).

68. *Id.*

69. *Id.* at 1240.

70. *Id.*

71. *Id.*

tion was not required in this second case, apparently, because the distributions of income from the trusts were to be used for different specified purposes.

The examples and limited discussion in the House report do not indicate that the multiple trust rule will be a major obstacle in the use of trusts to avoid the parental tax. The rule does not appear to be aimed at a situation in which separate trusts are created for each of a grantor's children or grandchildren.

Second, since the report states that the presence of different contingent beneficiaries will not prevent trusts with the same primary beneficiaries from being aggregated, perhaps the presence of the same contingent beneficiaries will not result in aggregation of trusts with different primary beneficiaries. An ability to create separate trusts with overlapping contingent beneficiaries would provide a grantor with reassuring latitude with respect to the ultimate disposition of the corpus of the trusts.

Finally, the second committee example indicates that some overlap of income beneficiaries may be permitted when the income of each trust may be used only for different specified purposes. The Tax Court in *Stephenson Trust* saw little purpose in creating multiple trusts other than the avoidance of taxes.<sup>72</sup> Drafters of trust agreements can view the matter with more imagination.<sup>73</sup>

At any rate, the legislative history of the multiple trust rule does not in any way indicate that the rule may be used to aggregate trusts when there is no overlap of beneficiaries. Thus, a grantor with several children or grandchildren might apparently set up at least one completely separate trust for each member of such groups without fear of IRS aggregation of such trusts under the multiple trust rule. It appears that the multiple-trust rule, as explained in its legislative history, will not completely prevent resort to multiple trusts to avoid the parental tax.<sup>74</sup>

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72. *Stephenson Trust*, 81 T.C. at 303.

73. Obviously, one can carry this notion too far. For example, assume that *X* has three children *A*, *B* and *C*, and sets up three trusts. As to trust one, the trustee may distribute income to *A* and may pay medical expenses of *B* and education expenses of *C*. As to trust two, the trustee may distribute income to *B* and may pay education expenses of *A* and medical expenses of *C*. As to trust three, the trustee may distribute income to *C* and may pay medical expenses of *A* and education expenses of *B*. The trusts would have separate purposes but it is difficult to imagine that their separate existences would be recognized for tax purposes because the existence itself of separate trusts could be attributed primarily to tax purposes. See H.R. REP. NO. 432, *supra* note 67, at 1240.

74. The major weapon of the Code against tax avoidance by accumulation of trust income, the throwback rule, which taxes distributions of accumulated income to a trust beneficiary as if they had been made when the income was accumulated, see I.R.C. §§ 666-668 (1988), would not be effective against this strategy because it does not apply to distributions of income accumulated

## 2. I.R.C. § 677(b)

When the minor beneficiary of a trust reaches age fourteen, the Act creates an incentive to have the trust distribute income to the beneficiary rather than continue to accumulate such income. This is because even unearned income of an unmarried taxpayer aged fourteen or older is taxed at rates applicable to a single individual. For such an individual, such income would be taxed at a rate of fifteen percent up to taxable income of \$17,850.<sup>75</sup> The raising of tax rates on trusts *vis à vis* individual taxpayers creates a new incentive to distribute income to beneficiaries rather than accumulate it in the trust.

Distributions of income to a beneficiary will result in taxation of such income to the grantor under section 677(b) if such income is applied or distributed "for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain."<sup>76</sup> If the Act's new rate scheme encourages a larger number of distributions of trust income to minor beneficiaries, there may very well be a great deal of litigation about whether such distributions may be regarded as in discharge of a legal obligation of support. Treasury Regulations applicable to section 677(b) provide no guidance or examples as to when a distribution to or for a minor child constitutes a discharge of a legal obligation of support.<sup>77</sup> The courts have looked to state law to determine whether it imposes upon the grantor an obligation corresponding to the purpose for which the income is distributed.<sup>78</sup>

for a beneficiary before he or she reaches the age of 21. *Id.* § 665(b)(2).

75. *Id.* § 1(c).

76. *Id.* § 677(b) provides in full:

Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

The statutory ancestor of § 677(b), Int. Rev. Code of 1939, ch. 63, § 167(c), 58 Stat. 51, 52 (1944), was enacted by Congress to overturn the rule of *Helvering v. Stuart*, 317 U.S. 154 (1942) (holding that if the income of a trust might, in the discretion of persons lacking a substantial interest adverse to the grantor, be applied in discharge of a grantor's legal obligations, such income would be taxable to the grantor regardless of whether or not it was so distributed). See S. REP. NO. 627, 78th Cong., 1st Sess. 68 (1943).

77. See Treas. Reg. § 1.677(b)-1 (as amended by T.D. 7148, 1971-2 C.B. 251).

78. See *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972); *Wyche v. United States*, 36 A.F.T.R.2d (P-H) ¶ 75-5241 (Ct. Cl. 1974); *Braun v. Comm'r*, 48 T.C.M. (CCH) 210 (1984). *Brooke* and *Wyche* looked to state law in reliance upon Rev. Rul. 56-484, 1956-2 C.B. 23. That

In leaving to state law the matter of which distributions will be regarded as in fulfillment of a legal obligation of support and, hence, taxable to the grantor, the Code, the IRS, and the courts have created uncertainty and lack of uniformity. This lack of uniformity has long been recognized as a problem in the tax law.<sup>79</sup> Obviously, a parent seeking to avoid taxation on distribution of trust income should be careful not to specify that distributions from trust income be made for purposes specified in a state statute as part of the parent's obligation of support. Most state statutes, however, are not very specific as to the extent of the parental obligation of support.<sup>80</sup> Nonetheless, even if a

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ruling, however, did not specifically involve the grantor trust provisions. It was concerned in part with the income tax effect of a transfer of property under a model custodian act. The ruling stated that if income from such transferred property were used "in the discharge or satisfaction . . . of a legal obligation of any person to support or maintain a minor," the income so used is taxable to such person under I.R.C. § 61. Rev. Rul. 56-484, *supra*, at 24.

This ruling calls for broader attribution than under I.R.C. § 677 since it can result in taxation of income to a parent even if he or she was not the transferor of the property. Nevertheless, it represents the most authoritative guidance from the IRS in determining whether a payment to or for a minor child is in satisfaction of an obligation of support.

79. See generally Nitzburg, *The Obligation of Support: A Proposed Federal Standard*, 23 TAX L. REV. 93 (1967); Note, *Federal Tax Aspects of the Obligation to Support*, 74 HARV. L. REV. 1191 (1961).

80. Although most states have not statutorily defined the elements of the parental support obligation, a few state statutes set out minimal *amounts* of support. See CAL. CIV. CODE § 4723 (West Supp. 1988) (also lists specific items); COLO. REV. STAT. § 14-10-115 (1987) (also lists specific items); S.D. CODIFIED LAWS ANN. § 25-7-7 (Supp. 1987).

All states have by statute provided for actions in which parental support obligations may be enforced in the context of a divorce, or otherwise. Most of the divorce statutes that describe child support obligations do not mention specific items. See ALA. CODE § 30-3-1, II (Supp. 1987); ARIZ. REV. STAT. ANN. § 25-320 (Supp. 1987); ARK. STAT. ANN. § 9-12-312 (Supp. 1987); CONN. GEN. STAT. ANN. § 46b-84 (1986); FLA. STAT. ANN. § 61.13 (West Supp. 1987); IDAHO CODE § 32-706 (Supp. 1987); KY. REV. STAT. ANN. § 403.210 (Baldwin 1983); MASS. GEN. LAWS ANN. ch. 208, § 28 (West 1987); MO. ANN. STAT. § 452.340 (Vernon 1986); MONT. CODE ANN. § 40-4-204 (1987); NEB. REV. STAT. § 42-364 (1984); NEV. REV. STAT. ANN. § 125.190 (Michie 1986); N.M. STAT. ANN. § 40-4-11 (1986); OHIO REV. CODE ANN. § 3105.21 (Anderson Supp. 1986); OKLA. STAT. ANN. tit. 12, § 1277 (West Supp. 1988); OR. REV. STAT. § 107.105 (1983); PA. STAT. ANN. tit. 23, app. § 504 (Purdon Supp. 1987); R.I. GEN. LAWS § 15-5-16.2 (Supp. 1987); S.C. CODE ANN. § 20-3-160 (Law. Co-op. 1985); TENN. CODE ANN. § 36-6-101 (Supp. 1987); UTAH CODE ANN. § 30-3-5 (Supp. 1987); VT. STAT. ANN. tit. 15, § 659 (Supp. 1987); WASH. REV. CODE ANN. § 26.09.100 (1986); W. VA. CODE § 48-2-15 (1986).

A few divorce child-support statutes refer to education in a general way as part of the support obligation that may be imposed. See N.H. REV. STAT. ANN. § 458:17 (Supp. 1987); N.J. STAT. ANN. § 2A:34-23 (West 1987); N.Y. DOM. REL. LAW § 32 (McKinney Supp. 1988); N.D. CENT. CODE § 14-05-22 (1981); S.D. CODIFIED LAWS ANN. § 25-3-11 (1984). One such statute permits imposition of the costs of private schooling. See COLO. REV. STAT. § 14-10-115(13) (1987). Another refers to education of an adult child. See HAW. REV. STAT. § 580-47 (Supp. 1987). Yet another permits imposition of education costs beyond a child's twenty-first birthday. See IND. CODE ANN. § 31-1-11.5-12(d)(1) (Burns Supp. 1987).

In addition to the California and Colorado statutes cited above, statutes in Maine and Michigan providing for orders of child support in divorce actions specify particular items that may be the subject of support orders. See ME. REV. STAT. ANN. tit. 19, § 752(10) (Supp. 1987); MICH.

parent studies judicial glosses on state support statutes, it will often be difficult, because of the family's economic circumstances, to tell whether distributions of trust income for an expensive music camp or a child's automobile would represent a parental support obligation.

Further, a parent may, in a separation agreement or agreement with a provider of services to a minor, assume a legally-enforceable obligation of support. The notion of a support obligation may thus be expanded to an almost unlimited degree.

The surprisingly few decisions that have considered whether payments to or on behalf of dependent children represent a legal obligation of support under section 677(b) reflect not only the variations in state law, but also varying approaches of the courts in evaluating the federal tax implications of state law.

*Estate of Hamiel v. Commissioner*<sup>81</sup> took a rather restrictive view of what constitutes an obligation of support. In that case, as part of a divorce proceeding, the father of a ten-year-old child agreed to pay \$115 per month to the child's mother for support of the child. In addition, the taxpayer and the child's mother conveyed their family home to the child, and the taxpayer also conveyed stock in trust for the child's

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COMP. LAWS ANN. § 552.16 (West Supp. 1987).

Like the divorce child support statutes, most state statutes that describe or authorize imposition of child support orders generally do not refer to specific items the cost of which may be imposed upon a parent as child support. For instance, the Utah child-support-obligation statute provides: "Every man shall support his child." UTAH CODE ANN. § 78-45-3 (1977). The comparable Virginia statute provides scant guidance with respect to the contours of this support obligation: "The court's decision shall be rendered based upon the evidence relevant to each individual case." VA. CODE ANN. § 20-108.1 (Supp. 1987). Most other such statutes are quite similar in their lack of particularity. See ALASKA STAT. § 25-20-030 (1983); ARIZ. REV. STAT. ANN. § 12-2451 (Supp. 1987); CAL. CIV. CODE § 196 (West 1982); CONN. GEN. STAT. ANN. § 46b-215 (West 1986); DEL. CODE ANN. tit. 13, § 501 (1981); D.C. CODE ANN. § 16-916 (1981); GA. CODE ANN. § 19-11-43 (1982); ILL. ANN. STAT. ch. 40, para. 505 (Smith-Hurd Supp. 1987); LA. CIV. CODE ANN. art. 227 (West 1973); ME. REV. STAT. ANN. tit. 19, § 446 (1964); MD. FAM. LAW CODE ANN. § 12-101 (1984); MASS. GEN. LAWS ANN. ch. 273, § 1 (West Supp. 1987); MINN. STAT. ANN. § 257.66, subdiv. 3 (West Supp. 1988); MO. ANN. STAT. § 454.480 (Vernon 1986); NEV. REV. STAT. ANN. § 126.291 (Michie 1986); N.J. STAT. ANN. § 44:1-143 (West Supp. 1987); N.C. GEN. STAT. § 50-13.4 (1987); OHIO REV. CODE ANN. § 3103.03 (Anderson 1980); OKLA. STAT. ANN. tit. 10, § 4 (Supp. 1988); PA. STAT. ANN. tit. 23, app. § 4322 (Purdon Supp. 1987); R.I. GEN. LAWS § 15-9-1 (Supp. 1987); S.C. CODE ANN. § 20-3-160 (Law. Co-op. 1985); TENN. CODE ANN. § 34-1-101 (Supp. 1987); TEX. FAM. CODE ANN. § 4.02 (Vernon Supp. 1988); WIS. STAT. ANN. § 767.25 (West Supp. 1987).

A few such statutes refer to education in a general way. See, e.g., HAW. REV. STAT. § 577-7 (1985); IND. CODE ANN. § 31-1-11.5-12(b) (Burns Supp. 1987); KAN. STAT. ANN. § 60-1610 (Supp. 1987); MONT. CODE ANN. § 40-6-211 (1987); N.D. CENT. CODE § 14-08.1-01 (Supp. 1987); S.D. CODIFIED LAWS ANN. § 25-7-7 (Supp. 1987). A few more statutes list other specific items the cost of which may be imposed as part of a support obligation. See IOWA CODE ANN. § 252A.4 (West 1985); MICH. COMP. LAWS ANN. § 552.451 (West Supp. 1987); N.Y. JUDICIARY LAW § 416 (McKinney Supp. 1988); WASH. REV. CODE ANN. § 26.18.020(2) (1986).

81. 253 F.2d 787 (6th Cir. 1958).

benefit. After the death of the named trustee, the grantor—without any authority in the trust indenture—treated the income from the trust as personal income of his child for most of the first four tax-years of the trust.<sup>82</sup> The Commissioner attempted to tax the income of the trust to the estate of the grantor. The income available to the child during the four tax-years involved was over \$27,000. A substantial amount of this was used to make mortgage payments and to cover maintenance on the child's home. Although the Tax Court treated the trust as a sham,<sup>83</sup> the Sixth Circuit reversed this finding.

The Sixth Circuit also rejected the finding of the Tax Court that the trust was created solely to enable the grantor (taxpayer) to satisfy his own obligations of support to his child. The appellate court determined that those obligations were discharged by the monthly payments of \$115 to the child's mother. The court did not refer to state law to determine what constituted the taxpayer's obligation of support, but rather assumed that it would be preposterous to treat the amount of annual income of the trust, which averaged over \$6,000, as support of the child:

It was not necessary to use the total income of the trust each year for the support and education of the child. Such an expenditure would have been utterly foolish and a deliberate waste and destruction of what belonged to the child. No court of equity would have permitted such folly

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It would not be unreasonable to regard shelter as part of an obligation of support for a child. The taxpayer in *Estate of Hamiel* was able to use trust income to provide shelter for his son. Conveying real estate to a ten year old may entail many complications, but in *Estate of Hamiel*, it helped to prevent payment of the mortgage on the child's home with trust income from being regarded as the discharge of an obligation of support of the grantor. This case demonstrates that a taxpayer, in a divorce context, may fix by agreement a level of payments that represent support and maintenance. Payments in excess of that level may be regarded as representing something other than fulfillment of a legal obligation of support. The decision also demonstrates a federal court's flexibility in evaluating what constitutes a support obligation for tax purposes.

In *Brooks v. United States*,<sup>85</sup> the taxpayer, a physician, deeded

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82. *Id.* at 789-90.

83. See *IRS v. Estate of Hamiel*, 15 T.C.M. (CCH) 1225, 1233 (1956), *rev'd*, 253 F.2d 787 (6th Cir. 1958).

84. *Estate of Hamiel*, 253 F.2d at 792.

85. 468 F.2d 1155 (9th Cir. 1972).

real estate that included his medical offices to his children. He was appointed their guardian and he collected rents from the building's tenants, including himself, for the benefit of his children. The income from the real estate was applied to the children's health insurance and education. The taxpayer also used income from the real estate for private school tuition, musical instruments and swimming and public speaking lessons for the children. Taxpayer also purchased an automobile for his oldest child and paid travel expenses to New Mexico for his asthmatic child.<sup>86</sup>

The Ninth Circuit upheld the gift-leaseback arrangement that permitted the taxpayer to deduct the rental payments he made to himself.<sup>87</sup> The court also held that the taxpayer was not required to report income paid on behalf of his children because he was not required under Montana law to provide such benefits to his children.<sup>88</sup> That finding is somewhat surprising in that Montana law provides that the parent entitled to custody of a child must give the child "support and education suitable to his circumstances."<sup>89</sup>

Such judicial flexibility in defining obligations of support has sometimes cut against the taxpayer, however. In *Morrill v. United States*,<sup>90</sup> the taxpayer-grantor used income from a trust to pay tuition and room charges for four of his minor children at exclusive private secondary schools and colleges.<sup>91</sup> The court held the income taxable to the grantor without reaching the issue of whether its use for private secondary and higher education represented discharge of a support obligation under Maine law.<sup>92</sup>

The court held that although the taxpayer had not expressly assumed responsibility for tuition and other charges at all of the schools involved,<sup>93</sup> he had impliedly obligated himself to pay such charges. The conduct that, according to the court, created this implied obligation included approval of the taxpayer of their enrollment at the schools and his receipt of bills from the institutions. There was also no indication of

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86. *Id.* at 1157.

87. *Id.*

88. *Id.*

89. 1947 MONT. REV. CODES § 61-104, *amended*, ch. 293, § 21, Laws 1975 (now codified at MONT. CODE ANN. § 40-6-211 (1985)).

The *Brooke* court also brushed aside a Montana decision relied upon by the government, *Refer v. Refer*, 102 Mont. 121, 56 P.2d 750 (1936), as "entirely limited to its facts." *Brooke*, 468 F.2d at 1158. Assuming such limitation, it is difficult to see how *Refer* would not control at least with respect to educational expenses. In that case a divorced father was ordered to pay \$35 per month for the college education of his son. *Refer*, 102 Mont. at \_\_\_, 56 P.2d at 752-53.

90. 228 F. Supp. 734 (D. Me. 1964).

91. *Id.* at 735.

92. *Id.*

93. In two instances the taxpayer had assumed such liability. *Id.* at 736.

any express agreements between the children and the schools.<sup>94</sup> Since the payment of the school expenses was treated as payment of the grantor's (perhaps unintentionally) assumed obligations, it was treated as a distribution to the grantor under section 677(a)(1).<sup>95</sup>

In *Braun v. Commissioner*,<sup>96</sup> the Tax Court held taxable to the grantor both payment of college tuition for his children over eighteen and payment of private high school tuition for his other children. With respect to college tuition, the Tax Court relied upon the New Jersey Supreme Court decision in *Newburgh v. Arrigo*,<sup>97</sup> which involved an attempt by an adult son to obtain a distributive share of the proceeds of a wrongful death action prosecuted by his father's administratrix. While stating that "[g]enerally parents are not under a duty to support children after the age of majority,"<sup>98</sup> the court held that "[i]n appropriate circumstances, parental responsibility includes the duty to assure children of a college and even of a postgraduate education such as law school."<sup>99</sup> The court held that whether such an obligation existed would be determined by a twelve-part test.<sup>100</sup>

*Newburgh* involved an estate dispute between the deceased's ad-

94. *Id.* at 737.

95. Could a taxpayer avoid taxation to himself of distributions for the same purpose by being more careful not to assume such implied obligations? Yes, according to The United States Court of Claims in *Wyche v. United States*, 36 A.F.T.R.2d (P-H) ¶ 75-5816 (Ct. Cl. 1974). In *Wyche*, private school tuition of a grantor's children was paid by a trust. The school made no contracts with parents concerning attendance. Tuition was payable in advance. The court held for the taxpayer, finding no obligation to provide such education under South Carolina law and no taxpayer-created implied obligation held so critical in *Morrill*. *Id.* ¶ 75-5820.

It seems absurd that the same expenditure may be taxable or nontaxable to a grantor depending upon the arrangement with the school, but a comparison of *Morrill* and *Wyche* would seem to permit such an interpretation of the law.

96. 48 T.C.M. (CCH) 210 (1984).

97. 88 N.J. 529, 443 A.2d 1031 (1982).

98. *Id.* at 543, 443 A.2d at 1038.

99. *Id.* at 544, 443 A.2d at 1038.

100. The factors in this test are:

(1) whether the parent, if still living with the child, would have contributed toward the costs of the requested higher education; (2) the effect of the background, values and goals of the parent on the reasonableness of the expectation of the child for higher education; (3) the amount of the contribution sought by the child for the cost of higher education; (4) the ability of the parent to pay that cost; (5) the relationship of the requested contribution to the kind of school or course of study sought by the child; (6) the financial resources of both parents; (7) the commitment to and aptitude of the child for the requested education; (8) the financial resources of the child, including assets owned individually or held in custodianship or trust; (9) the ability of the child to earn income during the school year or on vacation; (10) the availability of financial aid in the form of college grants and loans; (11) the child's relationship to the paying parent, including mutual affection and shared goals as well as responsiveness to parental advice and guidance; and (12) the relationship of the education requested to any prior training and to the overall long-range goals of the child.

*Id.* at 545, 443 A.2d at 1038-39.



ministratrix and the deceased's son by a former marriage. The Tax Court in *Braun* conceded that many aspects of Newburgh's twelve-part test would have no bearing outside such an adversarial situation.<sup>101</sup> The Tax Court held, however, that

the import to our facts is clearly that petitioners retained the obligation to provide their children with a college education. They were both able and willing to do so, a college education was imminently [sic] reasonable in light of the background, values and goals of the parents as well as the children, and petitioners have brought forward no facts or arguments which would militate against the recognition of this obligation on the part of these particular parents.<sup>102</sup>

The court found New Jersey law less clear with respect to the issue of private high school tuition as constituting an obligation of support but concluded that "it would be an anomaly to find a support obligation for college tuition for an emancipated child but none for private high school expense for a younger child in the same family."<sup>103</sup>

The approach of the Tax Court in *Braun* is troublesome. The court was forced to apply state law in a situation somewhat different from the closest precedent. Application of state law itself raises questions about uniform application of the tax law throughout the United States. Whether a distribution from a trust for a particular purpose will constitute fulfillment of a grantor's obligation of support will vary from jurisdiction to jurisdiction, although, with respect to higher education, it has been increasingly recognized as an obligation of support by state courts.<sup>104</sup> Further, if the obligation of support is based, as it is in so many jurisdictions, upon the circumstances of the parents, having sufficient accumulated wealth to place in trust will likely be regarded as a circumstance that warrants broad construction of the parental obligation of support.

There is a surprisingly small amount of case law concerning what sort of distributions from a trust will be regarded as fulfilling an obligation of support of the grantor. Changes in the tax rates of trusts may encourage more distributions to minors over fourteen, thus generating much more litigation than has occurred in the past. In order to avoid a spate of decisions that examine the intricacies and variations of state statutes and case law, Congress should consider "federalizing" for tax analysis the notion of an obligation of support by, for example, provid-

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101. *Braun*, 48 T.C.M. (CCH) at 213.

102. *Id.*

103. *Id.*

104. Annotation, *Responsibility of Noncustodial Divorced Parent to Pay for, or Contribute to, Costs of Child's College Education*, 99 A.L.R.3D 322 (1980); see also 59 AM. JUR. 2D *Parent and Child* § 47 (1987).

ing that use of trust income for particular purposes will be deemed as fulfilling a grantor's obligation of support.<sup>105</sup>

Until such an amendment is made, the changes wrought by the Act are likely to generate complexity and frustrate the objectives of tax reform. If the IRS and the courts view a parent's support obligation broadly, distributions from trusts to minors and other children over fourteen will not likely create a large loophole in the Act's restriction on the use of trusts to lower a family's total tax bill. Nevertheless, court decisions under the prior law do not provide any definite indication as to how broadly the parental obligation of support will be construed in the future.

### III. EFFECTS ON OTHER FORMS AND MEANS OF INCOME SHIFTING

One clear thrust of tax reform was against the use of trusts to shift income to minor family members. By taxing *all* unearned income of minors under fourteen at the tax rate of their parents, the Act goes beyond even the generally more restrictive Treasury, Reagan, and House proposals, which would have limited such taxation to income from parental sources. The taxation at parental rates of unearned income derived from property from grandparents, nonrelatives, or even from accumulated property representing prior earnings of the child is a dramatic change that may become even more dramatic if tax rates are eventually raised or made more progressive again.

The Act's parental tax will affect two areas outside the trust attribution sphere that have been the subject of specific legislative treatment: family partnerships and S corporations. It will now be more difficult to shift income effectively in either situation.

#### A. Family Partnerships

Partnerships, which generally allocate the tax attributes among the partners,<sup>106</sup> have long presented an opportunity for shifting income within a family. A sole proprietor may form a partnership with his spouse and children, or with trusts in which such persons are the beneficiaries, and allocate a significant portion of the income from the busi-

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105. Such action would be similar to the adoption by Congress in the Tax Reform Act of 1984 of a federal definition of alimony in § 71(b)(1). One of the primary reasons for this change was the belief of Congress that "[d]ifferences in state laws create[d] differences in Federal tax consequences and administrative difficulties for the IRS." STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984, 714 (Comm. Print 1984). The lack of uniformity of state laws with respect to what constitutes an obligation of support is likely to cause similar administrative difficulties for the IRS.

106. I.R.C. § 704(a) provides: "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement."

ness to the lower bracket "partners."

Congress might have regarded such a situation as simply too good to be true, but it did not. In section 704(e),<sup>107</sup> Congress permitted taxpayers to shift income by entering into a partnership with family members under certain conditions. Section 704(e), part of the Revenue Act of 1951,<sup>108</sup> was enacted largely in response to the judicial wake of *Commissioner v. Culbertson*,<sup>109</sup> and was generally intended to create a safe harbor for such arrangements without regard to the motives for which they are created.<sup>110</sup>

The House report clearly indicates the tolerant spirit of section 704(e):

Many court decisions since . . . *Culbertson* . . . have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnership. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated

107. I.R.C. § 704(e) provides:

(e) Family partnerships—

(1) Recognition of interest created by purchase or gift.—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) Distributive share of donee includible in gross income.—In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) Purchase of interest by member of family.—For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

108. Revenue Act of 1951, ch. 521, § 191, 65 Stat. 452, 511 (1951) (codified at I.R.C. § 704(e)(2)-(3)).

109. 337 U.S. 733 (1949).

110. *Culbertson* involved a rancher who "sold" interests totaling one-half of his business to his four sons. The sons "paid" for their interests with notes that were redeemed with income from the operations of the business as well as with gifts from the father. The Supreme Court ordered a remand of the case to the Tax Court, which had refused to give effect to the partnership for tax purposes, for consideration of whether there was a "bona fide intent" to create a partnership "either because of services to be performed . . . or because of contributions of capital of which they were the true owners . . ." *Id.* at 748.

by a desire to benefit the partnership business.<sup>111</sup>

The legitimation of such shifting of income without regard to motive, or notwithstanding a patent tax-avoidance motive, is reminiscent of the spirit of the grantor-trust rules.<sup>112</sup>

A partnership interest, whether created by purchase or gift, is recognized if the partner possesses a capital interest in a partnership in which capital is a material income-producing factor.<sup>113</sup> Regulations provide that capital is a material income-producing factor if "a substantial portion of the gross income of the business is attributable to the employment of capital in the business" but not "where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership."<sup>114</sup> The requirement that capital be a material income-producing factor generally rules out attempts to shift income to minor children who are "partners" in professional partnerships.<sup>115</sup>

Section 704(e) requires that when the partnership interest has been created by gift, the distributive share of the donee must reflect both an allowance of reasonable compensation for the services of the donor to the partnership<sup>116</sup> and the value of the donor's capital.<sup>117</sup>

Finally, consistent with the intent of Congress that only bona fide transfers of partnership interests in a family setting be recognized for

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111. H. REP. NO. 586, 82d Cong., 1st Sess., 32-33 (1951).

112. See, e.g., *Stephenson Trust v. Comm'r*, 81 T.C. 283 (1983) (discussed *supra* notes 65-72 and accompanying text).

113. I.R.C. § 704(e)(1).

114. Treas. Reg. § 1.704-1(e)(1)(iv) (1956).

115. See *Ketter v. Comm'r*, 70 T.C. 637 (1978), *aff'd*, 605 F.2d 1209 (8th Cir. 1979) (unpublished order). In *Ketter*, the taxpayer, a CPA, performed services as a sole proprietor for a partnership composed of trusts for the benefit of his children and his alma mater. The court held that capital was not a material income-producing factor of the partnership. 70 T.C. at 664; see also *Payton v. United States*, 425 F.2d 1324 (5th Cir.), *cert. denied*, 400 U.S. 957 (1970). In *Payton*, the court rejected an income-shifting scheme by an ophthalmologist who placed his related optical company in a partnership in which he had donated interests to his children. Noting that at the time of the donation of the interests the business had inventory of \$2,000 and non-inventory assets of \$752, the court held that capital was not an income-producing factor. *Id.* at 1326-27.

In *Ketter*, capital was insignificant as an income-producing factor when compared with the services of the donor-partner. *But see Turner v. Comm'r*, 24 T.C.M. (CCH) 544 (1965) (Tax Court found capital to be a material income-producing factor in a beer distributorship because its operations were funded with capital contributions and undistributed earnings); *O'Donnell v. Comm'r*, 23 T.C.M. (CCH) 210 (1964) (Tax Court made a similar finding on the basis that a partnership engaged as a manufacturer's representative for a woollens manufacturer used substantial amounts of capital to pay employees, defray costs of promotions, and secure guarantees of customer accounts).

116. See *Gorrill v. Comm'r*, 22 T.C.M. (CCH) 804 (1963).

117. See I.R.C. § 704(e)(2).

tax purposes,<sup>118</sup> the regulations require that the donee actually own the partnership interest.<sup>119</sup> The tests for ownership are based upon the particular facts and circumstances, the conduct of the parties,<sup>120</sup> and compliance with state law for creation of an irrevocable gift.<sup>121</sup>

Factors in the regulations emphasize the degree of control allowed the donee in the management<sup>122</sup> or conduct<sup>123</sup> of the partnership business in determining ownership of a partnership interest. Obviously a requirement that a donee of a partnership interest be recognized as, and participate as, an active partner in the partnership business would create insurmountable obstacles to recognition for tax purposes of the interests of young children; thus, the regulations provide that trustees<sup>124</sup> or fiduciaries<sup>125</sup> may exercise such control functions on behalf of the donee. In addition, limited partnership interests, even those of minor children, may be recognized if the limited partnership is "organized and conducted in accordance with the requirements of the applicable State limited-partnership law."<sup>126</sup>

In the once much-litigated area of family partnerships, Congress and the IRS have created safe harbors for shifting of income within a family unit, even when such arrangements are for no other purpose

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118. See H. REP. NO. 586, *supra* note 105, at 33.

119. Treas. Reg. § 1.704-1(e)(1)(iii) (1956).

120. *Id.* § 1.704-1(e)(2)(i).

121. *Id.*

*Manuel v. Comm'r*, 45 T.C.M. (CCH) 981 (1983), demonstrates the need, for tax purposes, to respect both substance and form. In that case the taxpayer was a widow who had inherited in fee a one-half interest in a farm and a usufruct (life estate) interest in the other one-half. She "donated" one-half of the crops of the farm in the years involved to her children. Substantively, she retained tacit power to determine which crops every year would be subject to the donation, how much money each child would receive, and how such money would be spent. The taxpayer was also not attentive to formal matters as she did not actually surrender the usufruct interest to the children, nor did she file partnership returns for the years involved. The court disregarded the donation of the partnership interests for tax purposes. *Id.*

122. Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956).

123. *Id.* § 1.704-1(e)(2)(vi).

124. *Id.* § 1.704-1(e)(2)(vii).

125. *Id.* § 1.704-1(e)(2)(viii).

126. *Id.* § 1.704-1(e)(2)(ix). In *Garcia v. Comm'r*, 48 T.C.M. (CCH) 425 (1984), the principal partnership business was the operation of a store that sold groceries, hardware, clothing, and building materials. The court found that management of the business by the general partner-donor, father of the limited partners, was consistent with normal practice in limited partnerships and did not require a finding that the children were not the true owners of their limited partnership interests. *Id.* at 436. The mother of the children had been appointed as their guardian and although the court opined that a more qualified guardian could have been chosen, it nevertheless respected the limited partnership interests of the children for tax purposes. *Id.*

*But see Pflugradt v. United States*, 310 F.2d 412 (7th Cir. 1962) (limited partnership interests of very young grandchildren of the donor-general partner were not respected for tax purposes because no trustee or fiduciary subject to judicial supervision had been appointed to supervise the interests of the minors during the tax-years involved).

than shifting income. Enactment of the parental tax disrupts this safe harbor with respect to children under fourteen, assuming that the partnership income of such children will ordinarily be unearned. However, it is not clear that the committees of Congress regarded use of a family partnership to lower a family's total tax bill as an evil that needed to be remedied.<sup>127</sup> While the Reagan<sup>128</sup> and Treasury<sup>129</sup> proposals did equate partnerships and S corporations with trusts for tax-avoidance purposes, both proposals viewed them as mere receptacles of income-producing property. Moreover, bringing even a young child into a viable family partnership business may involve a great deal more than simple shifting of income.

In the wake of the Act, parents who contemplate admitting their children to partnerships will not have as much of a tax incentive to act until such children are fourteen years old. While, as discussed earlier, with respect to property other than partnership interests, a parent may be inclined to place property in trust for a minor and allow the trust to accumulate the income until the child beneficiary is fourteen, a donor of a partnership interest who wishes to use a trust to avoid the parental tax must bear in mind that the regulations permitting recognition of a trustee as a partner may also lead to heightened tax scrutiny of the trust. In addition, if the donor-partner or someone amenable to his or her will is the trustee, the actions of the trustee will be scrutinized to determine whether they are consistent with ownership by the beneficiary—a prerequisite for recognition of the partnership.<sup>130</sup> Assuming

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127. In discussing the proposal to tax income of minors at the tax rate of their parents neither the Senate report nor the House report specifically discuss partnership interests. See S. REP. NO. 313, *supra* note 19, at 862; H. REP. NO. 426, *supra* note 18, at 800.

128. REAGAN PROPOSAL, *supra* note 17, at 84.

129. TREASURY PROPOSAL, *supra* note 16, at 92.

130. Treas. Reg. § 1.704-1(e)(2)(vii) provides:

(vii) Trustees as partners. A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects and interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular

that the trustee-partner must act in the interest of the beneficiary-partner, the action of the trustee in withholding income to serve the tax-avoidance needs of the donor—while permitted under the grantor-trust rules<sup>131</sup>—might be regarded as a conflict that would vitiate the partnership for tax purposes. Even if the tax-avoidance motive were viewed as in the best interest of the beneficiary-partner, such a motive might not be seen as possessing sufficient economic significance to be respected for tax purposes.<sup>132</sup> It is clear, however, that as to children under fourteen, the usefulness of the family partnership as an income shifting tool has been significantly lessened.

### B. S Corporations

A corporation that elects under I.R.C. § 1362 to be an S Corporation<sup>133</sup> is generally not subject to tax.<sup>134</sup> Rather, items of income, loss, deduction, or credit must be taken into account by the shareholders in proportion to the amount of stock they hold in the corporation.<sup>135</sup> The absence of taxation at the entity level and the pass-through to shareholders of tax attributes in S corporations are similar, of course, to the tax treatment of partnerships.

S corporations also possess the same opportunity for shifting income that exists with partnerships. Stock in an S corporation, like a partnership interest, may be given to a family member. Under section 1366, such a donee would quite mechanically account for the tax attributes of the corporation.

In addition, Subchapter S has a provision that parallels section 704(e), the family partnership provision. Under section 1366(e), if an individual who is a member of a family<sup>136</sup> of one or more shareholders of an S corporation renders services to the corporation or furnishes capital without receiving adequate compensation therefor, the IRS may make adjustments to distributable items of the corporation to reflect reasonable compensation to the person rendering services or donating

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consideration:

(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

131. I.R.C. § 674(b)(6) (1988).

132. *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960).

133. Subchapter S of the Internal Revenue Code comprises I.R.C. §§ 1361-1379.

134. I.R.C. § 1363(a) (1988).

135. *Id.* § 1366(a)(1).

136. Section 704(e)(3) defines "family" as one's spouse, ancestors, lineal descendants, and any trusts for the primary benefit of such persons.

capital.<sup>137</sup> Decisions under this provision indicate that where services rendered by a donor-shareholder are significant, a reallocation of income by the IRS is likely to be sustained.<sup>138</sup> On the other hand, when the donor has not performed services for the corporation on a substantial or full-time basis, the IRS has had difficulty in sustaining reallocations of income.<sup>139</sup>

The family reallocation provision of Subchapter S is simpler than section 704(e) because it does not contain the explicit requirement that capital be a material income-producing factor in the business. Regulations promulgated under former section 1373<sup>140</sup>—which have not been replaced—provide that a donee or purchaser of stock in a corporation is not considered to be shareholder unless “such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock.”<sup>141</sup> The regulations also provide that transactions between members of a family will be closely scrutinized.<sup>142</sup> These regulations are similar to those under section 704, and problems involving the economic reality of transfers of S corporation stock have generated case law similar to that under section 704(e).<sup>143</sup>

In the Subchapter S Revision Act of 1982,<sup>144</sup> the provision of former law that called for termination of S corporation status if a corporation had more than twenty percent of its gross receipts from passive investment income<sup>145</sup> was modified substantially.<sup>146</sup> The liberalization

137. *Id.* § 1366(e).

138. *See* Roob v. Comm’r, 50 T.C. 891 (1968); Krahenbuhl v. Comm’r, 27 T.C.M. (CCH) 155 (1968).

139. *See, e.g.,* Trucks, Inc. v. United States, 84-1 U.S.T.C. § 9418 (D. Neb. Apr. 3, 1984), *aff’d*, 763 F.2d 339 (8th Cir. 1985); Davis v. Comm’r, 64 T.C. 1034 (1975); Rocco v. Comm’r, 57 T.C. 826 (1972).

140. Now codified at I.R.C. § 1366.

141. Treas. Reg. § 1.1373-1(a)(2) (1960).

142. *Id.*

143. *See, e.g.,* Bierne v. Comm’r, 52 T.C. 210 (1969); Duarte v. Comm’r, 44 T.C. 193 (1965). The decision in *Bierne* was distilled into four factors in Mintz & Braddock, *Gifts of Sub S Stock and Loans from Short-Term Trusts Are Two Effective Ways to Shift Income*, 56 J. TAX’N 228 (1982), as follows:

1. The extent to which the minor shareholders possess effective ownership rights in the shares;
2. The extent to which the taxpayer-transferor exercises dominion and control over the transferred shares;
3. The extent to which the taxpayer-transferor retains the economic enjoyment of the transferred shares;
4. The extent to which the taxpayer-transferor deals at arm’s length with the corporation in transactions following the stock transfers.

*Id.*

144. Pub. L. No. 97-354, 96 Stat. 1669.

145. I.R.C. § 1372(e)(5) (1954), *amended by* I.R.C. § 1362(d)(3) (1982).

146. Under I.R.C. § 1362(d)(3), an S corporation’s status is terminated only if it has pas-



of the passive income rule opened up the possibility of resort to the S corporation as an alternative to the trust for shifting investment income.<sup>147</sup> As it would in the context of family partnerships, the parental tax would frustrate the use of donations of S corporation stock to shift income to children under fourteen. Such unearned income would be taxed at the rate of the parents.

Unlike partnership interests or other income-producing property, S corporation stock could not efficaciously be conveyed in trust for a child under fourteen with income to be accumulated until the child reached fourteen. While S corporation stock may be held by a qualified subchapter S trust, or by a trust in which a person may vest the trust's income or corpus in himself or herself during the taxable year,<sup>148</sup> all of such trust's income is required to be distributed currently to the individual beneficiary.<sup>149</sup> Moreover, in either case the income taxed to the minor beneficiary would be at the tax rate of the parents.

In sum, whether or not Congress really intended to do so, it has diminished the tax advantages of admitting minors under fourteen to an S corporation.

#### IV. AN EVALUATION

Did the Act bring reform with respect to income shifting? The elimination of the Clifford trust was a dramatic gesture. It removed one of the most popular, but also one of the most unfair, tax avoidance devices in the Code. Taxpayers seeking to shift income to children or grandchildren may continue to do so, but they must, for the most part, give up hope of getting such property back.

The parental tax on all unearned income of children under fourteen is also a dramatic gesture because it goes beyond what was intended by tax reformers initially. Because it is not limited to parental-source income, it will significantly diminish the usefulness for tax purposes of the Uniform Gift to Minors Act for donors other than parents. Whether it is justifiable to tax income from gifts from such donors at the rate of the donee's parents is questionable.

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sive investment income of more than 25% of its gross receipts for each of three consecutive years and it has Subchapter C earnings at the end of each of those three years.

Under § 1362(d)(3)(D), "passive investment income" is gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

147. See Gerhard & Walker, *The New and Improved Subchapter S Corporation*, 122 TR. & EST. 44 (1983); Kaney, *New Tax Law Opens the Door to Gifts of Subchapter S Stock in Trust to Minors*, 8 EST. PLAN. 343 (1981); Committee on Pre-Death Estate Planning, *Estate Planning After 1982 for the Subchapter S Shareholder*, 17 REAL PROP., PROB. & TR. J. 724 (1982).

148. See I.R.C. § 1361(c)(2)(A)(1). Under § 678, this would preclude accumulation of income in the trust.

149. *Id.* § 1361(d)(3)(B).

The parental tax will discourage resort to trusts to shift income, at least as to children under fourteen. Ultimately, however, the separate treatment of the trust as a tax entity, the real engine of intrafamily tax avoidance, has been left intact. To some extent, the trust may be used to undermine the parental tax. A measure of additional fairness has perhaps been achieved, but added complexity in the law will surely result as planners adapt the trust and other aspects of existing law to the parental tax.