

TAX FRONTIERS OF TRUST LAW

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IN a few decades United States tax laws have retired broad areas of centuries-old trust law by spawning wholly new forms and uses of trusts which will require the evolution of new definitions of fiduciary responsibility.

Much has been written on when to create and how to draft trusts which yield tax advantages. This article is *not* a consideration of how to use trusts for tax benefits. Rather, it seeks to recognize the extent to which trusts have been and will be created for tax purposes, to review the historically unfamiliar forms of trusts to which "old-fashioned" trust law must now be applied, and to investigate new areas of obligation for the trustee arising from the tax consequences of its actions.

I. TRUSTS—OLD AND NEW

The non-charitable trust as a legal entity for the holding and transmission of property is commonly supposed to have originated prior to the 15th century. It flourished in later societies as a vehicle for retaining family control of large estates through multiple generations, thus overcoming obstacles presented by the legal minority or incompetence of the beneficiaries. Its use later spread to personalty as well as realty, and trusts were readily carried over from England to this country as part of our common law.

For centuries trusts were almost a monopoly of individuals and families with large accumulations of property. No figures have been found as to the number of trusts in the United States prior to the imposition of the federal income tax in 1913, and indeed no figures are available for the first 24 years of the federal income tax.

In 1937, the first year for which any fiduciary income tax return statistics have been found, 182,973 trusts and estates filed taxable or nontaxable returns.¹ By 1954, the number had grown to 424,915.²

No figures separating trusts and estates are available for 1937. Of the 1954 fiduciary returns, 103,719 (approximately 25 per cent) were filed by estates. If we assume a relatively constant ratio of estates to population, the number of

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¹ Statistics for Income for 1937, U.S. Treasury Dept., Bureau of Internal Revenue (1940).

² Fiduciary Income Tax Returns for 1954, U.S. Treasury Dept., Int. Rev. Serv. (1957).

estates having any taxable or nontaxable income in 1937 may be estimated at approximately 81,000.³

From these figures it seems reasonable to conclude that the number of trusts filing tax returns (even without income) in 1937 was approximately 102,000, compared with 321,196 in 1954, or an increase of over 300 per cent in this seventeen-year period, during which time population increased by less than 25 per cent.

In this same period, estate and inheritance taxes have been increased and have served to dissipate many large fortunes amassed in earlier days, while high income tax rates have tended to prevent the establishment of equivalent fortunes.

One might have expected these factors to cause a decline or at least a leveling off in the number of trusts, instead of the increase noted. Certainly, some small portion of the increase represents population growth and a larger portion reflects greater prosperity. But the rate of prosperity would have been a far less significant stimulant if tax-oriented motivations had not become so important.

What are some of the tax purposes of trust creation and what impact have they had on trust patterns?

Primarily, each new trust is a new taxpayer. With a progressive income tax, each new taxpayer starts paying tax at the lowest bracket. Thus, trusts serve the function of skimming off high-bracket income into one or more new low-bracket taxpayers.

Next, high income tax rates are important to those with high earning capacity, even though they may have no large accumulations, so that this much larger group of taxpayers (as distinguished from those with large capital) turns to trusts to receive, and use or accumulate, non-personal-service income.

Then too, the marital deduction tax benefit has frequently caused two testamentary trusts to be created where only one blossomed before. Before 1948, a common practice was for one to leave all or a substantial portion of his estate in trust for his wife for life, with remainder over to his children. Now, this pattern of distribution has generally given way to the establishment of two trusts—a trust for the wife, exempt from estate tax by qualifying for the marital deduction, and a separate trust (subject to estate tax) for the wife and other family members.

Moreover, elimination of the premium payment test in the 1954 Code has given rise to a greater use of irrevocable insurance trusts as devices for freeing life insurance proceeds from estate and inheritance taxes.

Analysis of this startling growth in the number of trusts shows a clear preponderance of small trusts. Thus, in 1954, of all trusts reporting income, 24 per cent showed income of under \$1,000; 41 per cent, income of \$1,000 to \$5,000;

³ The figure may be larger because the death rate was 15 per cent higher in 1937 than in 1954.

15 per cent, \$5,000 to \$10,000; and only 20 per cent of over \$10,000.⁴ These figures do not reflect the impact of the 1954 Internal Revenue Code provisions, which undoubtedly have given rise to a large number of small short-term trusts.

Such changes in the number and size of trusts and in the objectives and backgrounds of trust grantors have caused major changes in the relative importance of various areas of trust law development.

In earlier periods, trusts for the life of one beneficiary (the wife) with remainders over for other beneficiaries (the children) probably constituted the bulk of all non-charitable trusts in existence. This circumstance, in turn, gave rise to an elaborate body of law as to the respective rights of income and remainder beneficiaries.

The marital deduction has changed the pattern. In most instances the husband's will leaves somewhat over half of his net estate (the full marital deduction) in trust for the wife during her life with an unlimited power in the wife to dispose of the corpus of this trust on her death. In these circumstances there is no conflict of interest between income beneficiary and remainderman. Thus, the rules as to the relative rights of income beneficiary and remainderman have become academic with respect to a large proportion of testamentary trusts.

Before the "Clifford Regulations" and wartime tax rate increases, trusts for a term of years (as distinguished from trusts for life or a series of lives) were relatively rare. Since then, and particularly since the embodiment of those regulations in the 1954 Code, term trusts disposing of income for a minimum of ten years (with principal returned to the grantor thereafter) have become widespread. Many such term trusts expressly provide that capital gains during the term shall belong to the income beneficiary (to avoid their taxability to the grantor in a year in which they will not be distributed to him); thus, here again traditional trust patterns and rules on allocation of receipts are reversed for tax reasons.

Much of Anglo-American trust law has developed around implied rather than express trusts, i.e., constructive trusts and resulting trusts. In these instances, having created trusts which had no trust provisions, the courts were obliged to establish rules as to the power of the trustee to deal with trust assets. Even where trusts were evidenced by trust instruments, the powers and duties of the trustee were frequently only sketchily described. To fill both needs, and influenced by the common purpose of most trusts to conserve assets over long periods of time for successive generations, chancery courts evolved a wide range of restrictions on trustee actions, although court decisions often gave lip service to the theory that the grantor could have given the trustee broader powers if he had so desired.

Today, influenced partly by the shorter-range tax purposes of increasing numbers of trusts, partly by variations in the length of the chancellor's foot in

⁴ Fiduciary Income Tax Returns for 1954, *op. cit. supra* note 2.

appraising particular trust transactions and partly by the essential vagueness of prudent man statutes, more and more trust draftsmen incorporate in the trust agreement express grants to the trustee of extensive discretionary powers.⁵ The frequency of such provisions has rendered obsolete a large portion of trust law and trust statutes on powers of a trustee.

During the centuries in which the trustee's primary function was to conserve corpus, trust administration law was primarily concerned with investments in real property, mortgages and publicly-held securities, with investments in business either prohibited or roundly punished if losses were incurred.

Today, the high-bracket trust grantor is motivated to place any income-producing asset in trust, the only ineligible income source under federal income tax laws being his personal services. Thus, trusts are often partners in partnership business enterprises where invested capital is necessary to the business.⁶ Or trusts are stockholders in close corporations where no market exists for disposition of the stock; in fact, transfers are commonly prohibited by express restrictive agreements.⁷ In each case the trustee is protected by an express grant of authority in the trust instrument.

Finally, trusts historically have tended to provide for current distribution of income (usually in specified shares to specific beneficiaries) except during legal minority or incompetence.

Today trusts in these historical patterns may still have tax advantages with respect to estate and inheritance taxes but only occasionally serve the grantor's income tax objectives. Trust income distributed to the grantor's wife or used for the support of his children is nevertheless taxable to the grantor. Trust income mandatorily distributable or actually distributed in the exercise of the trustee's discretion is taxable to the distributee, eliminating the trust's role as a separate taxpayer.

Trusts for beneficiaries within the immediate family therefore are increasingly departing from the traditional norm, providing either for income distributions only if the trustee so elects, or requiring accumulation of all income unless some kind of an emergency or change occurs.

When the trustee accumulates trust income, the trust is used to the full as a separate taxpayer, and becomes a form of savings account for the beneficiary. In pre-tax days such accumulation would have been held for a specific beneficiary at some specified future date, and, if the beneficiary did not survive, alternate takers were designated. Today, section 674 of the 1954 Code rigidly

⁵ See, for example, Stephenson, *Expanding Powers of Trustees*, 26 *Fordham L. Rev.* 50 (1957).

⁶ In 1954, 17,927 trusts had partnership income or loss, almost 70 per cent of which had aggregate income from all sources of under \$5,000. *Fiduciary Income Tax Returns for 1954*, op. cit. supra note 2.

⁷ In 1954, 5,919 trusts had direct business income or loss. *Fiduciary Income Tax Returns for 1954*, op. cit. supra note 2.

restricts the disposition of such accumulations lest the grantor be taxed with the accumulated income after all. And the restrictions are not dependent on the grantor's retaining the benefit of such accumulation.

Just as the tax law has recast the structure and planning of trusts, recent changes in tax law may bring in their wake new concepts and problems in trust administration.

Prior to the 1954 Code, trust accounting distinctions between corpus and income were basically recognized for tax purposes and the trustee was free, with some exceptions, to exercise discretionary powers to retain income and make other distributions without changing the tax burdens of either class of beneficiary.⁸

Adoption of the "distributable net income" concept of the 1954 Code, however, represented a policy decision by the government that taxable income of a trust be taxed to an individual distributee rather than to the trust even when the distributee had no right to trust income and, in terms of trust accounting, received only a corpus distribution.

When the trustee is given discretion to distribute to or withhold income from one or among several beneficiaries, the manner of exercise of this discretion may have important tax consequences for the beneficiary. Similarly, in exercising many of the newer powers customarily given to the trustee today, the trustee's election among alternatives will have differing tax consequences to the trust beneficiaries.

There is little present law considering the nature or extent of the trustee's duties in the exercise of discretionary powers which have varying tax consequences to the beneficiary.⁹ Just as much of existing trust law has been rendered obsolete by the grant of such powers, new types of powers must be developed to permit the trustee to allow for such tax consequences in making and withholding trust distributions, lest the courts retroactively create new responsibilities as yet unrecognized by many trustees and trust draftsmen.

II. TAX FACTORS IN TRUSTEES' DISCRETIONARY ACTIONS

Must the trustee allow for the tax consequences of alternatives available to it in exercising discretion to make or withhold trust distributions or to retain or sell trust assets?

To date, we have found only a few cases in which the trustee has been held to have any specific power or responsibility arising from the exercise of discretion in one manner where the alternative would have resulted in reduced taxes to the beneficiaries.

Three such cases dealt with the executor's election to deduct expenses of

⁸ Int. Rev. Code of 1939, § 162, 53 Stat. 66 (1939), as amended.

⁹ A similar but unrelated area is one in which the trustee is expected to exercise his discretionary powers to serve "family" purposes which may be inconsistent with traditional obligations to "income" and "remainder" beneficiaries.

estate administration on the estate's income tax return instead of on the federal estate tax return.¹⁰

Under present law it is frequently possible to reduce the aggregate estate tax and estate income tax burden by electing to deduct administration expenses on the estate's income tax return. If income and corpus beneficiaries are the same, no conflict of interest arises from this election; but if income and corpus beneficiaries are different persons, such an election will have significant property right consequences unless adjustments are made:

1. When estate income tax and estate tax brackets are identical, the income beneficiary receives the benefit of deducting administration expenses on the estate income tax return, leaving the residuary (corpus) beneficiary to pay estate tax on this amount which would otherwise have been deductible on the estate tax return—a direct benefit to the income beneficiary at a direct cost to the corpus beneficiary;

2. If the estate income tax bracket is higher than the estate tax bracket, the administration expense deduction is worth more on the income tax return, and, to the extent of the difference in brackets, an aggregate saving can be made available to the income beneficiary at no cost to the corpus beneficiary;

3. If the will contains a formula-type marital bequest, this election will increase the adjusted gross estate and thereby modify the above consequences to: (a) increase the marital bequest; (b) reduce the resulting estate tax to the extent of eliminating tax on the increase in the marital bequest; and (c) reduce the residuary estate to the extent of the increase in the marital bequest (less the estate tax saving resulting from freeing this portion from estate tax), as well as to the extent described in (1) above.

In two cases¹¹ (not involving marital formula bequests) the courts required adjustments restoring to the corpus beneficiary the amount by which federal estate taxes were increased by elimination of the administration expense deduction. Both courts felt that this exercise of discretion by the executor was permissible, and that it could be used to benefit the income beneficiary alone, but not to the extent that such benefit was at the cost of the corpus beneficiary.

The third case¹² involved the additional complication of a formula-type marital bequest. Here, the court appears to have held that "the benefit of all deductions which would have been available to the estate principal" should be credited to the residuary estate. In the absence of further details, it is unclear whether this order reduced the marital bequest to the amount which it would have been had administration expenses been utilized on the federal estate tax

¹⁰ See Bronston, *Elections and Discretions under the Code: The Executor's Dilemma*, 35 *Taxes* 986 (1957).

¹¹ *In re Warms' Estate*, 140 N.Y.S.2d 169 (Surr. Ct., 1955); *In re Bixby's Estate*, 140 Cal. App.2d 326, 295 P.2d 68 (1956).

¹² *In re Levy's Estate*, 9 Misc.2d 561, 167 N.Y.S.2d 16 (Surr. Ct., 1957).

return, or whether it departed from the earlier cases which gave the income beneficiaries the benefit of the net saving.

Two additional cases dealt with the converse problem of the power of the trustee to exercise its investment discretion to obtain tax benefits for one or more beneficiaries.

In re Dwight's Trust,¹³ which arose on an application to settle the accounts of a trustee, the court characterized the problem as a "recurring" one in trust administration, and decided the issue as follows:

Due to increased income tax rates, trustees are being met with demands by life beneficiaries, who are in high income tax brackets, to invest in tax exempt securities. In most cases such securities sell at a premium, with the result that upon maturity there is a loss in principal, even though the securities are redeemed at par. Such loss is visited upon the remaindermen of the trusts. It is unnecessary in the instant case to decide the broad questions of the liability of trustees under such circumstances, for here it is undisputed that the trustee, when informed of the high tax bracket in which the life beneficiary found herself, deliberately sold United States Savings Bonds, which it held as principal in the trust, at a loss to the estate, so that it could invest the proceeds in tax free securities. The redemption of the United States Bonds resulted in a loss of \$3,290.70. I hold that the objection of the guardian to such loss is well taken and that the action of the trustee constituted an unwarranted subordination of the interests of the remaindermen to that of the life beneficiary. There was no power in the trustee to redeem the bonds at a loss for the sole purpose of effecting a higher net income for the life beneficiary. The trustee will, therefore, be surcharged the amount of the loss so sustained.¹⁴

The implications of this case are striking and preventable.

In *Commercial Trust Co. of New Jersey v. Barnard*,¹⁵ the trustees had invested in tax-exempt securities, the return on which was below that on taxable securities. The three income beneficiaries were shown to be in the 83 per cent, 68 per cent and 65 per cent income tax brackets during relevant periods, although one of the beneficiaries, the objector in this litigation to settle the trustees' accounts, had the status of a non-resident alien during a portion of the period, and in that status was subject only to a 15 per cent rate. The latter fact, the court held,

. . . has no appreciable bearing on the duty of the trustees since they were required to deal with the *corpus* as a whole for the benefit of all three life income beneficiaries as well as the remaindermen. They could not be expected or required to change their investment policy because of the temporary tax status of one of the income beneficiaries.¹⁶

The philosophy of this quotation appears to be somewhat tempered by the court's addendum:

¹³ 204 Misc. 204, 128 N.Y.S.2d 23 (S. Ct., 1952).

¹⁴ *Id.*, at 205 and 23-24.

¹⁵ 27 N.J. 332, 142 A.2d 865 (1958).

¹⁶ *Id.*, at 340 and 869.

We might note that although the exceptants have had ample opportunity to do so, no evidence seriously disputing the accuracy of the income tax status of the beneficiaries or the calculations concerning relative advantages to them of tax-exempt versus taxable income from the trust has been offered. It is apparent that, on the whole, the life income beneficiaries fared better by having the trust *corpus* invested in low-yield tax-exempt securities than by having it invested in higher-yield taxable securities which it is alleged would have earned a yield of $4\frac{1}{2}$ per cent.¹⁷

At this writing only one other case has been found dealing with the unexpected tax consequences of the trustee's exercise of discretionary powers. In *Estate of Eleanor Elkins Rice*,¹⁸ decided by the Philadelphia Orphans Court in 1956, the court required the income beneficiary of a trust to reimburse trust corpus to the extent that the income beneficiary obtained a tax benefit by being allowed to deduct trustee commissions chargeable against corpus from trust income taxable to him. This is a particularly cogent illustration of growing discrepancies between tax accounting and trust accounting.

These examples, it is believed, are only the initial building blocks in the erection of a new legal structure dealing with the trustee's rights and duties relating to the tax impact of his patterns of trust administration. The variety of situations capable of creating such problems for the trustee is too great for cataloguing here; a review of some of the areas in which these problems may arise will suffice to illustrate their breadth.

Discretionary distributions affecting ordinary income tax burdens.—The manner in which the trustee exercises his discretionary distribution powers may determine which beneficiary bears all or a portion of the tax on ordinary trust income.

A simple example would be a trust in which the trustee in a given year exercised his discretion to withhold any distribution to the income beneficiary but elected to make a discretionary distribution of principal to a corpus beneficiary. In such event the corpus beneficiary would receive the distribution subject to tax as ordinary income to the extent of the distributable net income of the trust for that year.

The consequence of such an exercise of discretion would have been to transfer that year's tax burden from the income beneficiary to the corpus beneficiary. Unless the trustee is granted special powers by the trust instrument or by evolution of new doctrines of trust law, the corpus beneficiary can never recoup this loss from the income beneficiary.

The same illustration can present further complexities if the distribution to the corpus beneficiary were a required distribution of a percentage of trust principal. Did the beneficiary get the intended distribution or did he get such a distribution reduced by the unexpected ordinary income tax burden?

¹⁷ *Id.*, at 340 and 370.

¹⁸ Cited in Randall, *Consequences of Executor's Elections as to Administrative Expenses*, 15 N.Y.U. Inst. Fed. Taxation 1011, 1034 (1957).

A similar problem is presented if this were a trust in which corpus distributions were charged as advances to be deducted from final distributions.

Still another variation is presented where the trust contains a clause requiring corpus distributions to a beneficiary to bring that beneficiary's income from all sources to some stipulated amount or requiring corpus distributions to pay large medical expenses in an amount currently known.

The foregoing income vs. corpus problems relate only to undistributed income for the current year. Perhaps the most complex area in which the timing of a trustee's discretionary actions may have varying tax consequences is where distributions may fall under the "throwback" rules of the Code. (These rules apply only to trusts in which income distribution is discretionary. Such trusts are defined in the regulations as "complex trusts," an appellation which appears more descriptive of the consequences of the tax law than of the nature of the trust.)

The trustee desiring to make a discretionary corpus distribution from such a trust will usually find that whether or not the beneficiary receives the distribution tax-free will depend on whether any portion of trust income for the previous five years had been withheld from distribution. If so, a discretionary corpus distribution may represent taxable ordinary income to the beneficiary in whole or part. In these circumstances the problems already outlined may arise even though income for the current year has been fully distributed.

A slightly different problem would be presented in the administration of a trust requiring frequent corpus distributions. Would this fact (combined with the throwback rules) give the trustee more of an obligation to exercise his discretion to make current distributions of income?

Where a trust provides for discretionary distributions of income to one beneficiary and principal to another, the timing of the exercise of the discretionary power may affect the allocation of trust expenses under the tier system adopted by the present regulations (as well as under more complex tier systems recently under consideration by Congress).¹⁹ Thus, trustee charges computed on the basis of corpus may be deductible by the income beneficiary if there should be no distribution of corpus, or trustee's expenses chargeable against income may reduce the corpus beneficiary's tax if a distribution should be made from corpus but not from income. The problem, difficult enough with respect to current year transactions, becomes complicated five-fold if the timing of such distributions requires invocation of the throwback rules.

Discretionary distributions affecting capital gains tax burdens.—Under the 1954 Code it is probably true that most capital gains are taxable to the trust rather than to the beneficiary. Thus, distributions will usually not impose a capital gains tax liability on the beneficiary. Three exceptions, however, may pose administrative problems for the trustee.

¹⁹ See, e.g., 3 Hearings before the House Committee on Ways and Means on Topics Pertaining to the General Revision of the Internal Revenue Code, 85th Cong. 2d Sess. 2699-2805 (1958).

In one situation, the trustee by his course of conduct apparently can either reserve the capital gains tax liability to the trust or transfer it to the beneficiary.²⁰ Under the Regulations the test is whether the trustee "follows a regular practice of distributing the exact net proceeds of the sale of trust property. . . ." If so, the tax is upon the beneficiary; if not, it is upon the trust. In this state of the law, may the trustee be permitted to follow such a distribution practice where the liability becomes that of the beneficiary if the trustee knows the beneficiary's tax bracket to be substantially higher than that of the trust, or where all ordinary income is mandatorily distributable so that any capital gains tax to the trust would start at the lowest bracket?

A second situation where capital gains can become taxable to the beneficiary occurs where current distribution of capital gains is required, whether the requirement springs from local law or from the trust instrument. In these cases the trustee's decision on when to sell an appreciated corpus asset will determine the year in which the corpus beneficiary bears a capital gains tax liability which might otherwise have been deferred to some other year. If the beneficiary's income fluctuates substantially, does the trustee need stronger reasons for selling in a year in which the beneficiary's tax bracket is high than in a year in which it is low? Conversely, if the trust has depreciated assets, need the trustee give weight to the value of the loss to the beneficiary in any one year rather than another?

Lastly, in the year of final distribution, the trustee's decisions as to sale or retention of appreciated (or depreciated) assets will determine the year in which capital gains tax liabilities (or capital loss deductions) will be incurred by the beneficiary. Is the tax impact upon the beneficiary a consideration to be weighed by the trustee in determining whether or not to sell such an asset in the trust's final year?

Even where no immediate capital gains tax liability is imposed upon the beneficiary, the trustee's exercise of its discretion in making distributions of corpus can have sharply different tax consequences.

Many trusts provide for partial distributions to beneficiaries at various times, whether it be for some stated purpose, at fixed ages, annually or otherwise. Such trusts usually authorize the trustee to select the particular trust assets to be distributed.

If the trustee distributes cash or assets having a value equal to their basis, no special problems are created. But if the trustee selects assets worth more or less than their basis, a number of new considerations arise.

If appreciated assets are distributed in satisfaction of a specific dollar distribution provided in the trust instrument (or will), the trust (or estate) is treated as having made a constructive sale resulting in capital gain taxable to the trust (or estate).²¹

In such a case the beneficiary holds such assets with the higher basis of their

²⁰ Treas. Reg. §1.643(a)-3 (1956).

²¹ Treas. Reg. §1.661(a)-2(f) (1956); Rev. Rul. 56-270, 1956-1 Cum. Bull. 325.

current value, and trust corpus is diminished by the amount of this tax. If the trustee had distributed cash or unappreciated assets, neither of these results would have occurred. What are the trustee's powers and responsibilities in selecting assets to make such a distribution? Is the trustee protected if it would otherwise have sold such assets to make the distribution?

To date, the constructive sale doctrine has only been applied to a few types of partial distributions. If the scope of its application should be increased, the significance of the problems just discussed will also be enlarged.

Where the trustee distributes appreciated assets and the distribution does not constitute a constructive sale, the question of the real value of the distribution again arises.

Suppose a distribution is required to be made from trust principal to purchase a residence and the dollar amount is known at the time of distribution. If the trustee charged with selecting assets to make such a distribution actually distributes assets worth \$20,000 but having a basis of \$5,000, the beneficiary, under present rulings, would receive \$20,000 *less* a prospective capital gains tax liability on \$15,000, to be incurred on a subsequent sale (unless the beneficiary should die without having sold the asset).

In such a case did the beneficiary get the benefit the grantor intended? May the trustee allow for the potential capital gains tax liability in valuing the distribution? Or must the trustee sell the asset in order to distribute proceeds, thereby subjecting the trust to an immediate capital gains tax?

Perhaps a sharper focus on trustee responsibility in this area may be derived from considering a trust requiring simultaneous equal distributions to several beneficiaries. May the trustee distribute to one beneficiary securities having unrealized appreciation while distributing to a second beneficiary either cash or securities approximately worth their basis?

A further problem area involving a taxable distribution of appreciated assets may be found where some appreciated assets have holding periods of more and some of less than six months. The problems are similar to those already reviewed but less likely, since most trusts do not engage in active trading.

If the trustee selected assets worth *less* than their basis, a converse set of rules might apply.

Quite a different problem may arise where the trustee has discretion whether to distribute income, has power to make distributions in cash or in kind and the trust assets include securities with unrealized appreciation. If in making a discretionary distribution to the income beneficiary the trustee makes the distribution in cash, this income is taxable to the beneficiary as ordinary income, and the trust continues to hold securities carrying a potential capital gains tax liability. If, however, the trustee makes an equivalent distribution in appreciated securities, the beneficiary will receive the same amount of taxable income and will pay the same tax. It seems likely, however, that in this instance the securities will acquire in the beneficiary's hands a basis equal to the market value at the time of distribution. Thus, by exercising a discretionary

power to distribute in kind, the trustee may be able to free the trust of a potential capital gains tax liability without injury to the income beneficiary. If so, may a remainderman complain if the trustee should fail to eliminate potential capital gains liabilities in this manner?

III. ADJUSTMENTS TO REFLECT TAX CONSEQUENCES

Some of the preceding problems may be eliminated if the trustee is expressly permitted or required to allow for tax factors in valuing trust assets selected for distribution. Others may be answered if the trustee is permitted or required to make compensating adjustments to reflect the unexpected or accidental tax consequences considered earlier.

Without express authorization, however, the trustee will be seeking to take action as between beneficiaries for which it will find little or no precedent today.

The few cases reviewed in II above indicate that the courts will ultimately define both the extent to which the trustee must at its peril recognize the tax consequences of its actions and the extent to which the courts will find implied powers to permit the trustee to allow or compensate for these consequences.

This is the traditional way in which the respective rights of income and remainder beneficiaries have been delineated and in which many other types of powers and duties of the trustee have been judicially determined.

Modern trust draftsmanship, however, seeks to protect the trustee from the uncertainties of future judicial decision by granting the trustee broad, explicit powers of administration. Application of the same foresight to the problems considered requires that new trust provisions be developed to enable the trustee to deal fairly with such tax consequences and to protect the trustee in the exercise of its discretion.

Attached as an appendix is a first attempt at a model provision designed to equip the trustee with the tools and shields needed in this area. Its scope may be categorized as follows:

A. *Valuation problems.*—As described in II, many distributions of trust income and principal carry with them widely varying tax consequences depending upon the assets selected for distribution and the timing of the distribution.

When such distributions are directed or authorized under the trust instrument for some stated purpose which at the time of distribution is a known dollar amount, the trustee should be empowered to value the distribution in terms of the net amount available to the beneficiary for the stated purpose. This should be true whether the distribution is made in cash or in other assets. Such a power may not have been significant when tax rates were lower or when most distributions were not taxable to the beneficiary. But under the trust tax scheme of the 1954 Code, present high tax rates and probable further tax rate increases, the gross value of a distribution is in the process of becoming less and less meaningful.

Similarly, when specified percentages of trust assets are scheduled for distribution, valuation of the total trust estate and of the particular assets to be distributed can be greatly distorted if gross asset values are used.

The proposed model provision expressly authorizes the trustee, in determining the value of assets for distribution purposes (including cash), to discount the fair value of such assets by tax liabilities at relevant brackets flowing from the fact of distribution or inherent in the subsequent disposition of the asset by the beneficiary. Thus, distributions which carry tax liability for receipt of ordinary income or for receipt of capital gains may be discounted for the estimated tax liability; distributions of appreciated assets in kind not constituting a constructive sale may be discounted for the future capital gains tax liability.

B. *Adjustment of trust accounts.*—Independent of the valuation question, many types of discretionary actions by the trustee may have tax consequences which fall unfairly among the beneficiaries. These too may arise in distributions of both trust income and trust principal.

When do tax consequences fall “unfairly”? The current income beneficiary is expected to be taxed on current income distributions and to be allowed to deduct charges against income. The corpus beneficiary is expected to be taxed on distributions of capital gains and to obtain the benefit of deductions attributable to charges against corpus either directly or, if the trust pays the tax, indirectly. Any difference in tax consequences is “unfair” to the bearer of the shifted tax burden.

Granting the trustee power to make compensating adjustments of trust accounts will permit a restoration of “fairness,” but in most actual situations will present the trustee with impossibly complex choices. Progressive income tax rates require that calculation of adjustments for tax burdens or benefits be made on the basis of marginal brackets. If several items are involved, the computation often becomes self-contradictory, requiring the use of mutually inconsistent hypotheses. If different tax years are involved, additional variations in tax brackets between years must be considered. And if unrealized appreciation is involved, what year should be postulated, and what future rates and brackets? Experience illustrative of such problems may be found in computations sometimes required in business or family transactions where one party agrees to reimburse another for the excess of undetermined income tax liabilities over undetermined income tax benefits.

Such compensating adjustments by the trustee cannot be exact. But a reasonably estimated adjustment made by a responsible fiduciary can do much to restore the essential dispositive scheme of the testator or grantor. The trustee is no more incompetent to make adjustments of this nature than the executor to adjust for its election to deduct administrative expenses on the estate income tax return in a marital-formula estate, or the trustee to allocate some types of complex receipts between income and principal. The grant of such powers in the trust instrument should be as acceptable to the courts as

most grants of powers coupled with a fiduciary responsibility have been in the past.

C. *Exculpation of the trustee.*—Implicit in the foregoing discussion of tax law distortions of trust accounting is the risk that the trustee will be surcharged for some discretionary action because its tax consequences were unfair to one or another beneficiary. In effect, this has already occurred in five of the cases discussed in II, but in all cases except one the fiduciary still had access to trust assets to accomplish the reallocation ordered. This may not always be the case, and the trustee may find that his action is the subject of the case that establishes an unprecedented trustee's obligation in this area.

For this reason, and to protect the trustee in making a reasonable but necessarily inexact determination, either in valuing a trust asset or making an adjustment in the trust accounts to reflect unfair tax consequences, the model provision at the end of this article includes an additional exculpatory clause to encourage the trustee to restore the intended trust administration without personal risk for honest errors of calculation.

IV. CONCLUSION

This review of some new obligations of trustees arising under the tax laws is not intended to be all-inclusive. Rather, its purpose is to illustrate that just as the ancient institution of the trust has undergone a major transformation into a tax-saving instrumentality, so the tax laws have been revised to impose tax liabilities on individual beneficiaries whenever possible, even though the result is contrary to established trust accounting practice and to the intentions of the grantor or testator.

Many of these tax law provisions depart from customary trust accounting distinctions between corpus and income, both as to receipts and disbursements. The result is that trust income and deductions are often reportable on the individual tax returns of distributees other than those intended by the creator of the trust.

The accounting required for the preparation of proper trust tax returns must conform to the tax law. The result is that unless trustees are to keep two sets of books, one for trust purposes and one for tax purposes, they must be permitted to make adjustments to reflect tax consequences which are more consistent with the government's drive to have trust income taxed to individuals than with the grantor's intentions in establishing the trust. Such a result can be justified by imputing to the grantor the intention that distorted tax consequences be balanced by adjustments between beneficiaries made by the trustee.

Tax law has heretofore heavily influenced corporate accounting practices, and corporate officers have adjusted to many income tax accounting practices in corporate management.²² Tax law is similarly influencing trust accounting

²² In the *Trico* case (unreported), stockholders are reputed to have obtained substantial cash settlements from directors who failed to make dividend distributions which would have avoided

practices, but the resulting responsibilities of trustees have not yet been defined.

We believe that the tax motivations which underlie the increase in quantity and the change in form of modern trusts will be recognized by the courts in requiring trustees to allow for tax consequences in exercising their discretion and to adjust for tax consequences which flow from the unrelated timing of trust distributions. The thoughtful trust draftsman, however, will not sit idle during the process of judicial inclusion and exclusion; rather, he will seek to occupy the field with the grant of new powers and protections to the trustee to meet these challenges.

APPENDIX

The Trustee is authorized and empowered:

A. To value any trust property distributed or to be distributed to any beneficiary, including in the determination of such value such allowances as the Trustee, in its sole discretion, may deem reasonable for any current Income Tax Consequences (hereinafter defined) of such distribution and for any deferred Income Tax Consequences which may arise from subsequent disposition of assets having at the time of such distribution a fair market value other than the basis of such assets in the hands of the distributee; and

B. To make such adjustments by charges against and credits to the accounts of the beneficiaries hereunder (whether present or future, vested or contingent) as the Trustee, in its sole discretion, may deem reasonable to compensate for the Income Tax Consequences of the Trustee's making or failing to make any authorized distributions of trust income or corpus whenever, in the opinion of the Trustee, such Income Tax Consequences to the trust and such beneficiaries differ from those which would ensue as a result of the application of established trust accounting practices.

As used herein, "Income Tax Consequences" means any effect prescribed by or resulting from the application of laws imposed by any governmental authority with respect to taxes upon or measured by income, whether such effect be by imposition of liability for payment of taxes, by adjustment of the basis of property, or otherwise, and whether such effect be upon the Trust or upon any beneficiary hereunder, present or future, vested or contingent.

In making or failing to make such allowance in determining any valuation, and in making or failing to make any such adjustment, the Trustee shall be fully protected in making any estimate of applicable tax rates, in making any allowances for the complexity of exercising any such power and in determining any method of application of any such allowance or adjustment; and each decision of the Trustee, by action or inaction, shall be final and binding and not subject to question by any person.

a corporate liability for undistributed income surtax. See *Trico Products Corp. v. Commissioner*, 137 F.2d 424 (C.A.2d, 1943); *Trico Products Corp. v. McGowan*, 169 F.2d 343 (C.A.2d 1948).