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FEDERAL TAXATION OF TRUSTS

By ED. R. MOYLAN, *of the Denver Bar.*

IN 1932, a wealthy citizen of Colorado, let us call him John Jones, desiring that his minor daughter in her more mature years might have an income, set up an irrevocable trust for that purpose, naming a Denver bank as the trustee. The income therefrom was to be accumulated and added to the principal until the time of distribution. The instrument comprising the trust contained inter alia, this provision, of more or less common usage:

> "The income from the trust shall be accumulated and added to the principal until the termination of this trust provided that Celiste Jones, who was twelve years of age on August 1, 1932, may at any time after attaining the age of 27 years, request that the income arising after the date of her request be paid to her as long as she may live, and provided further that if at any time before the said Celiste Jones attains the age of 27 years, *her support and education* is not sufficiently provided for from other sources, the trustee may from time to time pay any income thereafter arising from the trust fund to or for the benefit of the said Celiste Jones, upon the approval of the Trustor or his wife, or without such approval if neither the Trustor or his wife be living."

In the latter part of 1936 an agent from the Denver Division, Department of Internal Revenue, examined into the setup of this trust and thereafter sent a copy of his report thereon to the trustee.

The agent stated in his report that this was an irrevocable trust; that it was for the benefit of the minor child; that the trustor had no power to alter or modify any provision thereof, but his report contained the following pertinent statement:

> "Inasmuch as the income of this trust may be used for the support and maintenance of this minor daughter, the income is taxable to the grantor under the provisions of Section 167, Revenue Act of 1934."

No tax liability had been shown on the trustee's return for two years for the reason that the income reported was insufficient in amount and kind to be reached by the tax.

The trustor was already paying an income tax that reached into the high surtax brackets, making these additional taxes on the income from the trust a considerable burden. Immediately thereafter the trustor's attorney filed a protest on this

assessment with the Bureau of Internal Revenue on the theory that, as the trustor retained no title to the property conveyed by the trust instrument, no control over the terms of the trust and no interest in the distribution of the trust income, the tax was arbitrary and unlawful.

Counsel further set forth that the gift to the minor daughter was present, executed and outright, and that the gift-tax thereon had been assessed and paid and further argued that to establish the contention that the income from the property of this irrevocable trust (the application of such income being for the benefit of others), was nevertheless the income of the trustor and might lawfully be taxed as his property, required something more tangible than a mere supposition that in the distant future, some part of the income of this trust might be used to discharge a legal obligation of the trustor i. e. the support of his child. He pointed out that the trustor was not bound to set aside a trust fund for his minor child. He was, it is true, charged with her support but he was not further charged.

The agent's interpretation was claimed to be arbitrary and irrational. The line of demarkation between the rational and the arbitrary in legislation, it was pointed out, was not to be drawn with an eye to remote possibilities. 1.*

The agent in charge in Denver sustained the agent who assessed the tax basing his decision on the language of the Supreme Court in recently decided cases. 2.*

Jones' counsel contended that the decisions depended on by the taxing authority were not in point with his case and were distinguished from it in the following particulars:

1. Jones had created an irrevocable trust.

2. He had divested himself of every incident of control over the trust estate.

3. He could not on the happening of any contingency have a reversion of the corpus of the trust.

1.* Barnett vs. Wells, 289 U. S. 670.

2.* Douglas vs. Willcuts, 290 U. S. 56 Supreme Court 58.
Helvering vs. Blumenthal, 56 Supreme Court 305.
Commissioner vs. Stokes, 56 Supreme Court 308.
Commissioner vs. Schweitzer, 56 Supreme Court 304.

The statute provides that the income of the trust is taxable to the beneficiary if the following three requirements are met:

1. The income must be income from property held in trust.

2. The trust must not be a revocable trust.

3. The trust must not provide that the income be distributed to the grantor, or accumulated for future distribution to the grantor in his discretion either alone or in conjunction with one not a beneficiary. To the extent that any part of the income of the trust is so distributed or accumulated, such part of the income is taxable to the grantor.*

(The tax to the beneficiary would be greatly less than if assessed to the trustor on account of the latters high surtax.) The sections of the statute which impose the second and third requirements above set forth were intended to apply to actual transfers of property to trustees where certain substantial rights to or control over the property or income therefrom were retained by the grantor.

Congress undoubtedly intended by the enactment of these provisions to prevent a taxpayer from reducing, or altogether avoiding his income tax liability by the creation of a trust to hold income-producing property and the retention of a power which would enable him at will, to withdraw the property or direct the payment of the income to himself. Securities First National Bank of Los Angeles Exes. 28 B. T. A. 288.

Counsel citing this case demanded to know on what theory the Internal Revenue Department arrived at its decision, that Jones should be taxed on the income of the trust he had set up, and on the property rights he had divested himself of in order that this property should produce income to take care of his daughter.

Income taxable by virtue of the Sixteenth Amendment had been clearly defined by the United States Supreme Court. Derived income was stated to be the indispensable characteristic of taxable income. 4.*

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*Sec. 167, Revenue Act, 1934.

4.* Eisner vs. Macomber, 40 Supreme Court 193.

Hence counsel asked how could Jones have derived any income from this trust, unless he applied part, at least, of the trust income to the support of his daughter. The highest court had declared that in tax cases, as in all others, facts must not be slighted in favor of suppositions.

An outstanding fact was that no income of the trust was ever devoted to the support of Jones' daughter.

The only theory on which Jones was taxed was that the trust agreement provided that at some future time, before the beneficiary reached the age on which distribution was to be made to her, should she not receive from other sources enough for her support and maintenance, then and in that event the trustee should pay the income to her. The fact that the trust agreement contained such a clause was by the Bureau deemed a benefit to the trustor, and the Bureau sought to tax such a benefit. When we speak of taxing benefits, we venture into the realm of economics, but economists' definitions of income have been previously rejected by the Supreme Court of the United States. 5.*

It is not yet the law that all economic benefits, no matter how contingent or remote, constitute taxable income. This theory finally prevailed.

On July 28, 1937, while the office of general counsel was occupied by a distinguished member of the Denver Bar the widely discussed case of Black vs. Commissioner came before the Board of Tax Appeals. It is reported in 36 B. T. A., page 346. The facts are as follows:

The Commissioner determined a deficiency of $2,559.56 in petitioner's individual income tax for 1934. Aside from minor adjustments, which are not assailed, the Commissioner included in petitioner's income $8,000.00 on dividends on corporate shares held by four trusts created by petitioner in 1933, of each which petitioner's wife and three minor children were the respective beneficiaries. This ruling was duly protested.

The Board of Tax Appeals in upholding the taxpayer's contention said:

5.* Eisner vs. Macomber, 40 Supreme Court 193.

1. "We are of the opinion that the Commissioner's determination is in error. The trusts were complete and irrevocable. Petitioner had no right to the income either presently or prospectively and none of it actually came to him. He did not benefit by its use for the support and maintenance of his wife and children or in the discharge of his own obligations (Cf Commissioner vs. Grosvenor, 85 Fed.) (2), and the trusts were at all times administered with a strict regard for their separate jural personalities. There is no occasion, therefore, to regard the income as constructively received by Petitioner."

Judgment was entered under Rule 50.

Shortly after the decision in the Black case this very pertinent memo issued from the office of the General Counsel:

(2) G. M. C. 18972, XV—33 8882 (p-6):

"The next question to be considered is what part, if any, of the income of trusts is taxable to the grantor under Section 167 of the Revenue Acts of 1933 and 1934? * * * This office has reached the conclusion that in cases where the trust income or at least part of it might in the discretion of the trustee have been used to support the minor children of the grantor, there should be taxed to the grantor only so much of the trust's income as is *actually distributed* for the support and maintenance of the beneficiaries whom the grantor is legally obliged to support. The fact that the trust's income may be distributed for the support of such persons (but actually is not) does not make any such income subject to distribution to the grantor within the meaning of Section 167 of the Revenue Acts herein involved. The opinion in E. E. Black promulgated by the Board of Tax Appeals on July 28, 1937, 36 B.T.A. No. 55 (p. 346). Acquiescence published on page 1 of this bulletin clearly states the rule."

In view of the above decision and memo the protest of Jones' Counsel prevailed and Jones' income was not subjected to the tax.

The General Counsel who wrote this memo, defining the future course of the department, thus putting at rest the mind of many a harassed taxpayer, is no longer with the Internal Revenue Department.* He also saw fit to disagree with some of its other policies and is again engaged in the general practice of law having won high esteem for his independence and legal ability before resigning.

*Hon. Morrison Shafroth.