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TAX CONSEQUENCES OF FUNDING TRUSTS WITH ENCUMBERED PROPERTY: THE DEMISE OF SECTION 677

INTRODUCTION

The trust has long been a popular device for shifting the incidents of property ownership for income tax purposes. Typically, an individual in a high income tax bracket will transfer property to a trust for the benefit of family members, which causes the income from such property to be taxed either to the trust or to its beneficiaries, both of whom are presumably in lower income tax brackets than the grantor. The success of such income splitting schemes depends on the grantor's compliance with subpart E of subchapter J of the Internal Revenue Code of 1954.[1] This subpart establishes certain requirements[2] that the grantor must satisfy to avoid being attributed with trust income.[3]

Within subpart E, section 677 generally provides that the grantor is taxed on any income that is or may be applied for his benefit. This provision has proven particularly troublesome to the operation of trusts funded with encumbered property. If the grantor retains an interest as either remainderman or primary obligor for the encumbrance, trust income that is used to discharge the indebtedness may be attributed to him under section 677.[4] Because of its limited scope, however, careful tax planners have been able to circumvent this provision. This results in the grantor receiving tax free economic benefits.[5] In these instances, the Commissioner has begun to assert an alternative rationale that looks to the tax consequences of the transfer in trust rather than the subsequent trust operation. Under this approach the transfer transaction is treated as a part-sale, part-gift in which

1. Unless otherwise indicated all references to the Code are to the INT. REV. CODE OF 1954. Subpart E contains §§671-78 of the Code. Similar provisions were contained in §§166 and 167 of the 1929 Code and certain regulations issued under §22(a) of the 1939 Code, commonly known as the *Clifford* and *Mallinckrodt* Regulations. TREAS. REG. §§39.22(a)-21, 22 (1953) (now superceded by §§671-78). *See* Helvering v. Clifford, 309 U.S. 331, 1940-1 U.S.T.C. ¶9265 (1940); Mallinckrodt v. Nunan, 146 F.2d 1, 1945-1 U.S.T.C. ¶9134 (8th Cir. 1945), *aff'g* 2 T.C. 1128 (1943), *cert. denied*, 324 U.S. 871 (1945).

2. Basically the trust must be irrevocable for a term of more than 10 years or for the life of the beneficiary. The grantor and nonadverse parties are restricted in their administrative control over the trust and their power of disposition over the beneficial enjoyment of the trust. In addition, the grantor is generally attributed with any income distributed for his benefit.

3. Subpart E "provides rules to determine when a trust's income is to be taxed to the grantor because of the grantor's substantial dominion and control of the trust property or income." S. REP. No. 1622, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess. 86 (1954).

4. The Commissioner has primarily argued that the payment of these obligations is either a discharge of the grantor's legal obligation when he is personally liable on the indebtedness or an accumulation of income for the future benefit of the grantor when he has retained a reversionary interest in the trust corpus.

5. Section 677 appears to be inapplicable if the grantor avoids personal liability on the encumbering debt, either by negotiating a nonrecourse loan or by providing that the trust assume primary liability for the debt. Section 677 has also been held inapplicable if the encumbrance is discharged with funds other than trust income.

the grantor realizes the amount of the encumbrance and recognizes gain to the extent this amount exceeds his basis.[6] The impact of this approach has been greatly enhanced by the decision of *Johnson v. Commissioner*,[7] in which the Sixth Circuit held the transfer in trust of encumbered property to be within the parameters of the *Crane* doctrine.[8] It is uncertain, however, which theory the Commissioner will continue to assert in the future.[9]

The focus of this commentary is on the application of section 677 to the operation of encumbered trusts. The following text examines the effectiveness of this provision in determining the proper tax consequences in various scenarios and explores the extent of its inherent limitations. While a complete analysis of the part-sale, part-gift concept is beyond the scope of this work,[10] this approach is examined in regard to its effect on the continued utilization of section 677. Finally, this commentary concludes that section 677 is functionally inadequate and that the part-sale, part-gift concept should be adopted as the appropriate method of determining the tax consequences of funding trusts with encumbered property.

TAX CONSEQUENCES OF TRUST OPERATION: THE TRADITIONAL APPROACH UNDER SECTION 677

Section 677(a) provides in part:

> "The grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
> (1) distributed to the grantor or the grantor's spouse;
> (2) held or accumulated for future distribution to the grantor or the grantor's spouse . . . ."

The application of this provision triggers section 671, which attributes the grantor with all items of income, deductions, and tax credits arising from the pertinent portion of the trust.[11]

The application of section 677 in instances involving the satisfaction of trust encumbrances is based on two fundamental prerequisites: the realization of trust income and the utilization of such income for the benefit of the grantor. To fulfill the latter requirement, the grantor must retain some

6. Malone v. United States, 326 F. Supp. 422, 1971-1 U.S.T.C. ¶9475 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972).

7. 495 F.2d 1079, 1974-1 U.S.T.C. ¶9355 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1975).

8. *See* Crane v. Commissioner, 331 U.S. 1, 1947-1 U.S.T.C. ¶9217 (1947). This case established the fundamental principle that on the sale of encumbered property the sum of the encumbrance is included in the amount realized, regardless of whether the seller is personally liable for the indebtedness or whether the buyer formally assumes the liability.

9. *Compare* Jack Wiles, 59 T.C. 289 (1972), *aff'd per curiam*, 491 F.2d 1406 (5th Cir. 1974) *with* Malone v. United States, 326 F. Supp. 422, 1971-1 U.S.T.C. ¶9475 (N.D. Miss. 1971), *and* Johnson v. Commissioner, 495 F.2d 1079, 1974-1 U.S.T.C. ¶9355 (6th Cir. 1974).

10. For a more complete analysis of the part-sale, part-gift concept, *see* Note, *Tax Consequences of Encumbered Gifts: The Advent of* Crane, 29 U. FLA. L. REV. (1977).

11. *See* TREAS. REG. §1.671-3.

interest in the trust through which he will accrue an economic benefit upon the discharge of the encumbrance. Generally, the Commissioner has successfully asserted that such an interest exists in two circumstances. The first instance is when the grantor retains a reversionary interest so that the payment of the encumbrance increases the value of the equity interest that he will ultimately acquire on reversion. The second instance is when the grantor remains personally liable on the indebtedness so that the payment of the debt is a discharge of his legal obligation. However, if the above prerequisite is satisfied, the application of section 677 is still, by definition, conditioned on the requirement that the benefit to the grantor accrues from the distribution or accumulation of *trust income*. Thus, if funds other than trust income are used to satisfy the encumbrance, the benefit to the grantor, if any, does not appear to come within the purview of section 677.

BENEFIT TO GRANTOR FROM SATISFIED ENCUMBRANCE

Enhanced Reversionary Interest

Under section 673, a grantor who retains a reversionary interest is treated as the owner of the trust unless such interest takes effect more than 10 years after the property's transfer in trust or on the death of the income beneficiary. In these instances the grantor will not be treated as the owner of the trust *income*;[12] nevertheless, he is still considered the owner of the trust *corpus* for purposes of section 677.[13] Thus, while the grantor is not attributed with ordinary trust income, he is taxed with income allocable to corpus because such income is accumulated for future distribution to him within the meaning of section 677(a)(2).[14] For this reason, capital gains from the sale of trust assets are taxed to the grantor who retains a reversion if such gains are allocable to corpus.[15] Since income applied toward indebtedness encumbering trust assets is properly allocable to corpus, it is likewise an accumulation of income for future distribution to the grantor.[16]

While the above reasoning is sound, the appropriateness of the result is questionable. Section 677(a)(2) would require the grantor to include the entire amount of the debt payments in his current income;[17] however, the trust

12. *Id.* §1.673(a)-1(a).
13. *Id.*
14. *Id.* §1.671-3(b)(2).
15. *Id.* §1.673(a)-1(a).
16. *But see* Riggs National Bank v. United States, 352 F.2d 812, 1965-2 U.S.T.C. ¶9728 (Ct. Cl. 1965). The trust corpus was devised to charity, but the provisions of the will were held inapplicable to trust income that passed by intestacy to the decedent's heirs. The trustee sought to take a charitable deduction on income applied toward trust encumbrances, contending that such income was also permanently set aside for charity since the ultimate charitable devise was increased. The court held that the indirect connection was too remote to be considered a "permanent setting aside for charity" and therefore denied the deduction. In view of the fact that the primary purpose of section 677 is to tax the grantor on realized income rather than to allow a deduction from gross income, it seems unlikely that a court would construe the provision as narrowly as the holding above.
17. TREAS. REG. §1.677(a)-1(f).

also benefits from the payments by retaining the present income interest that is dependent on the timely satisfaction of the encumbrances. To the extent that the grantor is taxed on the portion of the payments accruing to the benefit of the trust, the above result appears inequitable.

An alternative theory for the application of section 677 posits that debt payments accrue to the benefit of the grantor only to the extent that they currently reduce the lien encumbering his reversionary interest.[18] Under this rationale the grantor would be taxed with a fractional share of each payment determined by the proportion that the value of his reversionary interest bore to the value of the full estate.[19] Thus, instead of the entire payment being an accumulation for future distribution, only the appropriate share would be characterized as a present constructive distribution to the grantor. For example, assume that a grantor creates a short term trust for 10 years and a month, retaining the reversionary interest in himself. Further assume that in the first year the full value of the trust corpus is $100, $75 being the value of the income interest for the term of the trust and $25 being the value of the remainder or reversionary interest. In the first year, the grantor would be attributed with 1/4 of the amount of trust income paid toward encumbering debts. If in the final year of the trust the value of the income interest had declined to $10 while the reversion had increased in value of $90, the grantor would be taxed on 9/10 of each debt payment. Unlike the previous rationale, this approach does not ignore the benefit to the trust and its income beneficiaries; instead, the trust is attributed income in proportion to the value of its income interest.

No decision has fully articulated either of the above rationales for applying section 677.[20] While the first theory is supported by the statutory scheme of the Code, the second approach appears to be the most equitable and realistic. It is, therefore, suggested that the latter rationale should be the favored approach.

Discharged Legal Obligations

The second instance in which the grantor may receive a taxable benefit

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18. *Cf.* Herff v. Rountree, 140 F. Supp. 201, 1956-1 U.S.T.C. ¶9359 (M.D. Tenn. 1956).

19. *Id.* at 206, 1956-1 U.S.T.C. at 54,882.

20. The lack of a clear rationale for determining the tax consequences of retaining a reversionary interest in encumbered trusts has resulted in confused and conflicting decisions. For example, in Jenn v. United States, 1970-1 U.S.T.C. ¶9264 (S.D. Ind. 1970), the taxpayer triggered §677 in two ways: by remaining personally liable for the mortgage and by retaining a reversionary interest in the trust property. The court reasoned that since the entire amount of trust income was applied toward the mortgage, and since the mortgage was the legal obligation of the grantor, the entire amount of trust income was attributable to the grantor. However, in the last of several years being considered, the grantor relinquished 1/3 of his reversionary interest. For reasons left unclear by the opinion, the court concluded that by relinquishing this reversion the grantor ceased to be a beneficiary of that portion of the trust and allowed the attribution of only 2/3 of the income in the final year. It would appear that the relinquishment of the reversionary interest would not affect the grantor's personal liability on the encumbering indebtedness and that the grantor would continue to be attributed with trust income on the separate basis of the discharge of his legal obligation.

from the application of trust income toward an encumbrance occurs when he remains personally liable for the indebtedness. In this circumstance, the Commissioner asserts that the payment of the encumbering debt constitutes a constructive distribution to the grantor in the form of a discharged legal obligation.[21] By necessity, this application of section 677 is dependent on the nature of the grantor's liability for the encumbrance. Under the prevailing view, the grantor must be primarily liable for the indebtedness to realize a taxable benefit from its discharge.[22] Therefore, great significance has been placed on the legal technicalities that determine the grantor's personal liability subsequent to the transfer in trust. In light of the economic realities of mortgage financing, the above approach exalts form over substance and has resulted in inconsistent and unrealistic decisions.[23]

The basic premise of this application of section 677 is that the discharge of a legal obligation constitutes gross income to the obligor. This rule was established in *Old Colony Trust Co. v. Commissioner*,[24] in which the Supreme Court held that an employer's payment of an employee's taxes was income to the employee in the amount of the taxes paid. The same rule was applied in *Douglas v. Willcutts*,[25] in which the grantor of a trust was taxed on trust income used to satisfy his alimony obligations. This reasoning has been incorporated into section 677 by regulations that expressly trigger the provision on the discharge of the grantor's legal obligations.[26]

In the typical fact setting assets encumbered by the grantor's personal debts are transferred in trust without a formal assumption of liability by the trustee. Thus, the grantor remains legally liable, and the payment of the indebtedness, by definition, is a discharge of his legal obligation.[27] Neverthe-

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21. *See, e.g.*, Jack Wiles, 59 T.C. 289 (1972), *aff'd per curiam*, 491 F.2d 1406 (5th Cir. 1974).

22. In Rev. Rul. 54-516, 1954-2 CUM. BULL. 54, 56 the Commissioner stated that "if the Grantor remains liable in any capacity, other than as trustee, for the mortgage on real estate transferred to the trust, any income of the trust which is used to pay principal or interest on such mortgage will be taxable to him." This language would appear to encompass the capacity of a surety, but no decision has held a surety to realize a taxable benefit on the trustee's discharge of the obligation he guarantees. To do so would lead to the absurd result of finding that both the primary debtor and the surety realized the same benefit on the discharge of the indebtedness; moreover, the surety would be taxed with income whenever the actual debtor repaid his own obligation. Since this Revenue Ruling has never been asserted as authority for such a proposition, it is assumed that the Commissioner will not do so in the future. Furthermore, the Commissioner to date has not required a novation from the lender, in addition to the assumption of liability, even though the lender may generally hold either the original obligor or the assuming party primarily liable unless consent to the assumption is granted.

23. See text accompanying notes 37-44 *infra*.

24. 279 U.S. 716, 1 U.S.T.C. ¶408 (1929).

25. 296 U.S. 1, 1936-1 U.S.T.C. ¶9002 (1935).

26. TREAS. REG. §1.677(a)-1(d).

27. *See, e.g.*, Lucy A. Blumenthal, 30 B.T.A. 591 (1934), *rev'd*, 76 F.2d 507, 1935-1 U.S.T.C. ¶9270 (2d Cir.), *vacated per curiam*, 296 U.S. 552 (1935) (reinstating the B.T.A. opinion).

less, courts have questioned the reality of this liability when the debt is fully secured by the property transferred in trust.[28]

Other examples raise even more troublesome obstacles to section 677. If the primary liability is formally assumed by the trust, then the grantor has no remaining obligation to which subsequent trust income may be applied.[29] Furthermore, in the instance of a nonrecourse loan, for which the grantor is not personally liable on the debt, there appears to be no legal obligation to be assumed or discharged.[30] The varying effectiveness of section 677 must be examined in each of these circumstances.

Liability Retained by Grantor

The significance of the grantor's personal liability was demonstrated in the classic case of *Helvering v. Blumenthal.*[31] The taxpayer established an irrevocable trust for the benefit of her children. Stock worth $300,000 was transferred in trust subject to a personal note with a balance due of $33,000. The trustee was directed to pay the debt on receipt of accumulated but undeclared dividends. The Board of Tax Appeals found that without an express assumption the grantor remained primarily liable on the note; therefore, she was properly taxed on trust income to the extent it was used to satisfy her indebtedness.[32]

On appeal, the Second Circuit reversed the Board of Tax Appeals'[33] decision and concluded that "[t]he effect of transferring this stock, subject to the debt, was to make the stock the primary fund to meet the obligation and to place the [grantor] in the relation of surety only."[34] In support of this position the court noted: (1) the grantor received no enrichment since no income or reversionary interest was retained; (2) the bank holding the note customarily looked to the security prior to demanding personal payment, and since the collateral was worth approximately ten times the amount of the debt, there was virtually no possibility of a personal demand for satisfaction; (3) the trustee accepted the obligation to make the payment and the bank acquiesced to this arrangement; and finally (4) under New York law, "[w]here a mortgagor conveys mortgaged premises subject to a mortgage, even though there be no covenant on the part of the grantee to pay, the land remains the primary fund of the debt and to the extent of its value the grantee stands in the relation of principal debtor."[35]

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28. *See, e.g.*, Blumenthal v. Commissioner, 76 F.2d 507, 1935-1 U.S.T.C. ¶9270 (2d. Cir.), *vacated per curiam*, 296 U.S. 552 (1935). See also text accompanying notes 44-48 *infra*.

29. *See, e.g.*, Edwards v. Greenwald, 217 F.2d 632, 1955-1 U.S.T.C. ¶9114 (5th Cir. 1954). See also text accompanying notes 50-53 *infra*.

30. *Cf., e.g.*, Loeb v. Commissioner, 5 T.C. 1072 (1945), *aff'd*, 159 F.2d 549 (7th Cir. 1946). *See also* note 55 *infra*.

31. 296 U.S. 552 (1935), *vacating per curiam*, 76 F.2d 507, 1935-1 U.S.T.C. ¶9270 (2d Cir. 1935), *reinstating* 30 B.T.A. 591 (1934).

32. Lucy A. Blumenthal, 30 B.T.A. 591 (1934).

33. Blumenthal v. Commissioner, 76 F.2d 507, 1935-1 U.S.T.C. ¶9270 (2d Cir. 1935).

34. *Id.* at 508, 1935-1 U.S.T.C. ¶9270, at 9760.

35. *Id.*

Unconvinced by these arguments, the Supreme Court, in a per curiam decision, reversed the circuit court on the authority of *Douglas v. Willcutts* and reinstated the holdings of the Board of Tax Appeals.[36] Unfortunately, the absence of a written opinion leaves open to speculation the specific reasoning of the Court; moreover, since grantor liability is determined by state law, courts in other jurisdictions have reached different conclusions on similar facts.

In *Estate of Hays v. Commissioner*,[37] the Service sought to include trust property in the gross estate of a deceased grantor. Despite the estate tax context, the fundamental issue, as in *Blumenthal*, was whether trust income had been applied toward the legal obligation of the grantor. The property in question had been transferred in trust subject to a mortgage. Although there was no evidence in the terms of the trust or elsewhere that the grantor intended the trustee to assume the primary liability for the indebtedness, the instrument did require the trustee to make mortgage payments with trust income. The applicable state law provided that the acceptance of a trust with the obligation to make the payments on a debt was sufficient to constitute an assumption of primary liability.[38] Following this rule, the Fifth Circuit found the grantor to be a surety with only remote liability, contingent not only on the default of the trust but also on the existence of a deficiency after the foreclosure sale.[39] The court held that the discharge of such a contingent liability was too remote to constitute a taxable benefit to the grantor.[40]

In subsequent decisions the Fifth Circuit has followed *Estate of Hays* and distinguished *Blumenthal* on the grounds of state law.[41] Even the Commissioner has shown remarkable flexibility by arguing whichever side of the controversy results in the greatest revenue.[42] Nevertheless, *Blumenthal* is still viable and has been followed as recently as 1974.[43] While this continued reliance on a formalistic assumption of liability may be technically defensible, the results obviously have been inconsistent from state to state.

36. Helvering v. Blumenthal, 296 U.S. 552 (1935).

37. 181 F.2d 169, 1950-1 U.S.T.C. ¶10,762 (5th Cir. 1950).

38. *Id.* at 171, 1950-1 U.S.T.C. ¶10,762, at 12,929.

39. *Id.*

40. *Id.*

41. *See* Edwards v. Greenwald, 217 F.2d 632, 634, 1955-1 U.S.T.C. ¶9114, at 54,138-39 (5th Cir. 1954); *see* Malone v. United States, 326 F. Supp. 106, 111, 1971-1 U.S.T.C. ¶9475, at 86,698 (D.C. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972).

42. *See* Walther v. Commissioner, 316 F.2d 708, 1963-1 U.S.T.C. ¶9449 (7th Cir. 1963). The taxpayer expressly retained personal liability for a mortgage encumbering property transferred in trust and then claimed an interest deduction for payments made on the mortgage. The Commissioner asserted the exact argument rejected by the Supreme Court in *Blumenthal*: that the transfer of the encumbered property transformed the grantor from principal debtor to surety. Accordingly, it was asserted that the mortgage payments were voluntary and that the interest deduction should be disallowed. The Seventh Circuit, however, found that under state law the status of the mortgagor was unchanged by the transfer without a formal assumption and allowed the deduction. *Id.* at 710, 1963-1 U.S.T.C. ¶9449, at 88,220.

43. *See* Jack Wiles, 59 T.C. 289, 301, *aff'd per curiam*, 491 F.2d 1406 (5th Cir. 1972), *acquiesced in*, 1973-2 CUM. BULL. 4.

Other courts have recognized that the form of the transaction does not always reflect the economic realities of the grantor-grantee relationship.[44] As a general rule, the mortgaged property is the primary security for the debt.[45] Thus, even though the grantor remains personally liable after the transfer, he can still look to the property subject to the mortgage for satisfaction of the obligation. Consequently, to the extent of the value of such property, the grantor may be characterized as a "quasi surety."[46] This view conforms to the economic reality underpinning the transaction — that the grantor will never actually have to pay the debt himself so long as it is secured by collateral of equal or greater value.[47] This reality was clearly evident in *Blumenthal*, where the debt was secured by stock worth 10 times the amount due.[48] Under these circumstances, it was virtually impossible for the grantor to be subjected to personal liability. By giving away the collateral, the grantor, in substance, transferred the liability for the encumbrance. Of course, if the value of the collateral had declined below the amount of the debt, the grantor would have been liable for the difference. Barring such an eventuality, the payment of the debt subsequent to the transfer was an illusory benefit to the grantor and should not have been considered a constructive distribution of trust income within the meaning of section 677.

Liability Assumed by the Trust

The limitations of section 677 are more clearly demonstrated when the trustee expressly assumes full liability for the grantor's personal obligations. Here the subsequent application of trust income toward the encumbering debt discharges only the trustee's legal obligation. There is no basis under section 677 for attributing any trust income to the grantor because he is no longer primarily liable. Certainly the grantor in *Blumenthal* could have

44. *See* Herff v. Rountree, 140 F. Supp. 201, 1956-1 U.S.T.C. ¶9359 (M.D. Tenn. 1956).

45. *Id.* at 205-06, 1956-1 U.S.T.C. ¶9359, at 54,881-82.

46. *Id.*

47. The rationale of *Herff* is surprisingly compatible with the reasoning of the Supreme Court in the landmark case of Crane v. Commissioner, 331 U.S. 1, 1947-1 U.S.T.C. ¶9217 (1947). *See* note 8 *supra*. In *Crane* the Court reasoned that the owner of property worth more than an encumbering mortgage is under an economic compulsion to pay the debt rather than surrender the property. Thus, regardless of the legal liability, he would treat the mortgage as if it were his own debt. On transfer of the property there would be an assumption of liability, at least for tax purposes, since the new owner would be under the same economic compulsion. Therefore, in *Crane* there is an implied relief from liability because the new owner presumably will pay the debt so long as the property is worth more than the encumbrance. In *Herff* there is an implied relief from liability because even if the new owner does not pay the debt, the liquidation proceeds from the property will repay the obligation so long as the property is worth more than the encumbrance. The results are essentially the same except that *Crane* assumes the new owner will pay the debt, and *Herff* assumes that he will not. In both cases there is implied relief from liability so long as the property transferred is worth more than the indebtedness.

48. Blumenthal v. Commissioner, 76 F.2d 507, 508, 1935-1 U.S.T.C. ¶9270, at 9759 (2d Cir. 1935).

required the trustee to formally assume full liability. This would have been a negligible risk to the trustee since the accrued dividends at the time of the transfer almost equaled the balance due on the note.[49] In either case, however, the benefit to the grantor would have been essentially the same. She would have been relieved of liability either on the payment of the debt with trust income or on the assumption of the liability at the time of the transfer. Despite this economic reality, the application of section 677 would have the inconsistent result of taxing the grantor only in the former instance.

Where the assumption issue arose, early decisions failed to recognize the true nature of the transaction. In *Edwards v. Greenwald*,[50] two individuals acquired separate partnership interests in exchange for their personal notes. According to a prearranged plan, they immediately placed these interests in an irrevocable trust for the sole benefit of their children. The trust instruments named the grantors as trustees and provided for the assumption of the notes by the trustees in their representative capacity. The Service sought to tax the grantors on the subsequent payment of the notes with trust income on the authority of *Blumenthal*, but following *Estate of Hays*, the Fifth Circuit distinguished *Blumenthal* on the basis of a valid assumption of liability.[51] Additionally, the court noted that there was no independent and preexisting encumbrance, rather "the indebtedness of the trustee individually [meaning the taxpayers personally] was incurred contemporaneously with the establishment of the trusts and was incurred solely for the accommodation of the trusts and under the trust instruments no benefit or right to receive income was reserved to the trustees as individuals."[52] Finding no pecuniary benefit accruing to the grantors, the Fifth Circuit refused to attribute the trust income to them.

Although the court in *Greenwald* reached the correct result, their reasoning did not encompass the fundamental issues raised by an assumption of liability.[53] Under the rationale of *Greenwald*, it is unclear whether an assumption of the debt would have constituted a taxable benefit if the notes had been executed at a time prior to the transfer in trust. Moreover, the court apparently would have taxed the grantors had they remained primarily liable on the notes, but it is unclear why the lump sum assumption of an obligation results in less of a benefit than the piecemeal discharge of the debt from periodic installments of trust income.

The Fifth Circuit's inability to clearly articulate the rationale for the holding in *Greenwald* stems from its failure to comprehend the dichotomy between the tax consequences arising from the operation of the trust and those arising from the transfer transaction. When personal liability is assumed

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49. *Id.*

50. 217 F.2d 632, 1955-1 U.S.T.C. ¶9114 (5th Cir. 1954).

51. *Id.* at 634, 1955-1 U.S.T.C. ¶9114, at 54,138-39.

52. *Id.* at 634, 1955-1 U.S.T.C. ¶9114, at 54,138.

53. The court was obviously impressed with the fact that the grantor did not benefit from the proceeds of the loan since they were applied entirely for the benefit of the trust. Nevertheless, the benefit traditionally taxed by § 677 arises from the relief from liability, not from the use of the borrowed funds. The court ignored the benefit to the taxpayer arising from the trustee's assumption of his personal liability.

by the trustee, the benefit to the grantor is essentially the same as if the indebtedness were fully discharged, but this benefit is received in the transfer transaction. Since section 677 looks solely to the tax consequences arising from the subsequent operation of the trust, it is ineffective in detecting the true benefit realized by the grantor.[54]

Absence of Personal Liability

The dispute surrounding the assumption of liability becomes irrelevant in the instance of a nonrecourse encumbrance if the grantor has no personal liability for the trust to assume. Here the limitations of section 677 are manifest. After the transfer, the grantor has no further interest or obligation in regard to the trust property and receives no benefit from the discharge of its encumbrances.[55] Presumably, the grantor in *Blumenthal* could have negotiated a nonrecourse loan secured only by the stock as collateral, rather than her personal promise. Despite the substantial similarities in the net result, section 677 would appear inapplicable when the grantor had no legal liability for the debt. Like an assumption of liability, the benefit, if any, accruing to the grantor arises from the transfer in trust, not the operation of the trust. Even though the grantor is not personally liable prior to the transfer, he is burdened with the responsibility of paying the indebtedness or ultimately surrendering his property. After the transfer, this

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54. Under the part-sale, part-gift approach the grantor would also recognize no trust. Nevertheless, the benefit traditionally taxed by §677 arises from the relief gain, but the rationale for this result is clear. Because the grantor's note was for the full purchase price, this was also the amount of his cost basis in the property. Since amount realized equaled basis, no gain resulted. The contemporaneousness of the transactions was only relevant because it insured the equality between the encumbrance and basis. The same result would obtain if the note had been executed before the transfer so long as the amount of the note was still equal to the basis; however, gain would occur if the grantor had depreciated his basis without reducing the balance due on the note. This gain would reflect the tax benefit that had accrued to the grantor in the form of depreciation deductions from gross income. *See* Malone v. United States, 326 F. Supp. 106, 1971-1 U.S.T.C. ¶9475 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972).

55. *But see* Herbert A. Loeb, 5 T.C. 1072 (1945). In that case a creditor agreed to relieve the taxpayer of personal liability on his debts in exchange for a lien on certain stock, plus the right to 75% of the dividends from such stock for a period of 10 years. When the securities were subsequently transferred in trust, the Commissioner sought to attribute the grantor with the dividend income paid to the creditor by the terms of the agreement. The grantor argued that since he had no personal liability, the payments were not discharging his legal obligations. The court, however, concluded that the grantor had been released from personal liability on the indebtedness by "assuming for his own benefit a new and different obligation — the obligation to pay over the stipulated percentage of the dividend." *Id.* at 1077. Thus, the dividend payments were found to be discharging the grantor's new obligation and were attributed to him under §167 (now §677). It appears that the limitations of §167 forced the court in *Loeb* to utilize rather unrealistic reasoning. On the transfer of ownership, it was the trustee, not the grantor, who was legally obligated to pay the dividends to the creditor. It is clear that if the dividend had been withheld, the creditor's cause of action would have been against the trustee alone. The discharge of this obligation was of no benefit to the grantor, and he should not have been attributed with the income under §167.

burden is assumed by the trustee as the new owner of the property securing the indebtedness. The relief from this obligation is the benefit enjoyed by the grantor, but the transfer transaction in which this benefit is received is not within the purview of section 677. Thus, that provision is ineffective in accurately determining the correct tax consequences of such events.[56]

Source of Trust Funds That Satisfied Encumbrance

If the Commissioner, in his search for a taxable benefit, was frustrated by assumptions of liability and nonrecourse encumbrances, he must have been exasperated by the tax consequences of discharging an encumbrance with funds other than trust income. Since the basic purpose of section 677 is to attribute to the grantor any trust income that may be applied for his benefit, the realization of income is an absolute necessity. Without trust income, section 677 is, by definition, inapplicable.[57]

Recognizing the potential of this feature, ingenious tax counselors began to structure trusts so that cash could be generated without the realization of income. The most popular procedure is to discharge the indebtedness with proceeds from the sale or encumbrance of trust assets.[58] The trustee's receipt of borrowed money is not income because the concurrent obligation to repay the loan negates any increase in the net worth of the trust.[59] Similarly, the sale of trust assets normally does not create trust income, rather such proceeds are generally allocable to corpus.[60] However, the use of these funds to pay encumbering debts extinguishes any obligation that may have been retained. If this is accomplished prior to the realization of trust income, then section 677 is effectively avoided.[61] Subsequent trust income used to repay the borrowed money discharges only the obligation of the trust, not the grantor.[62] Thus, if the trustee in *Blumenthal* had paid the encumbering notes with funds other than trust income, apparently section 677 would have been inapplicable regardless of her personal liability.

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56. In the part-sale, part-gift approach, this transaction is resolved by applying the *Crane* doctrine, which results in the realization of the entire amount of the nonrecourse debt and the recognition of gain, if any, to the extent that such amount exceeded the grantor's basis. *See* notes 8, 47 *supra*. *See* Johnson v. Commissioner, 495 F.2d 1079, 1974-1 U.S.T.C. ¶9355 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1975).

57. INT. REV. CODE OF 1954, §677(a) reads in part: "The grantor shall be treated as the owner of any portion of a trust . . . *whose income* . . . is, or . . . may be . . . distributed to the grantor. . . ." (emphasis added).

58. *See, e.g.*, Lowenstein, *Federal Tax Implications of Gifts Net of Gift Tax*, 50 TAXES 525 (1972); Rief, *Donee-Paid Gift Taxes; Some Considerations*, 58 A.B.A.J. 1325 (1972).

59. *Cf.* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 1955-1 U.S.T.C. ¶9308 (1955); Woodsam Associates v. Commissioner, 198 F.2d 357, 1952-2 U.S.T.C. ¶9396 (2d Cir. 1952) (involving nonrecourse loan).

60. *See* INT. REV. CODE OF 1954, §643(a)(3). Although these proceeds may create taxable gain to the trust, so long as the terms of the trust do not allow such funds to be distributed to the beneficiaries, they will not be includible in trust "income." *See also* INT. REV. CODE OF 1954, §643(b).

61. Victor W. Krause, 56 T.C. 1242 (1971).

62. *Id.*

This plan was first recognized in *David Keith*.[63] Pursuant to a divorce proceeding, the taxpayer and his wife transferred property in trust for the benefit of themselves and their son. The trust instrument expressly directed the trustees to discharge the indebtedness of both grantors. To accomplish this and other objectives associated with the divorce, the trustees were authorized to raise the necessary funds by selling or encumbering trust property. In order to remove the resulting encumbrances or to restore the value of assets sold, the trustees were to create a sinking fund with 1/3 of the trust income. This plan was implemented and by 1930 all of the grantors' debts were liquidated, and the sinking fund was established.[64] Several years later the Commissioner sought to tax the grantors on the portion of trust income applied toward the sinking fund.[65] The Board of Tax Appeals found that the sinking fund payments made subsequent to the complete discharge of the indebtedness were neither subject to the grantors' control nor applied for their benefit within the meaning of section 167 (now 677).[66] Thus, trust income in years following the discharge was held not to be attributable to the grantors.[67] Since the tax consequences in the year of discharge were not at issue, all tax exposure arising from the debt payments was avoided.

The rationale of *David Keith* was reaffirmed in *Estate of Annette S. Morgan*[68] and is not a well established tax planning tool.[69] Furthermore, the decision of *Victor W. Krause*[70] resolved any doubts regarding the tax consequences arising under section 677 in the year the indebtedness is discharged. In that case, the Tax Court held that if the trustee has the discretion to apply income to the grantor's obligations, then the grantor is taxed on the accrued income as of the date of the discharge.[71] This result obtains regardless of whether the trust income is actually applied toward the indebtedness since section 677 is triggered by the mere discretion to distribute income for the benefit of the grantor. However, if the obligation is discharged

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63. 45 B.T.A. 644 (1941).
64. *Id.* at 645-46.
65. *Id.* at 646.
66. *Id.* at 647.
67. *Id.*
68. 316 F.2d 238, 1963-1 U.S.T.C. ¶9401 (6th Cir. 1963), *aff'g per curiam* 37 T.C. 981 (1962); *see also* Victor W. Krause, 56 T.C. 1242 (1971). *But see* Clifton B. Russell, 5 T.C. 974 (1954) (where grantor was taxed when he loaned money to the trustee for payment of a preexisting encumbrance assumed by the trust); Rev. Rul. 57-564, 1957-2 CUM. BULL. 328 (grantor was taxed when terms of trust instrument specifically direct the course of action to be followed by the trustee in borrowing the money).

69. In recent years this plan has been most popular in the field of net gifts when the donee is required to pay the donor's gift taxes resulting from the transfer. If the property is transferred in trust under such conditions, the Commissioner has asserted that the application of trust income toward these taxes discharges the legal obligation of the grantor (*i.e.*, his gift taxes) and is, therefore, a distribution for his benefit within the meaning of §677. The issue is essentially the same as when the property is encumbered with the grantor's preexisting indebtedness; the only difference is that in the net gift instance it is the grantor's gift taxes that encumber the property.

70. 56 T.C. 1242 (1971).
71. *Id.* at 1246.

prior to the realization of trust income, then there is no income that may be attributed to the grantor, and all tax liability under section 677 is effectively avoided.[72]

In these circumstances it is painfully apparent that the grantor is receiving, tax free, the same benefit held taxable to the grantor in *Blumenthal*. The only difference is that under the *David Keith* scheme the benefit is conferred with borrowed money in a lump sum discharge rather than from the direct application of trust income. In either case, the trust ultimately bears the burden; however, when trust income is finally applied under the above plan, the trustee is the obligor, not the grantor. The result is identical to a full assumption of liability — the issue that has troubled courts throughout the application of section 677. In instances when indebtedness is assumed on transfer, section 677 is inapplicable because the benefit did not arise from the operation of the trust. In the *David Keith* plan, the benefit arises from the operation of the trust, but section 677 is still inapplicable because the specific operation does not include trust income. With such a narrow scope of view, it is essentially impossible to accurately determine the true taxable benefits accruing to grantors who transfer encumbered property in trust.

Tax Consequences of the Transfer in Trust: The Alternative Approach of the Part-Sale, Part-Gift Concept

As the inadequacies of section 677 have become increasingly apparent, the Commissioner has sought to develop an alternative rationale for determining the tax consequences of using encumbered property as a trust corpus. In this effort, attention has been focused on the transfer in trust rather than the subsequent trust operation.

When property is conveyed in trust for no consideration, the transaction is treated as a gift.[73] Traditionally, the grantor has realized no income from such an event since any gain that he might have accrued from appreciation in value was deferred by transferring his basis to the trust.[74] However, when encumbered property is the subject of the transfer, the Commissioner has begun to assert that the discharge or assumption of the grantor's obligation is a taxable benefit extended by the trust as consideration for the receipt of the property. Under this theory, the transaction is characterized, not as a pure gift, but as a part-sale, part-gift transaction.[75]

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72. Although the question has never been litigated, it would appear that the distribution of trust funds from a depreciation reserve would also avoid the purview of §677. Normally depreciation deductions are allocated among the beneficiaries in proportion to their share of trust income. However, Treas. Reg. §1.167(h)-1(b) provides that any portion of the deduction may be allocated by the trust instrument to the trustee for the purpose of maintaining a depreciation reserve. It would seem that this cash reserve would not be trust "income" since any gross income retained by the trustee would be reduced by the deduction for depreciation. Accordingly, any payment on encumbering debts made from this fund would not be attributed to the grantor under §677.

73. Int. Rev. Code of 1954, §§2511(a), 2512(b).

74. Int. Rev. Code of 1954, §1015.

75. *See* Malone v. United States, 326 F. Supp. 106, 1971-1 U.S.T.C. ¶9475 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972).

As a partial sale instead of a pure gift, the transfer in trust of encumbered property is no longer considered a tax free event.[76] The amount of the encumbrance assumed or discharged is the amount realized in the sale portion of the transaction. From this amount, the grantor is entitled to restore his adjusted basis as a tax free return of capital, but any amount realized in excess of basis is recognized as taxable gain.[77] If the property transferred consists of capital assets held for more than six months, the resulting income will be taxed as long term capital gain.[78] As before, the grantor's basis will be transferred to the trust, but in addition to the normal credit to basis for gift taxes paid on the transfer, the trust is also entitled to increase its basis by the amount of gain recognized by the grantor.[79]

The characterization of a transfer as a partial sale depends on the grantor's receipt of consideration in the form of relief from a legal obligation. The approach brings to the fore once again the troublesome issue of the assumption of liability. If the trust formally assumes a personal obligation, then the benefit to the grantor is reasonably clear under notions of *Old Colony Trust*,[80] but the issue is inevitably complicated by the transfer of property subject to nonrecourse encumbrances. In this context the Commissioner has applied the *Crane* doctrine[81] and broadly asserted that the amount of the encumbrance is always realized by the grantor on transfer, regardless of whether he is personally liable for the indebtedness or whether such liability is formally assumed by the trust.[82] This approach provides a comprehensive method of determining the tax consequences of funding trusts with encumbered property and avoids the limitations of section 677.

The Commissioner, however, has been somewhat reluctant to adopt exclusively the part-sale, part-gift approach,[83] perhaps because it generally results in the realization of long term capital gain rather than ordinary income as under section 677. Nevertheless, if the transfer in trust is within the parameters of *Crane*, the subsequent application of section 677 should be

76. TREAS. REG. §1.1001-1(e)(1) reads in pertinent part: "Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis."

77. *Id.*

78. *But see* TREAS. REG. §1.1245-4(a)(3) for potential recapture.

79. INT. REV. CODE OF 1954 §§1015(a), (b), (d). *See also* TREAS. REG. §1.1015-2, -4; Citizen's National Bank v. United States, 417 F.2d 675, 1969-2 U.S.T.C. ¶9622 (5th Cir. 1969) (TREAS. REG. §1015-4 was held invalid to extent that it provided a cost basis rather than transferred basis precluding the tacking of grantor's holding period); Johnson v. Commissioner, 495 F.2d 1079, 1974-1 U.S.T.C. ¶9355 (6th Cir. 1974) (TREAS. REG. §1.1015-2 was suggested as the appropriate regulation controlling basis computation for part-sale, part-gift transfers in trust).

80. *See, e.g.*, Malone v. United States, 326 F. Supp. 106, 1971-1 U.S.T.C. ¶9475 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972).

81. *See* notes 8, 47 *supra*.

82. *See* Johnson v. Commissioner, 495 F.2d 1079, 1974-1 U.S.T.C. ¶9355 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1975) (the Sixth Circuit held for the first time that encumbered gifts in trust are within the parameters of *Crane*).

83. *See, e.g.*, Jack Wiles, 59 T.C. 289 (1972), *aff'd per curiam*, 491 F.2d 1406 (5th Cir. 1974), *acquiesced in*, 1973-2 CUM. BULL. 4.

precluded. The rationale of *Crane* mandates a realization of the indebtedness that closes the transaction as to the grantor, and a gain, if any, will be recognized only at the time of transfer. The amount of the encumbrance cannot be realized again during the subsequent operation of the trust. Thus, while the *Crane* doctrine provides an effective alternative when section 677 is avoided, it is also apparent that the rationale provides an equally effective defense when section 677 would otherwise be applicable.[84]

CONCLUSION

Despite its limitations, the Commissioner has continued to utilize section 677 in determining the tax consequences of using encumbered property as a trust corpus. By insisting on a formal assumption before relieving the grantor of primary liability, an occasional victory has been salvaged when careless taxpayers fail to meet the technical requirements of local law.[85] Nevertheless, it is obvious the variety of planning alternatives has enabled knowledgeable taxpayers to circumvent section 677 with impunity. If personally liable for the encumbrance, the grantor need only provide for the formal assumption of the indebtedness or for its payment with funds other than trust income. If it is possible to borrow without personal liability, then the property need only be transferred subject to the nonrecourse obligation. Since in negotiating the loan or in drafting the trust instrument the grantor has exclusive control over these determinative factors, tax avoidance is inevitable.

To determine the proper tax consequences in the above instances, the Commissioner must adopt the part-sale, part-gift approach of *Crane*. This treatment provides equitable, consistent, and predictable results that effectively preclude the subsequent application of section 677. Therefore, it is both necessary and desirable for the Commissioner to recognize the preemption of this provision and to accept the part-sale, part-gift rationale as the appropriate method of determining the tax consequences of funding trusts with encumbered property.

JOSEPH BAIRD LEFTER

84. *See* Citizen's National Bank v. United States, 417 F.2d 675, 1969-2 U.S.T.C. ¶9622 (5th Cir. 1969).

85. Typical of the Commissioner's recent applications of §677 is *Jack Wiles*, 59 T.C. 289 (1972), *aff'd per curiam*, 491 F.2d 1406 (5th Cir. 1974), *acquiesced in*, 1973-2 CUM. BULL. 4. The grantor in that case conveyed property encumbered by a mortgage on which he was personally liable. Although the inartfully drawn trust instrument apparently required the trustee to pay the mortgage installments, it was unclear whether there was an express assumption of primary liability. One clause stated that the trustee was to assume "certain indebtedness as hereinafter specified." *Id.* at 301. But no language thereafter provided for such an assumption. The court ultimately construed the instrument as not providing for an assumption; therefore, the grantor was found to be primarily liable for the mortgage. Following *Blumenthal* §677 was applied, and the grantor was taxed on the trust income used to pay the indebtedness.