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Trusts and Their Tax Saving Advantages

Richard B. Nystrom

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TRUSTS AND THEIR TAX SAVING ADVANTAGES

by
Richard B. Nystrom

Bachelor of Science, Business Administration
Wisconsin State University at Superior 1966

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Lyle C. Steinmier
(Advisor)

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CHAPTER I

Introduction

The general purpose of this paper "Trusts and Their Tax Saving Advantages" is to transmit to the reader information regarding the taxation of trusts. It is not the idea to be specific in all chapters of the paper, but the reader, upon completion, should have more than a general knowledge of trust taxation. A comprehensive paper regarding all the specific points covering all types of trusts would be impractical.

This paper covers the definition of terms relative to the trust relationship, the tax advantages available to trusts, the mechanics involved regarding the gross income, deductions, and allowances contained in the Internal Revenue Code and a discussion of the popular Short Term or Clifford Trust. The paper has been written with the approach of consolidating the opinions of a number of expert tax attorneys who have written numerous books and articles on the subject of trust taxation. This method or approach should give the best possible interpretations of the Internal Revenue Code and the court cases which are a part of our tax law by judicial interpretation.

CHAPTER II

Trusts in General

The first step in the discussion of trusts is to define the terms which are relative to the discussion and the parties involved in a trust relationship. According to Webster's Third New International Dictionary, a trust is defined as:

> A property interest held by one person for the benefit of another; an equitable right or interest in property distinct from the legal ownership of it.[1]

A more concise definition which presents the legal interpretation of a trust is:

> A fiduciary relationship with respect to property, subjecting the person by whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.[2]

There are generally three or more parties to a trust relationship. These parties are called the grantor, trustee, and beneficiary or beneficiaries.

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[1]Noah Webster, Webster's Third New International Dictionary, ed. by Phillip Babcock Gove (Springfield, Massachusetts: G. & C. Merriam Company, 1961), p. 2456.

[2]John Alan Appleman, Basic Estate Planning, Vol. II; (New York City, New York: Matthew Bender and Company, 1957), p. 483.

The grantor is defined as the owner of the trust property or the person who creates the trust. There are also a number of terms which are used interchangeably with that of the grantor. These terms include trustor, donor, or settlor. "The word settlor being taken from the old legal language of settling the property in trust."[3] In this discussion the term grantor will be used.

The person who is given the duty of administering the trust is called the trustee and is said to be in a fiduciary relationship in regards to the entire trust. It is the duty of the trustee to use care and diligence in the performance of his duties for the benefit of the beneficiary. The three most important of the subsidiary duties of the trustee are: (1) the duty to preserve trust property, (2) the duty not to delegate the administration of the trust, (3) the duty not to profit at the expense of the beneficiary within the scope of the fiduciary relationship.[4] If the preceding duties are breached by the trustee, the beneficiary can enforce his rights in a court of equity.

"The person for whose benefit a trust is created is commonly referred to as the cestui que trust or simply as the beneficiary."[5] In this discussion, the term beneficiary

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[3]Ronald A. Anderson and Walter A. Kimpf, Business Law, 8th Edition, Comprehensive Volume, (Chicago, Illinois: South Western Publishing Company, 1968), p. 673.

[4]Appleman, p. 483.

[5]Austin W. Scott, The Law of Trusts, Vol. I, 3rd ed., (Boston, Massachusetts: Little Brown & Co., 1967), p. 46.

will be used. There may be one beneficiary or a number of beneficiaries depending on the grantor's intent or wish. The beneficiary or beneficiaries are named in the trust instrument.

The property which is transferred in trust is called the trust corpus, trust res, trust fund or trust estate. The trust corpus, which will be used in this discussion, is generally regarded as the principal of the trust as distinguished from the income which is earned on the principal. An excellent example distinguishing between trust corpus and income is where stocks and/or securities are transferred in trust. The stock or security certificates are regarded as trust corpus whereas the dividends which the corpus earns is regarded as trust income. It is important to distinguish between principal and income because the trust instrument may specify that trust corpus is not to be distributed to the beneficiary, or that all long term capital gains are to become a part of trust corpus. These points will be discussed in subsequent chapters of the paper at a greater length.

A trust relationship can be created in two different manners: a trust instrument or the intent and position of the parties. The manner of creation classifies the trusts as either express or implied.

> An express trust is a trust created by the direct and positive acts of the parties as evidenced by same deed, will, or other instrument, wherein the language employed

> either expressly or by plain implication evidences an intention to create a trust.[6]

In other words, an express trust is in writing and the writing or trust instrument creates the trust.

> An implied trust is defined as those trusts which, without being expressed, are deductible from the relation of the parties and the nature of the transaction as matters of intent or which by operation of law are deducted from the transactions of the parties as a matter of equity independent of the particular intention of the parties.[7]

Generally, an implied trust is not written and arises by operation of law. In the case where land or real property is transferred in trust, a writing is required to satisfy the Statute of Frauds.

The law requires that a number of conditions must be met in order to create a trust. "There must be a grantor, an intention to create a trust, trust property, a trustee, and a beneficiary."[8]

The grantor is the owner of the property and he must make a disposition of the property. He cannot simply assign his rights to income, he must transfer title to the property in trust for the benefit of another. The grantor must also make a manisfestation of intent that a trust come into being. Generally, the grantor must possess the same capacity

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[6]Estate Planning, Vol. II, (Englewood Cliffs, New Jersey: Prentice Hall Inc., 1969), p. 3506.

[7]Ibid.

[8]Appleman, p. 482.

to contract as in the case of ordinary contracts.

There must be present a form of trust property either tangible or intangible. Obviously, there isn't any point to the creation of a trust if the property does not exist; in fact, there isn't an advantage to the creation of a trust unless the property is income producing. There is one very incidental advantage to the above which will be discussed later.

The requirement that there be a trustee is again obvious. Without a trustee, a trust is not created. The trustee must possess certain traits in order for the trust to be valid. These include the capacity to receive title, the capacity to hold title to the property and the capacity to administer the trust.

The beneficiary requirement demands that the beneficiary be certain or defined at the time a trust is created or at a time subsequent to creation but within the rule of perpetuities.

> The rule of perpetuities prohibits a person from creating by any transfer, whether in trust or not, a floating interest in property that will not become definite or vested until a date further away than twenty-one years after the death of persons alive at the time the owner of the property attempts to create the interest.[9]

This rule stems from the governments' position against having property ownership in one person or family for such a long period of time.

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[9]Anderson, p. 674.

The subject matter of a trust must be lawful, definite property.

> There is no limitation or restriction on its kind or nature, it being the rule that a trust may exist in any property, real or personal, legal or equitable, which is in existence and which, in the eye of a court of equity, is of value.[10]

Property which is commonly transferred in trust consists of the following: common stocks; preferred stocks; corporate bonds; municipal bonds; income producing real property; income producing land; deposits in bank accounts; promissory notes; an interest in a patent; a growing crop; leaseholds; future earnings; choses in action; proceeds from life insurance policies; etc. The preceding list is not exhaustive, but it does give us an idea of the variety of items that may be transferred in trust.

The classifications of trusts are numerous. Up to this point, trusts have been classified as express and implied, based on the manner in which they were created. The classification of implied trusts is defined in more detail as constructive and resulting trusts. This classification will be only mentioned, as it pertains to primarily the legal profession.

The Internal Revenue Code classifies trusts as to income distribution. The classifications are simple and complex trusts.

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[10]Harold J. Gilbert and Francis J. Ludes, Corpus Juris Secundum, Vol. LXXXIX, (Brooklyn, New York: The American Law Book Company, 1955), p. 740.

> A simple trust is one that provides for the current distribution of all its income, does not provide for any charitable beneficiaries, and does not make any distributions in a given year other than its current income.[11]

As distinguished from a simple trust a complex trust is defined as:

> A trust other than a simple trust; ordinarily the trustee either must, or may and does, accumulate income, and may possess powers with respect to the distribution of corpus and the making of gifts to charities.[12]

The specific trust may, by reason of the above rules, be a simple trust one year and a complex trust the next or visa versa. The classification of the trust is important because trusts have different deductions as is discussed later under the chapter "The Taxation of Trusts."

Trusts are also classified as to charitable and private. A private trust is one which is created for family or private purposes as distinguished from a trust which distributes its income to charitable organizations. The charitable trust has in the past enjoyed special treatment which will be discussed in a subsequent chapter.

Trusts are also classified as to when creation takes place based on the donor's time of transfer to a trust.

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[11]Mark H. Johnson and Jacob Rabkin, Federal Income, Gift, and Estate Taxation, Vol. LV, (New York City, New York: Matthew Bender and Company, Inc., 1962), p. 5458.

[12]John C. Chommie, Federal Income Taxation, (St. Paul, Minnesota: West Publishing Company, 1968), p. 316.

If the transfer is made during the donor's life, the trust is an inter vivos trust or a living trust. In the case where the trust is created by will upon the donor's death the trust is considered a testamentary trust.

CHAPTER III

The Taxation of Trusts

Section 641 of the Internal Revenue Code establishes the trust as a separate taxable entity only if the following restrictions are observed by the grantor.

> The grantor cannot: (1) retain the power to revoke the trust, (2) retain control over the beneficial enjoyment of the trust, (3) retain the power to administer the trust for his own benefit, (4) provide that the income be used for his benefit, (5) have the trust corpus revert to him within at least ten years.[13]

These five rules are known as the "Clifford Rules" and are discussed in detail in the chapter entitled "The Popular Clifford Trust." If the so called Clifford Rules are not complied with by the grantor, the trust will continue to be a trust for legal purposes, but for tax purposes the trust will fail as a separate taxable entity. Consequently, the trust income will be taxable to the grantor.

Trust corpus consists of the property transferred to the trust plus any additional increases in corpus from income which is generally governed by specific provisions in the trust instrument. The trust instrument may provide

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[13]Chommie, p. 317.

for specific items to be allocated between trust corpus and trust income or the trust instrument may give the trustee discretionary power to determine what is to be allocated to corpus and/or income. For example, the trust instrument may specify that all capital gains resulting from the sale of trust property are to be allocated to the trust corpus or that the original premium or discount on bonds transferred in trust is to be amortized and charged to income or allocated to the trust corpus. There are many instances where problems arise as to trust corpus or trust income. Each state has a body of laws governing the allocation of income to trust corpus or trust income. In the absence of a provision in the trust agreement, the applicable state law will apply.

The allocation of expenses to trust corpus and trust income becomes an important and technical process when a trust involves a life tenant and a remainderman. A trust may be created upon the grantor's death whereby the income from the trust is to be distributed to a beneficiary for his or her life. This beneficiary is called the life tenant. Upon the death of the life tenant, the trust corpus is to be transferred to a person who is commonly referred to as the remainderman. He is, in essence, the heir of the original grantor regarding the property in trust, whereas the life tenant enjoys the income from the trust for his or her life. In this manner, the family reduces its estate taxes by the mere fact that the property is not taxed twice on the transfer. The tax will be imposed upon the transfer to the remainderman and a gift tax will be imposed upon the transfer of the property in trust.

At the time the property is transferred in trust, a gift tax is imposed upon the grantor or donor of the gift. The donor has a lifetime exemption from the gift tax in the amount of $30,000. The $30,000 exemption is limited to $3,000 per person or donee. The donee, or beneficiary of the gift, in turn, will have an exemption of $3,000. As an example, assume A transfers in trust, securities with a fair market value of $6,000 for B and C. The gift tax on the transfer is 0. After the transfer, A will have $24,000 remaining of his lifetime exemption, and B and C will have used their entire exemption regarding gifts by the transfer from A in the current year. The above example is constructed on the basis that this was the first gift made during the donor's lifetime. The gift tax is not computed on the basis of present year gifts when previous gifts have been made. The prior years' gifts must also be taken into consideration. Stated in general terms, all gifts must be included in the computation taking into consideration the exemptions and a new tax is calculated. The donor receives a credit against this new tax for the tax he has paid in previous years.

The gift tax on the transfer of property in trust is based on the fair market value at the time the property is transferred in trust. If the trust is a short term trust, where the property is to revert to the grantor after a specified period of time, the present value of the reversionary interest must be deducted from the fair market value to arrive at an adjusted value. The value which is placed on the reversionary interest is difficult to determine and is viewed with close scrutiny by the Internal Revenue Service. The basis of the property transferred in trust is usually the fair market value of the property at the time the property is transferred. The grantor is not taxed on the so called paper profit resulting from his basis being lower than the fair market value at the date of transfer.

The gift tax rates are low in comparison with the individual income tax rates. For example, the gift tax on a $6,000 gift made by the donor to two different individuals equally is $165. One can readily see that the gift tax rates are extremely low and should be used to a certain extent in the planning of an individual's estate.

"The gross income of a trust is determined in the same manner as that of an individual."[14] In other words, if it is excluded for individual tax purposes, such as tax exempt bond interest income, it is excluded for trust tax purposes. Some of the more common forms of income which are included in trust income are rent, royalties, interest income,

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[14] 1970, U.S. Master Tax Guide, (Chicago, Illinois: Commerce Clearing House Inc., 1969), p. 166.

and dividends.

The Internal Revenue Code provides that the gross income of a trust includes:

1. Income accumulated in trust for unborn or unascertained persons.
2. Income which is to be distributed currently by the fiduciary.
3. Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.[15]

The trust is allowed by the Internal Revenue Code to deduct certain expenses and is allowed certain deductions. The deductions will be discussed first. The deduction allowed for distributions to beneficiaries depends on the type of trust. A simple trust is allowed a deduction of $300 whereas a complex trust is allowed a deduction of $100. As was stated in the preceding material, a trust can be a simple trust one year and a complex trust the next. The determination of the type of trust is important in the application of the above deductions allowed by the Internal Revenue Code. The trust as a separate taxable entity does not receive any deductions for personal exemptions or dependents as compared to individuals.

The remaining deductions allowed a trust are depreciation, depletion, taxes, interest, charitable contributions, loss carryovers, and capital gains deductions. The trust instrument may state in which manner these deductions are to be dealt with regarding allocation to trust corpus

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[15] 1970, U.S. Master Tax Guide, p. 166.

and income. In the absence of a provision in the trust instrument, the local state law applies. For example, depreciation, by a specific provision in the trust instrument, may be allocated to a reserve to provide for the replacement of an asset. In the case where the local law applies, the deduction for depreciation will usually be allocated to the trustee or trust and the beneficiary on the basis of income attributable to each.

The charitable contribution deduction is unlimited for a trust in the normal circumstance. The trust can take a deduction for amounts paid or permanently set aside for a donation to a charity. This deduction differs from the deduction allowed individuals which is limited to a maximum of 30% of adjusted gross income. The trust may lose its unlimited contribution deduction if it is managed in such a way as to involve itself in certain prohibited transactions. The prohibited transactions involve detailed situations which would involve parties to the trust such as the trustee, grantor, and beneficiary. Actually, a breach of fiduciary duty by the trustee and grantor or beneficiary, which involves tax evasion, constitutes the prohibited transactions.

The trust usually incurs during the taxable year two types of expenses. Those which are regarded as normal business expenses incurred in carrying on a trade or business and non-business expenses or expenses incurred in the administration of the trust. The two types of expenses are deductible by the trust. The expenses of administration must be reasonable. If a trust involves a security, the interest of which is non-taxable, the expenses of administration will not be allowed as a deduction. The theory here being, if it's not included in gross income, the deduction will not be allowed.

The trust's taxable income is the gross income of the trust less all deductions for expenses of administration, expenses incurred in carrying on the business of the trust, the dividend exclusion, the deduction for distributions to beneficiaries, and all distributions made to beneficiaries. If the trust is a simple trust in which all the trust's income is distributed, the trust will not have any taxable income and will not incur any tax liability. If the trust is a complex trust, the taxable income of the trust will be that amount which remains after the above deductions are taken. In the case where the trust has taxable income, the trustee is required to file the trust's tax return.

The deduction or deductions for distributions to beneficiaries by the trust, are in turn included in the gross income of the beneficiary. There is a limit to the amount which must be included in the beneficiaries gross income. This upper limitation is called distributable net income.

> The law sets up a yardstick called "distributable net income" to limit:
>
> 1. the amounts the beneficiaries must include in their gross income.

2. the deductions the fiduciary may take for distributions.[16]

The beneficiary does not, in any case, report more than his or her share of distributable net income. The distributable net income is calculated by taking taxable income of the trust (gross income less all deductions) and adding the following: distributions made to beneficiaries; the dividend exclusion; long term capital gains deduction and any capital losses deducted by the trust. From this adjusted amount the net capital gains taxable to the trust is deducted.

The trust's taxable income, if there is any, is subject to individual single tax rates. Previously, there has been a wide gap between the rates for a head of the household, married persons filing jointly and the individual single rates. The individual single rates being higher. This has to some extent been modified by the 1969 Tax Reform Act. The rates for individual single persons are still higher than those for heads of households and married persons filing jointly, but the gap has been narrowed to a certain extent.

The tax advantages of the trust are numerous. An important advantage is the shifting of income from a person in a high tax bracket to someone in his family in a low tax bracket, thereby saving the family tax dollars. For

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[16]Federal Tax Course, Student's Edition, (Englewood Cliffs, New Jersey: Prentice Hall, 1969), p. 3005.

example, let's assume that A is a successful businessman in a 50% tax bracket. B, his son, is a young professional man just starting his career and is in the 18% tax bracket. A transfers a four unit apartment building in trust for B. The income from the apartment building can effectively be taxed at the 18% rate or B's rate by means of a trust. This would result in a tax saving every year until the beneficiary B increases his income until he reaches the 50% tax bracket. The shifting of income from a high bracket taxpayer and the exact amount of the savings involved is discussed in detail in the hypothetical example in the chapter entitled "The Popular Clifford Trust."

The elimination of estate tax is also an important advantage of the trust. For tax purposes, a transfer in trust of property for another, whereby there isn't any reversionary interest, the property is not included in the decedent's estate for tax purposes. In other words, in effect, the grantor disposes of the property by gift and this bars inclusion under estate tax law. There are a number of tax consequences regarding the estate tax that must be taken into consideration. In estate planning, consideration should be given to the marital deduction and the general estate deduction of $60,000 before planning a savings by means of the trust.

Another advantage to the trust in estate planning is where the grantor wants to save the second tax. In this case, where a husband wants to make sure that his wife has income to support herself until her death, yet does not want the estate taxed twice, once when he dies, and once when she dies leaving the estate to their children, the trust is a valuable shelter. The husband can transfer the property in trust with the income to be distributed for life to his wife and upon her death, the trust corpus is to pass to their children. The wife, in this instance is called the life tenant and the children are called the remaindermen. In this case, the transfer would be included in his estate, if the transfer took place at his death, but would not be included in his wife's estate upon her death. This testamentary trust is distinguished from the inter vivos trust where the estate tax would be eliminated altogether.

There is a limitation on trusts that should be mentioned. The accumulation rule is a rule designed to prevent a complex trust from accumulating income and distributing the income in a lump sum to the beneficiary. This rule was enacted and many tax experts found numerous loopholes which prevented taxation of this accumulated income. The 1969 Reform Act has eliminated most of these loopholes and attempts to tax that income which is accumulated for a beneficiary's benefit.

Previously, the Throwback Rule was limited to the five preceding years and did not apply to capital gains income.

The following exceptions were made in regard to the Throwback Rule:

1. Distributions not in excess of $2,000.
2. Distributions before beneficiary's birth or the attainment of age 21.
3. Distributions to meet beneficiary's emergency needs.
4. A final distribution made more than nine years after the date of the last transfer to the trust.
5. Certain required distributions from Pre '54 trusts upon the beneficiary reaching a specified age.[17]

The Throwback Rule under the 1969 Tax Reform Act is designed to prevent the accumulation of trust income.

The major points which are relative are as follows:

1. After 1973 all of the above exceptions cease to be exceptions under the new Throwback Rule.
2. From 1969-1973 exceptions 2,3,4, and 5 will apply to the extent that the distribution is thrown back to income accumulated by a trust in taxable years before 1969.
3. The new Throwback Rule does not have a time limitation and it does apply to capital gains income.
4. The new Throwback Rule does not apply to income accumulated before 1969.[18]

The beneficiaries taxable income in the future will consist of the following: regular taxable income; ordinary income accumulated in trust; and capital gains income accumulated in trust. This income will be taxed if distributed or not to the beneficiary.

The 1969 Tax Reform Act regarding the accumulation of income makes the trust a little less attractive for persons

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[17]The Research Institute of America Inc., "1969 Tax Reform Act," <u>The Planning Report</u>, (New York City, New York: The Research Institute of America Inc., 1970), page 205.

[18]<u>Ibid</u>.

who previously set up trusts to accumulate income for children to be distributed when they reach majority. The other advantages previously discussed, however, are not affected by this rule.

The 65 Day Rule is another consideration in trust planning and administration. According to this provision, the trustee is allowed sixty-five days in which to determine the net income of the trust and in which to make distributions to the beneficiaries. The 1969 Tax Reform Act has reinstated this rule with some exceptions. The exceptions cover specific instances in which the 65 Day Rule will be disallowed and are too detailed for a paper of this type. The accountant should be aware of this provision and consult a standard tax service if the situation should arise.

CHAPTER IV

The Popular Clifford Trust

Before enactment of the Internal Revenue Code of 1954, trust taxation was a gray area and most of the rules and regulations that pertained to trusts were obtained from court decisions. In 1946, the modern area of trust taxation was begun by the Supreme Court decision in Helvering v. Clifford, 309 U.S. 331. From 1946 on, numerous cases involving trusts were brought before the Supreme Court until in 1954 the Internal Revenue Code enacted the so called "Clifford Rules."

The Clifford Trust, an express trust, is described as follows: Clifford, the donor, declared himself trustee. His wife was declared beneficiary and was to receive all the income from the trust. After a five year period or upon the death of either, the trust was to terminate. During the term of the trust, Clifford (the donor) was to have complete discretion in the distribution of income and broad powers of administration regarding the trust. In regard to broad powers of administration, Clifford retained the entire voting power of the securities, absolute power to buy, sell or exchange securities and the power to collect all revenue.

In Helvering v. Clifford, 309 U.S. 331, three factors of the trust were considered by the Supreme Court:

1. The duration of the trust was to be five years.
2. The grantor's wife was designated as the beneficiary.
3. The grantor had designated himself trustee, had retained broad powers of administration, and had absolute discretionary power over income distribution.[19]

In summary regarding the above case, the Supreme Court said:

> In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the principle by respondent all lead irresistibly to the conclusion that the respondent continued to be the owner.[20]

Following the Clifford Case, numerous cases were brought before the Supreme Court because of the ambiguity of the court's decision. These cases were the foundation upon which the Clifford Rules were constructed and enacted in the Internal Revenue Code of 1954. We have had, since that time, certain modifications in short term trust taxation but they have been minor.

The case of Commissioner of Internal Revenue v. Borbour, 122 F2D 165, is considered a precedent case which involves the reversionary interest rule. The facts of the case state that Borbour set up a short term trust involving corporate stock. The beneficiaries, his wife, his children, and his wife's mother, were to receive 4/10, 1/10 to each

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[19]Johnson, p. 5805.

[20]Helvering v. Clifford, 309 U.S. 331, 1946.

of his three children, and 3/10 respectively. The first deed of trust stated that the trust was to have a duration including subsequent extensions of six years and sixteen days after the duration, the corpus of the trust was to revert to the grantor.

In its decision regarding this case, the Supreme Court stated: "We find here the same retention by the taxpayer of the reversion and the same temporary reallocation of income within an intimate family group as in the case of Helvering v. Clifford, 309 U.S. 335." It was therefore held, in this case, that the income from the trust was taxable income to the grantor by means of the reversionary interest which he retained.

The enactment of the Internal Revenue Code of 1954 states that:

> The grantor is taxable on trust income if he has a reversionary interest which is to take effect within ten years after the creation of the trust.[21]

There are exceptions to the above rule. If the reversionary interest is to become effective upon the death of the beneficiary, and the beneficiary's life expentancy is greater than ten years, the reversionary interest is without effect on the taxable nature of the trust. Also, a life estate to an elderly parent is not deemed to have an effect on the trust's non-taxable position. Another exception to the reversionary rule is that the time limit may be reduced to two years in the case of a charitable trust. Noncompliance

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[21]Johnson, p. 5810.

with this code rule is sufficient grounds to justify taxation to the grantor. Trust planning requires that this condition must be met by the trust to insure the tax saving advantages through the distribution of income to lower bracket taxpayers.

The Internal Revenue Code of 1954 states the following in regard to control over the distribution of income of the short term trust.

> Where the power of control over the distribution of income is held by the grantor or a related or subordinate person or nonadverse party or both without the approval or consent of an adverse party, the trust income will be taxable to the grantor.[22]

There are a number of exceptions to this general rule which are self explanatory. The grantor of the short term trust will not be taxed on the income of the trust if he has reserved the power to:

1. Distribute income for the support of dependents.
2. Beneficial enjoyment after the ten year period.
3. Distribute income or principal or both by will.
4. Distribute trust principal.
5. Distribute income or principal during a beneficiary's minority or disability.
6. Determine between principal and income of the trust.

The case of George v. Commissioner of Internal Revenue illustrates the Supreme Court's position regarding control over distribution of income and the governments' acceptance of their position. This led to the inclusion of the forementioned rule regarding the control over distribution of income in the Internal Revenue Code of 1954. The pertinent facts in this case are as follows: The grantor was also

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[22]Johnson, p. 5816.

one of the three trustees and retained the following powers as grantor. The grantor may at any time modify or alter this instrument and the grantor may at any time direct the trustees to distribute free from trust any share of a beneficiary to the beneficiary who shall be entitled to the income. The court held that the income was taxable to the grantor by means of the broad powers he possessed regarding control over distribution of trust corpus. The Supreme Court's opinion states, "Being the owner because of his control over the corpus, he is, we think, liable for the tax."

The Internal Revenue Code of 1954 is much more lenient in regards to administrative control versus reversionary interests or control over the distribution of income or principal. The guideline which is to be used in the interpretation of the Revenue Code of 1954 is whether or not the grantor has the power to sell trust property or lend the funds of the trust. If the grantor retains one or both of these powers, it is generally accepted that he, as grantor of the trust, will be taxable on the trust income. If the grantor does not possess either of these powers, but still retains other broad powers of administration, he is not taxed on the trust income.

The preceding guideline is illustrated in the case of Cushman v. Com'r, <u>153F (2D) 510</u>. The facts pertinent to our discussion involve the grantor as trustee and his power to control the trust property, which was corporate stock, by means of retaining the voting power of the stock as trustee. The court, in this case, determined that the income was not taxable to the grantor because the trust corpus would never revert to him by the terms of the trust and the fact that he was, as a trustee, in a fiduciary capacity because of his knowledge and proficiency in the business world. It should be noted here that even if he had retained the power to sell trust property and lend trust funds, the court would probably have rendered the same decision. The fact that the grantor was considered to be a fiduciary and the fact that he would never receive benefit from the trust would have been the basis for their decision.

The last point to be covered regarding the Clifford Case was the fact that the wife was designated as the beneficiary. The Revenue Code of 1954 implies that the grantor of a short term trust cannot be taxable on trust income because of the sole fact that the beneficiary is a close relative of his. This point is illustrated in Stephen Hexter, 47 BTA 483.

In summary of the pertinent points regarding the above case, the grantor made a gift of property and securities to his wife in an irrevocable trust. No provision was made in the trust for the payment of the income or corpus to the grantor. Later, the grantor assigned two insurance policies to his wife as sole beneficiary. She used the trust income partially to pay the premiums due on the insurance policies. The United States Board of Tax Appeals held that the income of the trust was not taxable to the grantor by the mere fact that his wife was the beneficiary of the trust.

From the previous discussion regarding the Clifford Rules, which were enacted in the Internal Revenue Code of 1954, one can readily see the great impact that the Clifford Case had on short term trust taxation. The court's decision in Helvering v. Clifford, 309 U.S. 335. was vague and difficult to interpret. Many cases were brought to the courts to establish precedents regarding short term trust taxation. The decisions reached in those cases became the foundation for short term trust taxation which was enacted into the Internal Revenue Code of 1954. It is upon these rules that a great deal of our present day trust taxation is based.

The tax advantages of the short term trust for all practical purposes are contained in the transfer of income from the donor to the trust itself or the beneficiary or both.

The tax savings result when the income is taxed to a lower bracket taxpayer as compared to one who is in a higher tax bracket. The short term trust does not contain an element for the reduction in tax for estate purposes. In the ordinary short term trust with a reversionary clause which transfers the property back to the donor after a period of ten years or more, the property reverts back to the grantor after that period of time and is included in his or her estate for estate tax purposes.

As an aid to the understanding of short term trust tax savings, let it be assumed that A is in a 50% tax bracket. Each year he receives $5,000 net income from an apartment building. The amount of tax that A will pay on the $5,000 rental income is $2,500.

Assume further that A has a son B who is just starting his professional career and is in an 18% tax bracket. If A transfers the property to a trust for B's benefit and the entire amount of the income is to be distributed, a substantial tax saving can be realized over a ten year period.

The gift tax would be calculated as follows assuming that this is the first gift that A has made during his lifetime:

Fair Market Value of Property	$43,000
Less: Annual Gift Tax Exclusion	- 3,000
Amount Subject to Tax	$40,000

The gift tax on $40,000 would be $3,600. As mentioned previously, the gift tax is an accumulative type tax, and any previous gifts made by the grantor of the trust must be taken into consideration in the computation.

The income tax savings regarding our example would be calculated in the following manner:

Tax payable by A	
12 years X $2,500	$30,000
Tax payable by B	
12 years X $900	- 10,800
Income Tax Saving to Family	$19,200

The net tax saving would be calculated as follows:

Income Tax Saving to Family	$19,200
Less: Gift Tax on Transfer	- 3,600
Net Tax Saving to Family	$15,600

As can be seen, the short term trust can be a valuable tool in directing income from a high tax bracket person to a lower bracket person which results in substantial savings to the family. As in the previous discussion, generally any type of property that can be transferred in trust can be transferred to a short term trust.

The principle advantage of the short term trust is that the property does not have to be transferred in trust irrevocably. The grantor can have the property revert to him at the end of ten years thereby only giving up his beneficial ownership interest for a fixed period of time. During the period of the trust, the trustee will control the property and account for the property's income, deductions, etc.

CHAPTER V

Conclusion

The area of trust taxation is governed by a maze of complicated rules and regulations. The advantages are numerous and include the following tax saving advantages:

1. The shifting of income from a high bracket taxpayer to a lower tax bracket taxpayer.

2. The saving of the second tax by means of a trust constructed for a life tenant and a remainderman.

3. The exclusion of the trust property in a person's estate by means of a gift in trust made prior to death. In this manner, only a gift tax will be imposed upon the transfer.

The tax practitioner, in effectively planning tax savings by means of a trust, must be aware of the tax law and also the legal formation of a trust. He must also be aware of new developements in the tax law and be constantly reviewing prior trusts that he has constructed for clients. He must, if necessary, revise these trusts to conform to new requirements and regulations to insure that the tax saving will not be lost by the new law.

The interpretation and application of the tax law is a complex and demanding task. As can be seen though, the rewards are numerous, under certain circumstances, for even the small taxpayer in regard to his estate planning.

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