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SOME TAX ASPECTS OF TRUSTS
IN CONNECTION WITH ESTATE PLANNING

LLOYD W. KENNEDY*

Following the impetus to estate planning resulting from the marital deduction and split-income provisions of the Revenue Act of 1948, there has been a growing tendency to belittle attempts by the estate planner to achieve the maximum of permissible tax reduction. While it is manifestly true that tax consideration should be secondary to the achievement of the property dispositions which the client values more highly than any tax cost, it by no means follows that tax considerations are thereby of relative unimportance. Much of the value of authentic estate planning lies in the ability of the planner to suggest alternative dispositions which substantially comply with the client’s wishes, yet accomplish an overall minimum of federal estate, gift and income taxation.

It is assumed in this paper that tax minimization is not only morally proper, but is likewise highly desirable; provided only that the methods, tools and techniques used to attain this minimization do not injure or defeat the primary purposes of the estate owner. A discussion with the client of the available methods and techniques may often suggest to him possibilities of property dispositions which he had not previously considered, and which he would prefer to use in any event—even if there were no such thing as federal taxes. Considered purely as tools, trusts permit a combination of flexibility, safety, and tax minimization unequalled by any other single device. It is the purpose of this article to discuss, primarily in the context of estate planning, some of the uses and tax consequences of trusts, both living and testamentary, and of decedent’s estates during the course of administration.

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1. In his excellent tract on Estate Planning, Practicing Law Institute (1950), Joseph Trachtman refers at the outset (p.1) to “the usual pious warning against over-emphasizing tax-saving.” He tends, however, to consider maximum marital deduction clauses as “reaching for the stars,” stating (p.40): “There is perhaps no limit to what human ingenuity can accomplish—but one should exercise some restraint. Wills are not vehicles for the demonstration of skill in federal prose and arithmetic. And the testator who thinks he wants that kind of thing should be admonished.”

The American Law Institute’s booklet Lifetime and Testamentary Estate Planning (Oct. 1950), by Harrison Tweed and William Parsons, expresses the same attitude, and states (p.44) that because formula “clauses are untried, make property rights dependent upon federal tax laws, and leave uncertainty as to the amount of property that may be included in the marital share, they should be used with hesitancy and only upon the insistence of the client.” The present writer does not agree with these sentiments.

Inter Vivos Trusts

An inter vivos trust may be created by declaration, whereby the grantor acts as trustee, or by a transfer of property from the grantor to another as trustee. While either type of trust may generally be created by parol, and will be recognized as such for tax purposes, the advantages of a written trust instrument are so many and so important that reliance on establishing a parol trust plays little part in estate planning, and will not be further considered here.

Revocable Trusts

An inter vivos trust may be either revocable or irrevocable. If revocable, there are no changes in the grantor’s tax status. If it is expressly stated in the trust instrument that the grantor may revoke the trust at any time, the trust is not recognized as a separate entity for federal income tax purposes, and it is not necessary to file a fiduciary return. The trust income is reportable by the grantor as if no trust had been created.

Because of its revocability, it is at best an “Indian” gift. So far as the transfer of the trust corpus is concerned there are no gift tax consequences, and, in practice at least, no gift tax return need be filed. However, if the income of the trust is actually paid to another, the payment of income will constitute a gift by the grantor, but, unless the transfer of income per person per annum exceeds $3,000, there is again no requirement that a gift tax return be filed, as this is clearly a gift of a present interest within the annual exclusion of Section 1003(b)(3) of the Internal Revenue Code referred to hereinafter as the Code or merely by sections. The utilization...

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3. Provided, of course, it is recognized under the law of the state of the trust’s domicile. The applicable Statute of Frauds may prevent the creation of a parol trust of real property. See Reed v. Comm’r, 36 F.2d 867 (5th Cir. 1930), reversing 10 B.T.A. 1062 (1929), in which a parol trust of real estate is upheld under Texas law.

4. The establishment of a trust by parol evidence may be important where there has been no estate planning. This arises most often in connection with bank accounts. The so-called passbook cases or Totten trusts (In re Totten, 179 N.Y. 112, 71 N.E. 748 [1904]) are discussed in Herbert L. Dillon, 32 B.T.A. 1254 (1935).

5. 1 T. 2172, IV-1 CTR. BULL. 44 (1925), stating: “The grantor of a voluntary revocable trust should amalgamate the income and report the same as if the trust had never been created.” Corporate trustees, however, often file a Fiduciary Form 1041 for a wholly revocable trust. Such a filing is usually for their convenience in record keeping and eliminates possible trustee responsibility should the grantor fail to properly report the income of the trust.

6. Int. Rev. Code § 1006(a) requires an individual to file a return if he “makes any transfers by gift.” In U.S. Treas. Reg. 108, § 86.5, it is stated: “A gift is incomplete in every instance where a donor reserves the power to re vest the beneficial title to the property in himself.” It is curious to note that in Section 86.21 of the Regulations, which relates to the requirement for filing an information return or notice on Form 710, it is stated that a return should be filed by a donee or trustee, even if it is considered that the retention of a power by the donor renders the transfer wholly incomplete as a gift. No similar statement is made in Section 86.20 relating to returns by the donor.

7. If income from a revocable trust which is paid to another exceeds $3,000, but not $6,000, it may be treated as a split-gift by the grantor and his wife under Int. Rev. Code § 1000(f). To treat the gift of income as made one-half by each spouse, however, requires the filing of a gift-tax return Form 709, as this is the method chosen by the Commissioner to satisfy the manifestation of consent required under Int. Rev. Code § 1000(f)(2)(A). U.S. Treas. Reg. 108, §§ 20(b) and 86.3a(b).
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of a revocable trust for the purpose of paying income to a beneficiary may be a vehicle offering convenience and protection, but tax-wise its value is neutral; it leaves the grantor and the beneficiary in the same income tax position as before creation of the trust, and it carries no gift tax disadvantages.

The creation of a revocable trust likewise has no effect on the potential estate tax of the grantor. Being an incomplete “gift,” the corpus of the trust is includible in the grantor’s gross estate under Section 811(a), even though it may not form part of the grantor’s probate estate. If the trust becomes irrevocable upon the grantor’s death, legal title remains in the trustee, and the trust assets are not subject to administration by the grantor’s executor. There is thus no hiatus at the grantor’s death in the orderly management of the trust, and this fact alone may often suggest the use of a revocable trust in the planning of an estate.

Since revocable transactions leave the same degree of flexibility for future action in the grantor as he had before, and do not entail any change in the federal income, gift or estate tax status of the grantor, their use in estate planning may perform the same function as a will, with the added lifetime convenience which they may offer. Such trusts do not, of course, eliminate the need for a will, but the employment of a so-called “pour-over” clause in the will permits the major dispositive provisions and administrative powers, which will become for the first time irrevocably fixed at the grantor’s death, to be placed in the trust instrument, rather than in the will. This may offer some advantage in that a revocable trust may not only be amended from time to time without the formalities accompanying the execution of a new will, but its use offers the grantor the opportunity

8. It is also includible in the grantor’s gross estate under the more specific provisions of Int. Rev. Code § 811(c) (1) (B).

9. It is not the purpose of this paper to discuss the many non-tax advantages which can be achieved by the employment of living trusts. They are numerous and include, in addition to continuity, an avoidance of publicity relating to the size and the beneficiaries of the grantor’s estate, and further offer the possibility of a substantial reduction in administration expenses. If the family situation indicates a possible threat of a will contest on the grounds of mental incompetency or undue influence, the fact that the property in question has been placed in an operating trust during the grantor’s lifetime, tends to weaken the threat of such potential litigation.

10. A “pour-over” clause is a bequest or devise to the trustee of a previously created and presently outstanding trust which was either revocable or irrevocable during the grantor’s lifetime. Although valid under the law of most states, the attorney planning the estate should make certain that the law of the state having jurisdiction over the decedent’s estate is relatively certain as to the validity of this technique, especially where (a) the trust is amended after execution of the will, and (b) the trustee, having been appointed by will as a testamentary trustee, might not be authorized to perform fiduciary duties in the state. The latter is most likely to arise where a corporate trustee is not authorized to do business in a foreign state, but so far as the writer is aware no decision has invalidated the bequest to the trust, or the trust itself, where a “pour-over” clause has been used, even though the trustee or the inter vivos trust who receives the bequest (had the trustee been nominated in the will rather than in the instrument creating the inter vivos trust) would not be authorized to do business in the state having probate jurisdiction. See Shatnuck, An Estate Planner’s Handbook, p. 81, and 83-96, for a complete discussion on the “pour-over” clause.

11. See Tweed and Parsons, op. cit. supra note 1, at 74, on the dangers inherent in the use of codicils.
during his lifetime to see how the trusteeship is working out in practice. The sole proprietor of a business or the owner of closely held stock, for example, may place these interests in a freely revocable trust, appointing as co-trustees with himself those persons who he would wish to carry on after his death, and thus train them in their future management duties under the terms of the trust instrument.

A revocable trust also may be highly useful as a method of obtaining flexibility over life insurance proceeds where the options available under the policy are too limited, which is by no means an unusual situation. Except for long outstanding policies, the return under an insurance interest option is likely to be considerably below the net return on trust funds, and annuity options will seldom compare favorably with the value of flexibility of payments under trustee discretion, which can be provided for in a liberally drawn trust instrument. In relatively small estates, where life insurance on the life of the husband may be his major asset, the creation of a revocable trust, vesting wide discretionary powers in the trustee, and the designation of this trustee as the beneficiary of the life insurance, will often provide an ideal vehicle for management of the insurance funds which accrue at death. Inasmuch, however, as the interest increment in lifetime installment payments of insurance proceeds is no longer regarded as taxable to the beneficiary, whereas payments from a life insurance trust are taxable to the beneficiary to the extent of the trust’s income, the future income tax burden on the beneficiary under the trust arrangement must be estimated and balanced against the advantages in flexibility and potentially higher but less secure return which the trust offers.

Irrevocable Trusts

The creation of an irrevocable inter vivos trust immediately modifies the status of the grantor with respect to all three of the major federal taxes—income, gift, and estate. If the trust is drawn and operated so as to fall outside the ambit of the Clifford regulations, the income from the trust corpus becomes taxable to the trustee or beneficiary or partly to each, and is no longer included in the grantor’s income. The fair market value of the interest irrevocably granted to the beneficiary is the measure of the grantor’s gift for gift tax purposes, which may or may not qualify for the annual $3,000 exclusion under Section 1003(b)(3). If the grantor survives the

12. Many banks having a common trust fund designed for the investment of estates under $50,000 are earning well over 3% after all administration expenses. This compares with the 2% rate used in the computation of the installment option in currently or recently acquired life insurance. Investment in organizations similar to the Keystone series of investment trusts offer net returns in reasonably conservative investments upwards of 4%. No trust, of course, offers the safety of a grade A commercial insurance company.


14. Most insurance companies will not permit a trustee to elect an installment option. This reduces what would be a very desirable degree of flexibility in cases where life insurance proceeds are payable to a trust, and requires the estate planner to forecast many variables. See example I in the Appendix.
creation of the trust by three years, the value at his death of the interest given the beneficiary will be excluded from his gross estate for estate tax purposes; if he does not survive the required three years, it may still be excluded from his estate if the burden of proof of non-contemplation of death can be met.

Gifts for Life of Beneficiary or Term of Years

A gift in trust of income producing assets for the life of a person to whom the grantor regularly contributes from his current taxable income, offers an attractive income tax advantage in many situations with a minimum of gift tax disadvantage. This type of trust is most useful where the beneficiary is older than the grantor, and is in a low income tax bracket compared with the grantor. The most common example is a gift in trust for a parent, or other relative, whom the grantor has been supporting and wishes to continue to support for the balance of the beneficiary’s life. A married man with a taxable net income after exemptions of $32,000, for example, may be augmenting his widowed mother’s insurance receipts at the rate of about $100 a month. If he has assets which he can place in a trust for the life of his mother which will produce about $1,200 annually, he will pay at current rates $564 less income taxes each year at a price of a tax to his mother of about $108 while she is under the age of sixty-five, with no tax to her if she is over that age. The tax saving can easily run into many thousands of dollars, and, as the grantor may himself be the sole trustee, the only cost of the trust will lie in a possible gift tax. If the

15. INT. REV. CODE § 811 (1), amended by the Revenue Act of 1950. Since a fully completed gift made more than three years before the grantor’s death is now excluded from his gross estate, even though actually made in contemplation of death, it is the “feeling” of many tax specialists that (a) revenue agents auditing estate returns will in many situations tend to characterize a gift made within three years of death as being in contemplation of death where, before the change in the law, they might not have done so, and (b) courts will tend to construe the burden of proof on the taxpayer in connection with gifts within the three-year period more strictly than was done under the two-year period of the old law. This is referred to as a “feeling,” as it is premised more on human psychology than pure rationality.

16. Even if it cannot be met, the gift tax, if any, is removed from the grantor’s estate, and constitutes an estate tax credit under Section 813(a). To the writer’s knowledge, the right to an estate tax credit under Section 813(a) has never been considered as itself an asset of the decedent within the scope of Section 811(a). A person of considerable wealth might win by deliberately making a substantial gift on his deathbed, and thus incur a gift tax liability constituting a debt of his estate deductible under Section 812(b). By this method the amount of the gift tax would be excluded from estate tax, yet would be available as a credit under Section 813(a).

17. This type of trust will not shift the income tax from the grantor to the beneficiary where the trust payments discharge a legal obligation of support owed by the grantor to the beneficiary. But it will shift the tax if the duty is merely moral, not legal. See the discussion on this point in KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 6.18, and decisions cited therein.

18. There is little danger of the Clifford doctrine in this type of trust. Even if the grantor-trustee uses language in the trust instrument giving him very wide powers to deal with the corpus, such language will ordinarily not be interpreted as empowering the grantor to manipulate the corpus for his own economic advantage. Cf. Cushman v. Comm’r, 153 F.2d 510, 514 (2d Cir. 1946); Hall v. Comm’r, 150 F.2d 304, 308 (10th Cir. 1945); David L. Loew, 7 T.C. 363 (1946).
grantor's mother was sixty years of age at the date of creation of a trust to pay the income to her for life, the corpus reverting to the grantor at his mother's death, the value of the gift of the life income, which is measured on the value of the corpus, would be $11,298, assuming the corpus to have a fair market value of $30,000. As a gift in trust where all of the income is currently payable to the beneficiary is, peculiarly enough, considered as a gift of a present interest of future as well as current income, the annual exclusion is applicable. If the grantor's wife consents to split the gift under Section 1000(f), each spouse has made a net gift under the assumed facts, of only $2,649, and there will be no gift tax unless the lifetime $30,000 exemptions have been previously used.

In the situation assumed in the preceding paragraph, the grantor, instead of providing for a reversion of the corpus to himself at his mother's death, could give the remainder interest at her death to his wife or children, and thus reduce his potential estate tax. There would be no danger of income taxation to the grantor-trustee at his mother's death if the remainder-man was then a minor child. Since the 1943 amendment to Section 167(c), the grantor of a trust for the benefit of a person whom he is legally obligated to support is taxable to the grantor, even where the grantor is sole trustee with discretionary powers to pay or accumulate income, only to the extent that the income is actually applied for the dependent's support. The dividing line between trust distributions to a grantor's minor children which discharge his duty of support, and distributions for luxuries, has never been sharply drawn, and is largely an unexplored field.

A man presently at the height of his earning power whose income tax

20. The Regulations (see note 19 supra) state that where a donor creates a trust under which a specified annuity is payable to the donee, the value of the gift should be determined under Table A or Table B, whichever is applicable. These tables appear in the regulations following Section 86.19(j). Where a life interest in property is given, a hypothetical annuity at the rate of 4% of the value of the property is used, and this hypothetical annual return is valued upon the life expectancy of the donee. The tables used by the Commissioner make no distinction as to sex, though insurance companies currently use tables giving a female annuitant five years greater expectancy than a male. The tables are also based on a 4% return under the century-old Actuaries' or Combined Experience Table of Mortality. It is noted in Henry F. du Pont, 2 T.C. 246, 260 (1943), that while 4% may be too high a rate today for money safely invested, this error tends to be offset by the much higher life expectancy of United States' residents over the expectations used in the tables, which have long been obsolete. The latest taxpayer attack on both the 4% rate and the use of the outmoded Actuaries' or Combined Experience Table of Mortality was again unsuccessful in George G. McMurtry, ¶ 16.23 P-H TC 1951.
21. The decisions are collected in Paul, Federal Estate and Gift Taxation (1946 Supp.) ¶ 15.11, n. 72. Odd as it may seem, a gift in trust to a seventeen year old child, with the income payable currently and principal at age twenty-one, is less of a present interest than the same gift with principal payable at age twenty-five. In the first gift, the present interest consists of four years of income, as against eight years in the latter. Cf. Wisotskey v. Comm'r, 144 F.2d 632 (3d Cir., 1944); Charles v. Hasset, 43 F. Supp. 432 (D. Mass., 1942).
22. U.S. Treas. Reg. 111, § 29.167-2, third paragraph, requires that the grantor's discretion must be in his capacity as trustee.
23. A trust for the future college education of the grantor's children was, inter-
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bracket exceeds 50%, and there are many such today, may with wisdom consider creating an accumulative term trust, with the accumulated income passing eventually to his children, or to his wife. If he wishes to avoid a controversy with the Commissioner, he must make the term of the trust before reversion of the corpus longer than ten years in any event, and longer than fifteen years if he wishes to act as trustee with normal administrative powers. These ten and fifteen year rules are the heart of the so-called Clifford regulations introduced in 1947.

A trust may be created to accumulate income for sixteen years, all accumulated income to go to the grantor's son at the end of the term, and the corpus to then revert to the grantor. The grantor may be sole trustee and, subject to the rule that the income must not be used to discharge the grantor's legal obligation to support his son, the grantor will not be taxable on the income of the trust during the sixteen year term. If the grantor has income-producing property with a fair market value of $100,000, which is averaging a return of $4,000, and which is subject to a 50% tax in his hands, he will be able to accumulate within his family circle $18,912 more than he would be able to save had he continued taxable on the income produced by the $100,000 placed in such a trust. Yet at the end of the sixteen year period he is revested with full ownership, which may coincide with his retirement or a period of lesser income. The present value under the Commissioner's Table of the gift of $100,000 in a sixteen year reversionary term trust is $46,609. As the income is not payable currently to the beneficiary, the entire gift is a future interest, but if the grantor and his spouse had not previously used their combined $60,000 exemption, no gift tax would be payable. There would be no estate tax saving in such a trust unless the grantor died before the revestment. Should the grantor die when the trust had twelve more years to run, for example, the...
present value of his reversionary interest under Table B would be reduced from $100,000 to $62,460.

An accumulative term trust must be of particular value where a grantor’s major asset is represented by stock in a closely held corporation. On the hypothetical facts assumed in the preceding paragraph, the grantor-trustee would have $3,182 in the trust each year after taxes to invest, or a total over the sixteen year term of $50,912.29 As the owner of closely held stock which should be retained in the family, the grantor may secure cash funds from time to time and still retain ownership in the family, by selling this stock to the trust at its then fair value. The entire original corpus of the trust might consist in stock in a family corporation and the trust, in lieu of purchasing more of the same shares or other property from the grantor, might purchase the reversionary interest in the very stock held in trust, paying the grantor the present discounted value of this reversionary interest. The stock so purchased would be distributed to the grantor’s son at the end of the sixteen year term, as it would represent the investment of the income accumulated for his benefit. It goes almost without saying, of course, that all dealings between the grantor qua grantor and the grantor qua trustee must be completely bona fides. Any sale of the grantor’s property to the trust at a price higher than its true value would be in violation of the grantor’s fiduciary obligations, and would justify the Commissioner’s disregard of the trust as a separate taxable entity. Any sale at substantially less than its fair value would constitute a taxable gift of a future interest. If the fair market value of the closely held stock is uncertain, a sale of a small amount of the stock to the trust resulting in a capital gain to the grantor may offer one method of testing out its value in the eyes of the Bureau, before a more substantial disposition of the stock is made.30

Term Trust for Life Insurance on Beneficiary

An accumulative term trust may be used to acquire insurance on the life of the beneficiary as a primary objective, rather than merely accumulating dollars at low income-tax brackets for investment and reinvestment in securities or other income producing assets. A ten payment life policy in a mutual company on a ten year old child, for example, can be purchased at an annual premium of about $45.50 per $1,000; ordinary life at about $14.25. A trust-producing net taxable income of $1,397 annually will, after payment of income taxes at present rates, service a $25,000 face value ten payment policy on the life of a ten year old child. When the child is

29. This again ignores income on invested and reinvested accumulated income, which should bring the total to a considerably higher figure. However, the grantor is likely to make some distributions to the beneficiary under his discretionary power to distribute or accumulate, and these two factors should tend to offset each other.

30. Referring to the various factors and methods used in appraising certain stocks where there have been no sales, a taxpayer’s expert witness testified that market value is an estimate which “is based on the conception of a transaction which did not take place between two persons who do not exist.” Victoria L. Cotton, 5 T.C.M. 618, 622, P-H 1946 TC MEM. DEC. ¶ 46,171 (146).
twenty years of age and the policy is fully paid, the trust will have an asset which, through non-taxable dividend additions, will have a cash surrender value approximately equal to the premiums paid. This could be borrowed against, if necessary, to finance the child's further education, but if not needed, the receipt by the child on his twenty-sixth birthday of a $25,000 paid-up policy on his own life, which would come to him at the end of the trust as an asset acquired through the investment of income accumulated at comparatively low tax rates, would be very beneficial indeed.

To acquire a $25,000 ordinary life policy on a ten year old child would require trust income before taxes (assuming present rates and the total taxable income of the trust as not exceeding $2,100) of only $420. If the policy were delivered to the child at the conclusion of the trust, the child then twenty-six years of age, would be able to continue this policy at annual premiums of about $356. To take out an ordinary life policy in this amount at age 26 would cost the child annual premiums in the neighborhood of $515. Furthermore, had the non-taxable dividends on the policy been applied to acquire additional insurance, the child would also receive a substantial amount of paid-up insurance which had been acquired free of tax.

Trusts as Limited Partners

Since the undue "emphasis" previously given by the Commissioner and the Tax Court to the Tower and Lusthaus cases has been substantially reduced under the present interpretation of the Culbertson decision, it is again feasible to consider the creation of a trust which will become a member of a family partnership. In the words of Circuit Judge Stone in the recent Maiatico decision: "The determinative inquiry is as to the good faith intent of the parties to combine for a business purpose."

Where a would-be grantor has no income producing assets to use as the corpus of an irrevocable trust (or trusts) for the benefit of members of his family except a going sole proprietorship or partnership, it may now be possible to make gifts in trust of this business interest which will stand up. If the grantor who possesses listed securities, or holds rental real estate as an investment, can use this property as the res of trusts for minor children, and in his capacity as trustee can invest, reinvest and manage the property for their benefit, without the income remaining taxable to him, there seems

31. Dividends on unmatured policies are considered as a reduction or return of premiums and are not taxable income. U.S. Treas. Reg. 111, § 29.22(a)-12. On paid-up policies, the dividends may also be used to purchase paid-up additions and are wholly excluded from income until they exceed the aggregate premiums previously paid. Thus the application of dividends to acquire additional paid-up insurance (which is not subject to a loading charge for salesmen's commissions) permits the acquisition of additional insurance with funds which have not been taxed to anyone.
32. 327 U.S. 280 (1946).
33. 327 U.S. 293 (1946).
34. 337 U.S. 733 (1949).
35. 183 F.2d 836 (D.C. Cir. 1950), reversing 12 T.C. 146 (1949).
36. Wherever there is more than one beneficiary, and the trust is to be wholly or partly accumulative, separate trusts should be created for each beneficiary. On the problem of multiple trusts generally, see Kennedy, op. cit. supra note 17, § 1.16.
no logical reason why assets which are used directly in the grantor’s business cannot likewise form the res without placing the trust in the category of a controlled trust.

Under the currently developing “reinterpretation” of family partnership cases, the trend seems quite definitely to be in this direction. The Seventh and Third Circuits in the Skemp and Brown decisions respectively, reversed the Tax Court holdings that a transfer to a family trust of title to property used in the grantor’s business, followed by a lease-back arrangement, left the income taxable to the grantor. While the Tax Court at first expressed a disinclination to follow the Seventh Circuit’s holding in the Skemp case, a majority of the Tax Court in the recent decision in Theodore D. Stern held that family trusts could be limited partners in a business enterprise with the grantor, with dicta indicating this would be true even if a trust could not technically be a partner under state law.

The District of Columbia Circuit has also recently reversed an earlier Tax Court decision in the Maiatico case, and upheld a family trust of a fractional interest in realty, which the grantor owned jointly with several others. The opinion indicates that all decisions relating to family partnerships during the period between the Tower and Lusthaus cases in 1946 and the Culbertson decision in 1949, placed undue “emphasis” upon the tests suggested in the two former cases.

The forthcoming opinion of the Eighth Circuit in Hanson v. Birmingham, which may be announced before this article appears in print, should serve to indicate the effect of state law on the tax validity of a family trust as a limited partner in a partnership which contains the grantor-trustee, in his individual capacity, as a general partner. The opinion in the Hanson case contains a very thorough analysis of the problem, but concludes that a trust cannot be a valid partner because this relationship was unknown at

37. 168 F.2d 598 (7th Cir. 1948), reversing 8 T.C. 415 (1947).
38. 180 F.2d 926 (3d Cir. 1950), reversing 12 T.C. 1095 (1949).
39. Opinion of Judge Leech in Helen C. Brown, 12 T.C. 1095, 1101. There were 6 dissents.
40. 15 T.C. 521 (1950).
41. There were five dissents, but without opinion. At the time of this writing (Feb. ruary, 1951), the Government has not filed an appeal. The majority opinion states: “If not a partnership under state law, it may still be a joint venture, and thus a partnership for present purposes. Thus, even if a trust could not be a partner under common law, and even though the enlarged definition of a partnership now appearing in Section 3797 may not have been for the express purpose of covering such a situation, nevertheless, it should be used and it has been used for that purpose.”
42. See note 35 supra.
43. In Zander v. Comm’r, 173 F.2d 624 (5th Cir. 1949), for example, the opinion holding invalid a family-trust-partnership in a loan business, relies largely on the Tower and Lusthaus cases in affirming the Tax Court holding that the trusts in question were not bona fide and real, but were merely the alter ego of the grantor-trustee-partner. This opinion, however, antedates the Culbertson case and may not reflect the present attitude of the Fifth Circuit. Cf. Tobin v. Comm’r, 183 F.2d 919 (5th Cir. 1950). See also A. Bluestein Estate, 15 T.C. (1950).
44. 92 F. Supp. 33 (N.D. Iowa 1950) on appeal to the Eighth Circuit.
common law. The majority of the Tax Court in the Stern case, which was decided a few weeks later, did not agree.\textsuperscript{45}

Caution probably dictates a sparing use of this device until the decisional law has been further clarified. Recognition for federal tax purposes of a trust of (1) sufficient duration to represent a substantial shift of economic interest, which (2) has for its corpus assets previously employed in a sole proprietorship or business partnership, which (3) has for its beneficiary a member of the grantor’s immediate family who can not or does not actively participate in the business, and which (4) has for its trustee the grantor himself or another family member who then, \textit{qua} trustee, becomes a limited partner in a continuance of the business which is headed by the grantor \textit{qua} grantor, cannot fairly be considered as opening the door to a flood of “quasi tax avoidance.” The recognition of this type of trust merely places the relatively small businessman on a par with the relatively more wealthy class, whose members already have outside assets of the kind more traditionally used to serve as the corpus of a trust. Whether it is the trustee, the beneficiary, or the trust corpus itself, which becomes the partner in a limited partnership,\textsuperscript{46} should not be controlling so far as federal taxation is concerned. As said by Judge Murdock in the Stern case, “If not a partnership under state law, it may still be a joint venture and thus a partnership for present purposes.” It may be hoped that the decisional-law development during 1951 will permit limited partnerships with family trusts to be safely used in estate planning. Individuals of great wealth, through the employment of family trusts, have always been able to multiply and conserve this wealth from an ever more rapacious federal fisc. Persons of lesser wealth, the major portion of whose assets are employed in a business enterprise, and who thus have no assets to give in trust except the business interest itself, should not be penalized under the controlled-trust doctrine merely because they must of necessity remain in control of the enterprise in which the trust participates. Whether this participation be in the form of a trust as lessor, as a joint venturer, or as a limited partner, should be immaterial.

The professional man however—the lawyer, doctor, accountant, for example—whose business income is not predicated upon the employment of tangible property as a substantial contributor to this income, still remains beyond the pale. The facts that a professional man cannot secure the boon of capital gains and ordinary losses under the differential treatment of Section 117(j), cannot make gifts in trust until he has acquired assets other than his training and knowledge, cannot include himself in a pension trust, and cannot secure the remarkably “inexpensive” insurance and other benefits under the Social Security laws, is merely a set of facts useful in dis-

\textsuperscript{45} See note 41 \textit{supra}.

\textsuperscript{46} Judge Graven in the Hanson opinion, \textit{supra} note 44, compares this problem with ascertaining where the pea is in a shell game, and concludes it has “somewhat similar elusiveness.”
tangishing a professional man from a business man; tax-wise it will probably remain insignificant.

**Testamentary Trusts**

The creator of an irrevocable inter vivos trust must consider the immediate change in his personal status with respect to the three major federal taxes. Unless the trust is so drawn or so operated as to come within the class of “Income for Benefit of Grantor” trusts which remain taxable to the grantor under Section 167, and which includes funded insurance trusts on the life of the grantor, or within the class of trusts presently taxable under Section 22(a), the creation of the trust will immediately shift the tax on the income earned by the trust corpus from the grantor to the trustee or to the beneficiary, or partly to each. Its creation will likewise have a present gift-tax effect on the grantor and will reduce his potential estate-tax liability. Although a grantor has already become a testator by the time a testamentary trust comes into being, and the tax aspects of the testamentary trust will then be of primary concern to the beneficiary, this does not imply that these future tax aspects of the trust thereby become of little concern to the grantor. On the contrary, the grantor’s planning of the types and terms of testamentary trusts can pass tax advantages to beneficiaries which may be of great value to them, and which they otherwise might not be able to achieve.

**The Two-Trust Plan**

Since the advent of the marital deduction in 1948, the use of two testamentary trusts, one for the wife which qualifies for the deduction, and one for the children which does not qualify, is coming to widespread use. This might be called the basic two-trust plan, the marital trust being referred to as Trust A, and the other as Trust B.

Trust A may be qualified directly under Section 812(e) (i) (F), which requires all of the income to be distributed currently to the wife for her lifetime, coupled with a power to appoint the entire corpus, free of trust, either to herself during life or to her estate after death. The power, whether exercisable by deed or by will, must be “exercisable by such spouse alone and in all events.” If the grantor elects to give his wife a power to appoint to herself by deed, her position with reference to the trust is identical with the position of a grantor to a wholly revocable inter vivos trust of his own creation.

On the other hand, if the grantor qualifies Trust A by granting a power to his wife to appoint to her estate only, he has given her protection against dissipation of the trust through unwise investments or the importunities of strangers. If the grantor, in addition to the testamentary power makes his wife the donee of a special inter vivos power to appoint within the class of limited takers specified in Section 1000(c) (1), and foregoes the use of spendthrift provisions, he has given her substantially all the advantages of
flexibility in her own estate planning which she would have through outright ownership. This assumes, of course, that the trustee is given a broad discretionary power to invade the corpus on her behalf, should this become necessary for her welfare.

The granting of a special power of appointment exercisable during life will enable the wife to make gifts to children or grandchildren and their spouses from Trust A and thus secure the pleasure of making such gifts, and at the same time reduce her own potential estate-tax liability. It is the Treasury's contention, however, that the inter vivos exercise of a special power of appointment qualifying under Section 1000(c)(1), by a person who is also the donee of a general testamentary power which does not qualify under Section 811(f)(2)(A), is an act resulting in a taxable gift.\footnote{47} The reasoning is that while the exercise of the power is not in itself a taxable gift, it has the effect of relinquishing the donee's right to receive the trust income for life, and is a release of the general power to appoint by will. Therefore, it is a taxable relinquishment of a life estate under Section 1000(a), and a taxable release of a general power under Section 1000(c), and consequently is a taxable gift of the entire value of the property so appointed. Whether the courts will sustain this rationalism, or will regard the "loophole" as a blunder which Congress itself should remedy, is too speculative for this writer.\footnote{48} In either event, the use of an inter vivos special power will permit the wife to make family gifts as freely as if she owned the property outright.

If the wife's future economic condition became such that she no longer required the income of Trust A for her own use, the absence of spendthrift provisions will make it possible for her to create a lifetime or a long-term trust of her life interest in the income, thus shifting the income tax to her children or other beneficiaries. The gift need not be of the entire income of the marital trust, but may be of a fractional part only.\footnote{49}

If the trustee is given discretionary power to invade the corpus of Trust A on the wife's behalf, and a discretionary power to also invade the corpus of Trust B for her benefit after Trust A has been exhausted, with either a mandatory or discretionary power to pay the income of Trust B to the wife, the grantor has (1) secured a reduction of his own estate tax

\footnote{48} It is interesting to note that the Government did not choose to appeal the 1948 decision of a Georgia District Court in Schwab v. Allen, 78 F. Supp. 234 (M.D. Ga. 1948), where the donee of a testamentary power "to encroach upon the principal or corpus to such extent as in his sole judgment is necessary or desirable from the standpoint of his welfare," was held to have a special power under Section 811(f)(2)(A), and consequently no part of the property subject to the power was in the donee's gross estate for estate tax purposes.
\footnote{49} Although a fundamental and perplexing problem in federal income taxation is the distinction between a transfer of property and a transfer of income from property, it has been unchallenged since Blair v. Comm'r, 300 U.S. 5 (1937), that an assignment by a life income beneficiary of a specified amount in dollars to the assignee for his life, or for the assignor's life, is an actual transfer of part of the beneficiary's equitable property interest in the trust, which shifts the tax upon the income from the original beneficiary to his assignee. On the general problem of assignment of trust income, see Kennedy, op. cit. supra, note 17, § 4.13.
through qualifying Trust A for the marital deduction, (2) has given his wife wide flexibility coupled with the protection afforded by holding the corpus of both trusts subject to invasion for her needs, yet (3) Trust B has been eliminated from her taxable estate, and (4) his wife has been given the power to also eliminate Trust A from her taxable estate if her future financial situation should warrant it.

Where the wife has income property of her own, so that her individual income when combined with the income of Trust A would place her in needlessly high brackets, the trust may be qualified for the marital deduction under the general provisions of Section 812(e) (1) (A) without reliance on Subsection (F), which requires a current distribution of the income and possession of a general power of appointment. The Treasury regulations consider that an accumulative trust will qualify for the marital deduction if the trust provides that the corpus and all accumulated income shall be paid to the wife's estate. The ability to use an accumulative marital trust, or a trust in which income distributions to the wife are discretionary with the trustee, permits a continual use of an additional taxable entity. When one considers that a wife has become a widow when the testamentary marital trust takes effect, and can no longer enjoy the split income provisions applicable to joint returns of spouses, the ability to accumulate income in the separate tax bracket of Trust A may prove highly advantageous. If the widow will have need of all of the income of Trust A, this, of course, becomes meaningless.

Home in Trust

Even though the combined estates of spouses may be of such size that it is certain the wife will need all of the income, a substantial income tax saving can be achieved over the wife's lifetime by placing the family residence in Trust B. If the will creating Trust B gives the family residence to this trust, directing the trustee to charge all expenses of maintenance against trust income before determining net income which may be distributed, and further directs that the widow be permitted to occupy the home rent-free for the balance of her life, the trust will remain taxable on the income applied to the expenses of maintaining the property. The

50. U.S. Treas. Reg. 105, § 81.47a(b)(2), 3rd paragraph, gives as an example of an interest which will be considered as passing from H to W, "If W is entitled to the trust income for a term of years following which the corpus is to be paid to W or her estate, or if the trust income is to be accumulated for a term of years or for W's life and the augmented fund paid to W or her estate, . . ." Since W and W's estate are considered the same under the terminable interest rule, the trust qualifies for the deduction as an interest passing from H to W under subsection (A) of Section 812(e)(1), which is not a terminable interest under subsection (B). The trust may thus qualify without reference to subsection (F).

51. Since real estate taxes are deductible, it is immaterial whether they are paid by the trustee or by the widow, assuming, of course, that the remainder of the income of Trust B will be paid to the widow. As title to the home is in the trustee, it is wise to provide in the will that the wife shall pay the taxes if this is desired, though under the decisional law, it is apparently not necessary to entitle the wife to a deduction for the taxes paid by her. See Cornelia C. P. Horsford, 2 T.C. 826 (1943).
difference in tax brackets between the trust and the widow can mean very substantial income-tax savings over the period of a lifetime. Although the right to occupy the home rent-free is clearly a benefit to the wife, this does not make the amount paid by the trust for maintenance taxable to the wife who currently benefits from it. Maintenance payments in this situation are neither distributable nor distributed income to the wife.\(^52\)

This type of trust cannot be used, of course, if the family home is held by the husband and wife in joint tenancy or as tenants by the entireties.\(^53\) If title to the property is already in the wife, the life use of the home by the husband should be provided in her will, likewise using a trust if she has any other assets to fund it.

**The Three-Trust Plan.**

The basic two-trust plan, with relatively few exceptions, is suitable for estates of all sizes. One variation which may prove useful in larger estates, especially in estates where the wife has substantial property of her own, is the use of what may be termed the three-trust plan. The three-trust plan contemplates the creation by will of at least three trusts, two of which will qualify for the marital deduction. Trust A is drawn to qualify under Subsection (F) of Section 812(e)(1), Trust A, to qualify as an accumulative trust under Subsection (A)\(^54\) and Trust B, which does not qualify, is designed for the children or other beneficiaries.\(^55\) The purpose of drafting two trusts, A and A,, is to permit the wife at the husband's death to review the situation as it then exists and elect the type of trust most suitable. This can be accomplished by instructing the executor to notify the wife of the assets he intends to use to fund Trust A, with a provision that any or all of the assets thus proffered may be refused by the wife, and if refused they shall be used to fund Trust A,, and if again refused, shall become part of Trust B. The mechanics of working

\(^52\) Comm'r v. Plant, 76 F.2d 8 (Cir. 1935), affirming 30 B.T.A. 133 (1934).

\(^53\) In Estate of Mortimer B. Fuller, 9 T.C. 1069 (1947), aff'd, 171 F.2d 704 (3d Cir. 1948), a testamentary trust providing that up to $50,000 of income each year be used to maintain a large family estate on which the testator's widow and adult children resided rent free, was admittedly taxable to the trust, and not to the individuals who benefitted.

\(^54\)Unless the home was originally acquired at a time of inflated prices, sound estate planning will usually suggest that H, if the home was acquired with his funds, make a present gift of the remaining one-half interest in the property to his wife, or at least change the title into a tenancy in common. Where the home has appreciated in value, which is the usual case today, the surviving spouse will not obtain the benefit of new basis under Section 113(a)(5) if the title is joint, even though the entire value is included in the taxable estate of the spouse first to die. Splitting the joint tenancy into tenancy in common will at least give the higher basis to one-half of the property. If the title was joint with survivorship, the husband paying the entire purchase price, he, at that time, made a gift to his wife of a one-half interest in the property. U.S. Treas. Reg. 108, § 86.2(a)(5). Consequently, there will be no gift tax in changing the title into a tenancy in common. Unless there was a substantial difference in ages between H and W, the same is true with reference to property acquired in a tenancy by the entirety. Cf. U.S. Treas. Reg. 108, § 88.2(a)(5) and § 86.19(h).

\(^55\) If there is more than one child, there should be a separate and distinct trust for each child or other beneficiary, though the corpus of each such trust may consist of an undivided fractional interest in the residuary estate. See note 36 supra.
this series of disclaimers will vary with the attorney, but it does seem clear
that the act of disclaimer cannot be considered a taxable gift. Nor
should it in any way tend to defeat the applicability of the marital deduc-
tion to the portion not disclaimed.

The use of the three-trust plan as the basic framework for testamentary
dispositions, while perhaps needlessly elaborate in estates of ordinary size,
has the merit of providing the utmost in flexibility. Its intelligent use
presupposes that the wife will exercise judgment in the light of the con-
titions actually existing upon the husband’s death and will, in effect, under-
take the process of estate planning in reaching a decision as to the exer-
cise of her disclaimer privilege and the various powers of appointment con-
tained in the trust provisions. If the wife is likely to accept, willy nilly,
property of a value equal to the maximum marital deduction without regard
to the size of her own estate, and is likely not to pass any property over to
children during her lifetime, the effort to secure a higher degree of flexi-
bility will be wasted. The problem then may be merely one of assuring
that the wife be given the minimum required by state law. In this un-
fortunate situation the estate-planner must operate with one hand fettered.

ESTATES DURING ADMINISTRATION

Other than the difference in exemptions and minor administrative
details, a decedent’s estate may be regarded as a special type of trust. For
income tax purposes, both are covered by Supplement E of the Code, and
the various sections of this Supplement refer to estates and trusts usually
without distinguishing the two.

A testamentary trust does not come into being as a separate taxable
tentity until the executor has transferred assets to it. As stated by Professor
Scott, “Where the same person is named executor and trustee it is not
always easy to determine the exact point at which he ceases to act as
executor and enters upon the performance of his duties as trustee.”

Normally, testamentary trusts are not set up until toward the close of the
period of administration, but this need not always be the case. Their
ey early funding may often be wise if the estate is in high income-tax
brackets.

56. See Paul, op. cit. supra note 21, § 16.03 n. 8, and authorities therein cited,
particularly Brown v. Routzahn, 63 F.2d 914 (6th Cir. 1933), cert. denied, 290 U.S.
641, aff’d on rehearing, 95 F.2d 766 (6th Cir. 1938).

57. The portion not disclaimed remains an interest passing from the decedent to
his spouse. Cf. Inr. Rev. Code § 812(c)(4). In the Senate Committee Report on
changes made by the 1948 Act, it is stated: “A disclaimer is a complete and unqualified
refusal to accept the rights to which one is entitled. If a person uses these rights for his
own purposes as by receiving a consideration for his formal disclaimer he has not refused
the right to which he was entitled. There can be no disclaimer after an acceptance of
such rights, expressly or impliedly.”

58. Scott on Trusts § 6. Professor Scott then quotes an observation of a late
nineteenth century English author that “Sir John Wckens, a very nice observer, used to
tell his pupils that it invariably took place in the dead hours of the night.”

59. If the assets are not actually transferred by the executor into the name of the
testamentary trustee, a mere crediting of estate income to the unfunded trust will not
Other than making certain that the executor is adequately protected from personal liability in making distributions prior to the complete settlement of all liabilities of the estate, there is also no reason why distributions of estate income as such cannot be made during the course of administration. Executors have this power under the law of most states even though the will does not make specific provision for interim-income distributions, though careful will-draftsmanship will employ a provision authorizing (but not demanding) the executor to make early payments of income. Any distribution of income which is properly paid or credited to a beneficiary during administration is deductible by the estate and taxable to the beneficiary under Section 162(c), and it is not necessary that the will make provision for such distribution.  

Under post-1942 law, the income earned by an estate during its final year is income which "becomes payable" during that year, and is deductible by the estate and taxable to the recipient under Section 162(b). Although a capital gain is not income under state law, but is an accretion of principal, its realization by the estate in its final year has been held to be a distribution of income which is taxable to the beneficiary under Section 162(b).  

Except where the will contains mandatory language requiring the distribution of income during the course of administration, the rules relating to the taxation of estate income may be summarized as follows:

1. Income which is not distributed within the taxable year of the estate or within sixty-five days thereafter, is taxable to the estate under Section 162(a)(3).

2. Income which is properly distributed as income during taxable years of the estate before the taxable year in which administration is completed, is taxable to the recipient and is deductible by the estate under Section 162(e).

3. Income of the estate during the taxable year in which administration is completed, is deductible by the estate and taxable to the recipient under Section 162(b). As previously stated, this has been held to include a capital gain. The use of estate income to discharge a pecuniary legacy, however, is neither deductible by the estate nor taxable to the pecuniary legatee.

4. The sixty-five day rules of Section 162(d) apply to these distri-
butions in the same manner as they apply to distributions from a trust to a beneficiary.

During the period of administration the executor of a decedent’s estate is in a position in many respects similar to that of a trustee of a discretionary trust whose income may be wholly accumulated, wholly distributed, or partly accumulated and partly distributed. Through the use of refunding bonds or other methods of securing the executor against personal liability from premature distributions, there is no reason why an executor should not use his discretionary power to make periodic payments of income to beneficiaries if this will effect an over-all tax saving. There is no principle in federal tax law which prevents it. That tax reduction via this method often remains unaccomplished is due, not to the law, but to the timidity of the executor or the failure of the estate’s attorney to suggest it.

APPENDIX

Example 1

Assume that H and W are each forty years of age and have two minor children. H is an executive earning $15,000 a year. H is acquiring a $25,000 home on mortgage, but other than personal property of value of $3,000 or $4,000 has no other assets. W has no estate. H decides to take out a $100,000 policy on his own life, on which the premiums are $3,255 annually. To meet his monthly mortgage payments, finance his family, pay his income taxes, and pay $3,255 insurance premiums annually, H regards as a real sacrifice, but he feels he must give his wife and children the protection of this policy, at least for an indefinite number of years.

H assumes (is willing to gamble) that if he lives until he is sixty, he will have been able to increase his earnings in the meantime to the point where he will have acquired an estate sufficient to see his wife through the balance of her life without complete dependence on insurance, which he regards as a poor investment during a period of inflation. Should he die within the next few years while his children are still minors, H considers $6,000 per year as the minimum his wife should have.

H’s $100,000 insurance policy will pay the following amounts in monthly payments to W for her life (ten years certain): At W’s age forty, $4,116 per year; at fifty, $4,824 per year, and at W’s age sixty, $5,880 per year. H decides that if he should die tomorrow, $20,000 of his insurance should be left with the company at interest, and $80,000 placed under the installment option, which would give his wife a guaranteed annual income of $3,292, plus some interest at 2% on the amount left under the interest option. The $20,000 at interest could be withdrawn in part from time to time to supplement the installment payments so that W could have about $6,000 per year during the period before the children’s education was completed. Under this plan there would be nothing for the children unless W dies within the ten year certain period.

H is shocked to discover that $80,000, under an annuity plan which
will completely exhaust the principal, will give W an income of only $3,292 per year for her life. H decides, rather than to eliminate a possible inheritance by the children, to forego the safety of insurance company payments, and to have the entire $100,000 of insurance proceeds paid to a revocable trust. He chooses a corporate trustee whose earnings on trust funds have consistently been netting about 3½%, and grants to the trustee adequate discretionary powers to invade the principal from time to time. If W uses $20,000 to augment her income until the children are educated, H estimates that the remaining $80,000 should give his wife an annual income of about $2,800. This is approximately $500 per year less than the insurance option and is taxable income to W, whereas the insurance payments are not. At present rates, W’s income tax on $2,800 would vary between $384 and $144, depending on whether she had one or three exemptions. Assuming that her income taxes for her lifetime might average $400 per year, she would have $900 per annum less spendable income from the trust than from an exercise at age forty of the insurance installment option. Her life expectancy at age forty (using the 1937 Standard Annuity Table currently in use) is 38.28 years. Ignoring the interest factor, W would statistically receive $34,452 ($900 times 38.28) less from the trust, but the entire $80,000 would be left in the trust for the children at W’s death, rather than nothing under the insurance contract. When H considered this fact, plus the flexibility of the trust, he decided that the greater security offered by the insurance company was not worth the adoption of a plan which would, if W survived him by ten years and consumed the reserved $20,000, guarantee nothing for the children.

Since insurance and annuities presently sold (February, 1951) are based on a 2% return, it is interesting to note that under 1951 rates a single person must have a taxable net income after exemptions and deductions of over $16,000 before a tax-free 2% return becomes more valuable in terms of spendable income than a 3% fully taxable return. Stated otherwise, a net taxable return to an unmarried person of 3% on $500,000 is more valuable than a 2% wholly tax-free return on the same amount.