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# TAXATION OF DISTRIBUTIONS FROM ACCUMULATION TRUSTS: THE IMPACT OF THE TAX REFORM ACT OF 1976

David T. Link\* and Michael J. Wahoske\*\*

## I. Introduction

The complex rules governing the taxation of income from trusts and estates have at times been described as incomprehensible.<sup>1</sup> Perhaps the most confusing of these are the accumulation distribution throwback rules. In an effort to alleviate some of this confusion,<sup>2</sup> Congress included accumulation trusts within the purview of the Tax Reform Act of 1976.<sup>3</sup> Though Congress claimed that the rules are now "considerably simplified,"<sup>4</sup> it is not without some effort that one is able to translate the statutory language into a form useful to the practitioner.

Given the complexity of the rules, it is necessary to begin with a caveat. This article is prepared with the assumption that the reader knows something of accumulation trusts and their income taxation. Only so much of the general theory and operation of the throwback rules will be explained as is necessary to introduce the changes made by the 1976 Act and to illustrate their effect. It is hoped that in this way the new rules may be succinctly presented without unnecessary forays into areas essentially unaffected by them.

## II. The Throwback Rules Prior to the 1976 Act

### A. Basic Principles of the Throwback Rules

Trusts are generally treated as separate entities, taxed in a manner similar to individuals. An important difference, however, is that trusts are allowed a deduction for distributions of ordinary income to beneficiaries. The beneficiaries are required to include such distributions in their income for the year, and thus the trust acts as a conduit, channeling the income to its beneficiaries who then pay such tax according to their own tax rates.<sup>5</sup>

The throwback rules relating to accumulation trusts are part of the mechanics giving effect to the conduit principle. They are designed to prevent the accumulation of income by a complex trust over a period of years with distribution to a beneficiary only in years during which that beneficiary has a comparatively low non-trust income.<sup>6</sup> Thus, the rules are intended to prevent tax avoidance, for without them it would be possible to shift part of the tax on a

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1 See Lauritzen, *We Must Simplify the Taxation of Estates and Trusts*, 49 A.B.A.J. 146 (1963).

2 See H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 184-85, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3078-80.

3 Pub. L. NO. 94-455, 90 Stat. 1520 (1976).

4 H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 5, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2899.

5 See *Id.* at 183, U.S. CODE CONG. & AD. NEWS 3077-78.

6 *Id.*

trust's income from a beneficiary to the trust itself and yet distribute most of that income to the beneficiary. Where the beneficiary's tax bracket is significantly higher than that of the trust, a substantial amount of income tax could thus be avoided over a period of years.

### *B. Operation of the Throwback Rules*

Essentially, the throwback rules are designed to prevent tax avoidance by taxing the beneficiary as if the distribution of income from the trust had been made in the year in which the trust accumulated it. The basic operation of this process is not complicated. If, during the tax year in question, there were any distributions by the trust in excess of its distributable net income,<sup>7</sup> these "accumulation distributions"<sup>8</sup> are deemed thrown back to the earliest preceding taxable year in which the trust had undistributed net income.<sup>9</sup> They are then taxed to the beneficiary in the same manner as if distributed in that year. If an accumulation distribution exceeds the undistributed net income for that first throwback year, the excess is then carried forward to the next taxable year of the trust in which there was undistributed net income.<sup>10</sup> One exception to this rule is that accumulation distributions of ordinary income made by a trust in a tax year beginning after December 31, 1973 cannot be carried back to tax years beginning before January 1, 1969.<sup>11</sup>

This may be best illustrated by way of an example. Assume that in 1975 there is an accumulation distribution of ordinary income of \$18,000 from a trust which has taxable years going back to 1965. Further assume that the trust had undistributed net income of \$6,000 in 1967, \$10,000 in 1970, and \$2,000 in 1973; there is no other year with undistributed net income. How would this accumulation distribution be allocated, or "deemed distributed" to the beneficiary, for the preceding years?

The earliest preceding taxable year in which the trust had undistributed net income is 1967. But here the exception operates to prevent a throwback to years beginning before January 1, 1969. Thus, the first eligible year would be 1970. Since the \$18,000 accumulation distribution exceeds the undistributed net income for that year, the balance of \$8,000 is carried over to the next eligible year, 1973. Here again the remaining accumulation distribution exceeds the year's undistributed net income, but now there are no more eligible years. This, then, is the effect of the throwback rules in this simple example: \$10,000 is deemed distributed to the beneficiary in 1970 and \$2,000 in 1973. The remaining \$6,000 of the \$18,000 accumulation distribution essentially passes tax free to

7 "Distributable net income" essentially equals the taxable income of the trust, with certain modifications. See I.R.C. § 643.

8 An "accumulation distribution" is the excess of distributions not required to be distributed currently over distributable net income, after income required to be distributed currently has been subtracted from distributable net income. See I.R.C. § 665(b).

9 I.R.C. § 666. "Undistributed net income" is the excess of distributable net income over the sum of (1) taxes imposed on the trust and (2) the "required" and "other" distributions for that year. See I.R.C. § 665(a). "Taxes imposed on the trust" equal federal income taxes allocable to undistributed amounts of distributable net income and to net gains from the sale or exchange of capital assets. See I.R.C. § 665(d).

10 I.R.C. § 666.

11 Treas. Reg. § 1.666(a)-1A(b)(1) (1972).

the beneficiary as would a distribution of trust corpus. What has happened in the case of this \$6,000 is that the effect of the conduit principle has been avoided because of the pre-1969 years exception. The \$6,000 has not escaped taxes completely; the trust would have paid tax on it in 1967, according to the rates for the trust's bracket. But here the income tax on the \$6,000 has been successfully shifted from the beneficiary to the trust itself and the latter's presumably lower tax rates.<sup>12</sup>

While this example may serve as an illustration of allocation under the throwback rules, the statement above that the beneficiary is taxed on the thrown back amounts as if they had been distributed in the prior years is much too simple. First of all, the beneficiary is liable for whatever tax is imposed on the accumulation distribution in the year he actually receives it.<sup>13</sup> One does not go back and re-open prior years. It is the *amount* of the liability that depends on the distributions deemed made in prior years. Prior to the 1976 Act, this amount was determined by either the "exact" method or the "short cut" method at the beneficiary's option, as shall be explained below. Also, the value of any income taxes paid by the trust in a year to which the accumulation distribution is deemed thrown back is deemed to be an additional distribution to the beneficiary. This rule applies insofar as those taxes imposed on the trust are attributable to the accumulated income now being distributed.<sup>14</sup> No double taxation results, however; the beneficiary is allowed a credit for a proportionate part of the trust's taxes paid in that prior year.<sup>15</sup>

Thus, under the rules in operation prior to the 1976 Act, the tax liability of a beneficiary in the year in which he actually received an accumulation distribution is the sum of: (1) a partial tax on the taxable income for the year computed at the normal rate and in the usual manner, with the amount of the accumulation distribution excluded from this computation; (2) an additional partial tax on the ordinary income accumulation distribution, using either the exact or the short cut method of computation; and (3) an additional partial tax on any accumulated capital gains distribution, again using either the short cut or exact method.<sup>16</sup>

Before the 1976 Act, the beneficiary was free to choose the method of computation, exact or short cut, which resulted in the lesser tax.<sup>17</sup> In the exact method,<sup>18</sup> the tax liability was simply recomputed for the throwback years by adding the amount of the accumulation distribution deemed distributed, including a proportionate share of taxes imposed on the trust, to the taxpayer's other

12 If the trust's bracket in 1967 had not been lower than that of the beneficiary, the trustee would likely have sought to distribute it then, assuming tax saving motives and the power to distribute income. See H.R. REP. No. 94-658, 94th Cong., 1st Sess. 183, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3077-78.

13 See I.R.C. § 667. Prior to the 1976 Act, this rule was found in § 668.

14 I.R.C. § 666(b).

15 See I.R.C. § 667(b) (as amended prior to the 1976 Act).

16 In the interest of completeness, note that a number of limitations, qualifications, and exceptions may be applicable to these computations. See I.R.C. § 668(b)(2)-(5) (as amended prior to the 1976 Act).

17 Some limitations did apply. See I.R.C. § 668(b) (as amended prior to the 1976 Act).

18 See I.R.C. § 668(b)(1)(A) (as amended prior to the 1976 Act) and the Regulations applicable thereto.

income in each throwback year. After recomputing his liability, the beneficiary was then allowed a credit for his share of the taxes already paid by the trust. In other words, under the exact method a beneficiary's tax liability on the amounts deemed distributed could not exceed the aggregate of the taxes that would have been payable had the distributions actually been made in the applicable throwback years.

On the other hand, the short cut method<sup>19</sup> utilized an averaging technique. An average income was computed by dividing the total of all amounts deemed distributed, including taxes imposed on the trust, by the number of prior taxable years to which throwbacks were applicable. This average was then added to the beneficiary's other income for his three immediately preceding taxable years. The difference in each of the three years between the tax computed without the inclusion of the average and the tax computed with the inclusion was termed the additional tax for that year. The additional taxes for those three years were then added together and the sum was divided by three; the resulting quotient was then multiplied by the number of preceding taxable years in which an accumulation distribution was deemed to have been made, and that product, less a credit for taxes imposed on the trust and deemed distributable to the beneficiary, was the tax liability of the beneficiary under the short cut method.

Perhaps another example is in order.<sup>20</sup> Assume an accumulation trust created in 1971 earns \$1,200 in interest income annually and has yearly expenses of \$100 allocable to income production. In 1981, the trust pays out to its beneficiary \$9,550 of accumulated undistributed net income and \$1,000 of current net income. The total amount of taxes paid by the trust on the accumulated income during the 1971-1980 ten year period is \$1,450. The beneficiary is treated as receiving an \$11,000 distribution (\$9,550 plus \$1,450), and the income for the current year (1981) is taxed directly to him. The tax liability on the \$11,000 is computed as follows under the short cut method: the \$11,000 of accumulation distribution plus taxes is divided by the ten years to which the distribution is deemed thrown back, yielding a \$1,100 "average income" per year. Assume that adding the \$1,100 to the income of each of the beneficiary's three preceding years produces tax liability increases of \$350 in 1980, \$300 in 1979, and \$250 in 1978 for a total of \$900. This \$900 total additional tax divided by three equals \$300, the average annual increase in tax. This average annual increase times ten (the number of years to which the accumulation was deemed thrown back) equals \$3,000. Deducting the \$1,450 of taxes paid by the trust and attributable to the undistributed net income now deemed distributed leaves \$1,550. This last amount represents the short cut method computation of the partial tax on the accumulation distribution. As mentioned above, it would increase the beneficiary's tax liability for 1981, the year in which the accumulation distribution was actually received.

After computing the tax using both the exact and the short cut methods to find the lesser liability, under the law prior to the 1976 Act the beneficiary's task

19 See I.R.C. § 668(b)(1)(B) (as amended prior to the 1976 Act) and the Regulations applicable thereto.

20 See Treas. Reg. § 1.668(b)-1A(c)(2) (1972). For purposes of the example, assume the 1976 Act was not passed.

was still not completed. A capital gain throwback<sup>21</sup> computed separately from that for ordinary income was still to be evaluated. All accumulation distributions were considered to be made first out of ordinary income until all of any accumulated ordinary income had been distributed. Only then was a remaining distribution amount considered to have been made out of a capital gain accumulation. Moreover, the capital gain throwback rule only applied in the case of a trust not required to distribute all of its income currently. Thus a simple trust escaped the rule's operation even if it made extra distributions to a beneficiary. Once a capital gain accumulation distribution was found to have been made, the beneficiary allocated the capital gain throwback and figured the partial tax liability in a manner similar to that used for ordinary income accumulation distributions, including use of either the exact or short cut method. As with ordinary income throwbacks, taxes imposed on the trust on the accumulated capital gain were deemed an additional distribution and could also be claimed as an offsetting credit.

### III. Accumulation Trust Taxation Under The Tax Reform Act of 1976

#### *A. Principal Changes*

As practitioners well know and as others may have inferred from the foregoing discussion, the accumulation distribution throwback rules caused a number of administrative problems.<sup>22</sup> For example, since trustees are generally under an obligation to the beneficiaries to compute the throwback under whichever method results in the least tax, both the exact and the short cut method had to be tested before filing a return. Thus the short cut method, intended by Congress to simplify calculations and eliminate record-keeping problems involved with the exact method,<sup>23</sup> failed to achieve the hoped-for simplification. Regarding the capital gain throwback rule, more than a few questions were raised as to whether its complex application was not more trouble than it was worth to the IRS.<sup>24</sup> Consequently, in the Tax Reform Act of 1976, Congress attempted to alleviate these and other throwback rule problems.

The revisionary attempt has resulted in a number of significant changes:<sup>25</sup> A new partial tax computation method is provided for beneficiaries, replacing the former alternative exact and short cut methods. Changes are made in the credit which beneficiaries may claim for taxes paid by the trust on the accumulation distribution. The capital gain throwback rule is repealed, but a new special tax is imposed on the sale of certain trust property. The pre-1969 rule regarding the taxation of accumulation distributions to minor beneficiaries is restored, and a limit tied to the trust's accounting income is placed on the "deeming" of an accumulation distribution.

21 See I.R.C. §§ 665(f)-(g), 669 (as amended prior to the 1976 Act) and the Regulations applicable thereto.

22 See note 2, *supra*.

23 *Id.*

24 *Id.*

25 The following changes appear in § 701 of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

### B. Beneficiary's New Partial Tax Computation

In a sense, the least novel of the changes under the 1976 Act is the new beneficiary's partial tax computation method.<sup>26</sup> Effective for distributions made in taxable years beginning after 1975,<sup>27</sup> the new method is essentially a revision of the former short cut method. The computation is based on the five taxable years of the beneficiary which immediately precede the year in which the accumulation distribution occurs, whereas the prior short cut method utilized the first three preceding years. However, from that five-year base the year in which the beneficiary had his highest taxable income and the year with the lowest taxable income are eliminated. Thus the partial tax computation base is still a three-year period, though not necessarily the same three-year period as under the old short cut method.

The new partial tax itself amounts to the excess amount (if any) of the average increase in taxes for the three-year computation base multiplied by the number of years to which the distribution is deemed thrown back<sup>28</sup> above the amount of taxes paid by the trust and deemed distributed to the beneficiary. The new law thus provides for an offset against the partial tax for taxes deemed distributed to the beneficiary, which offset is essentially a variation of the former credit for taxes imposed on the trust. However, if the amount of the taxes deemed distributed is larger than the amount of the partial tax, neither the trust nor the beneficiary is allowed to use the excess as a general credit against tax liability arising from other sources of income or to claim a refund on it. It is also important to note that the taxable income of the beneficiary cannot be less than zero in a year for purposes of selecting and utilizing the three base years. Thus if a beneficiary has a net operating loss in a year to which the partial tax computation applies, his taxable income for that particular year will be treated as zero.

With these points in mind, the beneficiary's partial tax on an accumulation distribution can be calculated in what amounts to a five-step process:

(1) *Determine the number of preceding taxable years to which the accumulation distribution is deemed distributable.* For this calculation, the rules as they existed prior to the 1976 Act are retained, including the twenty-five percent rule, except that there is no capital gain throwback rule.<sup>29</sup> For example, assume that a calendar year cash basis domestic trust makes an accumulation distribution in 1976 of \$20,000. Further assume that there was undistributed net income of \$2,000 in 1968 and \$3,000 in each of the years 1970-75. Since the pre-1976 Act rules still hold for the allocation process, there can be no throw-

26 I.R.C. § 667. See § 701(a) of the Tax Reform Act of 1976.

27 See § 701(h) of the Tax Reform Act of 1976.

28 There is an exception to this way of determining the multiplier which is discussed in note 29, *infra*.

29 I.R.C. § 665(e). See § 701(d) of the Tax Reform Act of 1976. It is appropriate to note at this point that the new Act retains the rule that if the amount of undistributed net income deemed distributed in any preceding taxable year of the trust is less than 25% of the amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated (under § 666(b)), the number of preceding taxable years of the trust with respect to which an amount is deemed distributed shall be determined without regard to such year. I.R.C. § 667(b)(3). See § 701(a)(1) of the Tax Reform Act of 1976. Cf. I.R.C. § 668(b)(2)(G) (as amended prior to the 1976 Act).

back to a year beginning before January 1, 1969.<sup>30</sup> Thus 1968 will be disregarded, and the number of throwback years under the first step is six.

(2) *Determine the three-year base period.* This is accomplished by taking the five immediately preceding taxable years and excluding from them the two years in which the beneficiary's income was the highest and the lowest. Using the same example begun in the first step, assume that a single beneficiary received the distribution and his taxable income for the five years preceding 1976 was:

1975	\$20,000
1974	(\$3,000) loss
1973	(\$2,000) loss
1972	\$14,000
1971	\$16,000

The three-year base period for the partial tax computation would be the tax years 1971, 1972 and 1973. Note that under the former short cut method, the years comprising the base period would have been 1973, 1974 and 1975, since the three immediately preceding years would have been used.<sup>31</sup>

(3) *Add in the average amount of the accumulation distribution deemed distributed to each of the three years comprising the base period.* First, the total of the amounts deemed distributed under I.R.C. § 666(a) must be found. This total will not necessarily equal the amount of the accumulation distribution, for it will include only those amounts deemed thrown back to eligible preceding taxable years.<sup>32</sup> Therefore, in the above example, since 1968 is not an eligible year, only the total of the amounts deemed distributed to the beneficiary in the years 1970-75, or \$18,000, will be relevant here. To this total is added the amount of the taxes imposed on the trust attributable to the amounts deemed distributed.<sup>33</sup> This sum is then divided by the number of eligible throwback years as determined in the first step. The resulting average is then added to the beneficiary's taxable income for each of the three base years.<sup>34</sup> Continuing the example, assume that the taxes imposed on the trust attributable to the \$18,000 deemed distributed amount to \$3,000. The average amount to be added to the three base years would thus be \$21,000 (\$18,000 plus \$3,000) divided by six (the number of throwback years), or \$3,500. Adding this average to each base year's taxable income would yield adjusted taxable income of \$3,500 for 1973,<sup>35</sup> \$17,500 for 1972, and \$19,500 for 1971.

(4) *Compute the average yearly increase in taxes for the three-year base period.* This is done by first calculating the tax increase in each of the base years occurring as a result of the inclusion of the average amount deemed distributed

30 I.R.C. § 665(e).

31 See I.R.C. § 668(b)(1)(B) (as amended prior to the 1976 Act).

32 See I.R.C. §§ 665(e), 666(a), 667(b)(1).

33 See I.R.C. §§ 666, 667(b)(1).

34 I.R.C. § 667(b)(1)(C).

35 Recall that for purposes of this computation, the taxable income of the beneficiary for any taxable year shall be deemed not to be less than zero. I.R.C. § 667(b)(2). See § 701(a)(1) of the Tax Reform Act of 1976. Thus, even though 1973 was a loss year for the beneficiary in the example, his taxable income for the year, to which the average computed in the third step is added, is figured as zero.



as computed in the third step. The increase for each year is found by determining the difference between the tax figured for each year without the inclusion of the average amount and with the inclusion.<sup>36</sup> The fourth step is then completed by adding the tax increases for each of the three base years and dividing the sum by three, which quotient equals the average yearly increase in taxes. For purposes of the example, assume the tax increases for the three base years resulting from the inclusion of the average amount deemed distributed are \$595 for 1973, \$1,130 for 1972, and \$1,220 for 1971. The average yearly increase in the beneficiary's taxes would be \$2,945 divided by three, or \$982.

(5) *Find the partial tax on the total of the amounts deemed distributed to the beneficiary in preceding years.* This final step first requires multiplication of the average yearly increase in taxes found in the fourth step by the number of eligible throwback years as determined in the first step. From that product is then subtracted the amount of taxes imposed on the trust and deemed an additional distribution to the beneficiary.<sup>37</sup> The result is the beneficiary's partial tax on the accumulation distribution.<sup>38</sup> Concluding the example, recall that the average yearly increase in the beneficiary's taxes was found to be \$982. That number multiplied by six (the number of eligible throwback years found in the first step) equals \$5,892. Subtracting the total of taxes imposed on the trust and deemed an additional distribution, or \$3,000, yields a result of \$2,892, which equals the beneficiary's partial tax on the accumulation distribution as computed under the provisions of the 1976 Act. This tax is due and payable at the same time as the tax on the beneficiary's other income in 1976, the year of the distribution in the example.

### C. Changes in the Credit for Taxes Imposed on the Trust

It will be recalled that in the above example the credit for taxes imposed on the trust allowed to prevent double taxation was less than the beneficiary's partial tax liability. In a case where the total amount of taxes imposed on the trust is greater than the amount of the partial tax liability, however, the 1976 Act limits the effect of the credit allowed. Neither the trust nor a beneficiary is allowed to claim a refund or credit for a preceding taxable year as a result of an accumulation distribution. Therefore, should there be an excess of the amount of taxes already paid by the trust above the partial tax on the accumulation distribution, that excess is lost. It cannot be used as a credit against the beneficiary's tax liability arising from other sources of income, nor may it be claimed as a refund.<sup>39</sup>

36 Although Congress claims that it will no longer be necessary to recompute the beneficiary's tax returns, see H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 185, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3079-80, this double computation—once with the inclusion and once without—is necessary to determine the additional tax. See also the text accompanying note 70, *infra*.

37 I.R.C. § 667(b)(1). See I.R.C. § 666(b) and (c).

38 Note that under the new Act no refunds or credits will be allowed to any beneficiary or trust as a result of an accumulation distribution I.R.C. § 666(e). See § 701(a)(2) of the Tax Reform Act of 1976. See also the discussion of changes in the credit for taxes imposed on the trust, note 39 *infra*, and accompanying text.

39 I.R.C. § 666(e). See § 701(a)(2) of the Tax Reform Act of 1976.

The effect of the new no refund or general credit rule is to exact a penalty for the privilege of having the trust pay the taxes in a case where the beneficiary's tax rate is lower than that of the trust. This does not give effect to the conduit principle, for the beneficiary is paying more than he would have had to pay had the income actually been passed on to him when earned. Thus, far from being an attempt to implement the conduit principle, the rule places a tax upon the decision to accumulate the income instead of distributing it when earned.

#### D. *The Multiple Trust Penalty*

Another new provision even more closely approximates an outright penalty. This special "multiple trust rule"<sup>40</sup> applies whenever a beneficiary receives accumulation distributions from three or more trusts relating to the same prior taxable year. The rule states that where income accumulations from two trusts have been deemed distributed to a beneficiary in a single prior taxable year, that beneficiary may not take the offset for taxes already paid by the third trust or, indeed, any other subsequent trust which is deemed to have distributed accumulated income in that same year. With no offset for the taxes already paid, there is a double taxation of the amount deemed distributed by the third trust in the year in question.<sup>41</sup> There is a *de minimus* rule which partially mitigates the penalty by making the special multiple trust rule inapplicable when an accumulation distribution from a trust, including all prior accumulation distributions from that trust to the beneficiary for that same year, is less than \$1,000.<sup>42</sup> Here again, the conduit principle is not entirely followed, for both the trust and the ultimate recipient of the income are taxed, instead of the burden of taxation finally flowing through to the ultimate recipient alone.

#### E. *Distributions to Minor Beneficiaries*

In contrast to the credit changes and the special multiple trust rule, two additional changes in the accumulation distribution rules should favor the beneficiary in their operation. The first of these, regarding distributions to minor beneficiaries, returns to a policy which existed prior to the Tax Reform Act of 1969.<sup>43</sup> The 1976 Act provides that distributions of income accumulated by a trust before the beneficiary's birth, or while the beneficiary is under twenty-one years of age, are not considered accumulation distributions;<sup>44</sup> thus the throwback

40 I.R.C. § 667(c). See § 701(a) of the Tax Reform Act of 1976.

41 Note that those taxes paid by the third trust are not deemed an additional distribution under this rule, I.R.C. § 667(c). Nevertheless, there is still a double taxation of the rest of the income accumulated by the trust and now deemed thrown back to the beneficiary's prior tax year in question. For example, if the trust earned income of \$2,000 in 1974 and did not distribute it in that year, it would pay income tax on it at its own rate. Assume, *arguendo*, that it pays a tax of \$400. That leaves \$1,600 of the original \$2,000 left in the trust to be later distributed as an accumulation distribution. If, when that later distribution occurs, it falls under the special multiple trust rule, the beneficiary will include the \$1,600 in his partial tax liability computation but will not get credit for the \$400 in taxes already paid by the trust. Thus, \$1,600 of the original \$2,000 income will be subject to double taxation.

42 I.R.C. § 667(c)(2).

43 83 Stat. 487. See H.R. REP. No. 94-658, 94th Cong. 1st Sess. 185, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3079-80.

44 I.R.C. § 665(b). See § 701(b) of the Tax Reform Act of 1976. Note that the trust making the distribution must be "other than a foreign trust" for the exception to apply. *Id.*

rules do not apply and the distributions will be treated as if made from the trust corpus. This exception applies only to the accumulation distribution throwback rules, however, and does not change the rules for taxing amounts currently distributed to a beneficiary. Moreover, under an exception to the exception, this minor beneficiary rule does not apply if the beneficiary falls within the provisions of the special multiple trust rule.<sup>45</sup> Thus, when a beneficiary receives accumulation distributions attributable to the same throwback year from more than two trusts, not only does he lose the credit for taxes paid by the third trust, but the income accumulated during the years prior to his attaining the age of twenty-one is also taxable to him. Obviously, then, this minor beneficiary exception in no way mitigates the operation of the special multiple trust rule. Indeed, by denying a benefit available to all those not falling within the special multiple trust provisions, it makes the penalty of the multiple trust rule even more onerous for some beneficiaries.

#### *F. Distributions Not Exceeding Trust's Accounting Income*

Another change applicable to all types of beneficiaries deals with what Congress found to be an unsatisfactory side effect of the rules which determine when an accumulation distribution has been made.<sup>46</sup> Under the law prior to the 1976 Act, when a trust had deductions that were taken into account in determining distributable net income,<sup>47</sup> the accounting income of the trust<sup>48</sup> was greater than its distributable net income. In such a case, some distributions that were actually of the current year's trust income were treated as accumulation distributions because of the way such distributions were defined.<sup>49</sup> The new law is designed to prevent this result. Under the now prevailing rules defining an accumulation distribution,<sup>50</sup> if the amounts properly paid, credited, or required to be distributed by the trust for a given taxable year do not exceed the trust's income for that year, no accumulation distribution will be deemed made in that year. Thus an income distribution from a trust will not be subject to the throwback rules unless it exceeds that year's accounting income.

#### *G. Special Tax on Transferred Property Replaces Capital Gain Throwback*

Perhaps the most striking change made in the throwback rules by the 1976 Act is the complete repeal of the capital gain throwback rule<sup>51</sup> for distributions made in tax years beginning after 1975.<sup>52</sup> The repeal came in response to a feeling in Congress that preservation of the conduit principle through the capital gain throwback rule created unwarranted complexity.<sup>53</sup> However, since there

45 See note 40 and the accompanying text, *supra*.

46 See H.R. REP. No. 94-658, 94th Cong., 1st Sess. 186, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3080-81.

47 For example, fees chargeable to corpus.

48 Defined in I.R.C. § 643(b).

49 See notes 7 and 8 and the accompanying text, *supra*.

50 I.R.C. § 665(b). See § 701(c) of the Tax Reform Act of 1976.

51 I.R.C. § 669 (as amended prior to the 1976 Act).

52 Section 701(d)(1), and (h) of the Tax Reform Act of 1976.

53 See H.R. REP. No. 94-658, 94th Cong., 1st Sess. 184-85, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3078-80.

was concern about possible abuse in a situation where a grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust and its lower progressive tax rate structure, Congress provided a substitute provision.<sup>54</sup> The price paid for the repeal was the passage of § 644.<sup>55</sup>

This new section states that if property is sold or exchanged at a gain within two years of its initial transfer in trust, the tax on the gain will be computed as if the sale or exchange were made by the grantor, although the tax itself will be paid by the trust. The special tax is based on the amount of "includable gain" realized by the trust, which amount is the lesser of (1) the difference between the fair market value of the property at the time of the transfer and the trust's basis for the property "immediately after" the transfer, and (2) the gain realized by the trust.<sup>56</sup> The trust may initially acquire the property by outright gift from the transferor or through a bargain sale effected by him, or it may acquire the property as a transfer from another trust. Note, however, that in the latter case the two-year period runs from the initial date of the transfer of the property in trust by the transferor.<sup>57</sup> If the trust sells the property in a short sale within the two-year period, the two-year period is extended to the date of the closing of the short sale.<sup>58</sup>

The actual computation of the special tax is relatively simple. It is the difference between (1) the amount of income tax that the transferor would have to pay on the "includable gain" if this gain had been included in his taxable income in the year when the trust disposed of the property, and (2) the tax actually imposed on the transferor for the year.<sup>59</sup> Double taxation is avoided by the exclusion of the includable gain, less any deductions, from the trust's taxable income for the year.<sup>60</sup> Thus the trust's special tax liability is to be computed separately from the tax liability for its income from other sources. Additionally, since the "includable gain" is not included in the trust's taxable income, neither will it be included in the trust's distributable net income. The consequence of this is that the includable gain cannot be taxed to a beneficiary if it is currently distributed to him, nor will such gain be subject to the accumulation distribution throwback rules.<sup>61</sup>

There are a number of exceptions to the special tax imposed by § 644.<sup>62</sup> Of primary importance, § 644 does not apply when a sale or exchange occurs within two years of transfer but after the death of the transferor. Section 644 also is not applicable to property acquired by a trust from a decedent, by a pooled income fund, by a charitable remainder annuity trust,<sup>63</sup> or by a charitable remainder unitrust.<sup>64</sup>

There is also a special rule in § 644 which allows the trust to defer re-

54 *Id.* at 186, U.S. CODE CONG. & AD. NEWS 3080-81.

55 *See* § 701(e) of the Tax Reform Act of 1976.

56 I.R.C. § 644(a)-(c).

57 I.R.C. § 644(a)(1)(A).

58 I.R.C. § 644(d).

59 I.R.C. § 644(a)(2).

60 I.R.C. § 641(c). *See* § 701(e)(2) of the Tax Reform Act of 1976.

61 *See* S. REP. No. 94-938, 94th Cong., 2d Sess. 173-74 (1976).

62 *See* I.R.C. § 644(e).

63 Defined in I.R.C. § 644(d)(1).

64 Defined in I.R.C. § 644(d)(2) and (3).

porting a gain from a sale that occurs in one taxable year until the trust's next taxable year.<sup>65</sup> This occurs where the trust and the transferor have different taxable years and the trustee cannot ascertain the amount of tax that the transferor would have to pay. Use of this special deferment rule triggers an additional tax, however. That tax is computed by multiplying the amount of the § 644 tax on the amount of gain deferred by an annual rate of interest established under § 6621.<sup>66</sup> Note that if, on a sale to which § 644 applies, a trust elects to report income on the installment method, then each installment is treated as a separate sale or exchange to which § 644 applies, including those installments received after the two-year period. Of course, the section states that "includible gain" does not include any portion of an installment received by the trust after the death of the transferor.<sup>67</sup>

#### IV. Conclusion

Through the Tax Reform Act of 1976, Congress hoped to simplify the operation of the accumulation trust distribution throwback rules. In many areas this goal was realized. For example, the new method of computing the partial tax eliminates the trustee's burden of computing the tax under both the old exact and short cut methods to find the lesser tax; it also means that trust beneficiaries need only keep records of their own income for the five years prior to the year of distribution.<sup>68</sup> The complex capital gain throwback rules have been repealed. But this simplification has not come without a price. No credit or refund may come about as the result of an accumulation distribution, and the use of multiple trusts may well be curtailed as a result of the special penalty imposed.

There is yet another consequence of the new simplified short cut method. Prior to the 1976 Act, an accumulation distribution thrown back to a beneficiary's preceding tax year was added to his gross income for that year. His tax for that year was then recalculated; this recalculation included some deductions the limits of which depended on adjusted gross income, such as medical and charitable deductions.<sup>69</sup> Under the new Act, however, throwback income is added

65 I.R.C. § 644(a)(2).

66 *Id.*

67 It is significant to note at this point that while the House of Representatives and the Senate both agreed that the capital gain throwback rule as such should be repealed, they were not originally in agreement on how to replace it. See H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 186 (1975); S. REP. NO. 94-938, 94th Cong., 2d Sess. 172 (1976).

The House preferred a mechanism whereby property placed in trust, the market value of which exceeded the price paid for it by the trust (*i.e.*, where there is any bargain element in connection with the transfer), would be subject to a two-year holding period in order to qualify for long term capital gain treatment. See H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 186 (1975). If sold by the trust within two years of the transfer, any gain realized by the trust up to the amount of any bargain element involved in the original transfer would be treated as short term capital gain and taxed to the trust as such. Gain realized above any bargain element would only have to meet normal holding period requirements, and there would be no tacking of any period during which the original transferor held the property. *Id.*

The Senate rejected this technique in favor of a system taxing the unrealized appreciation in the property at the time it was placed in trust at the grantor's rates. S. REP. NO. 94-938, 94th Cong., 2d Sess. 174 (1976). The conference committee essentially selected the Senate version to become law as I.R.C. § 644. H.R. CONF. REP. NO. 94-1515, 94th Cong., 2d Sess. 441-42 (1976).

68 See Barnett, *The Taxation of Accumulation Trust—Six Years After TRA*, 10 INST. EST. PLAN. ¶¶ 700, 727 (1976).

69 See Treas. Reg. § 1.668(b)-3A(b) (1972).

directly to the beneficiary's taxable income for the throwback year, thus not affecting the calculations based on gross income, since the prior year's tax need not be completely recalculated; all that need be figured is the increase in the tax liability due to the throwback income and any calculations based on taxable income.<sup>70</sup>

Thus, while Congress may have succeeded in its attempt to alleviate some of the confusion inherent in the taxation of accumulation distributions, this has not been achieved without sacrifice, in some cases of the conduit principle itself. Nor is the full impact of the Act's revision yet known, since the new Regulations implementing the Act have not yet been issued.<sup>71</sup> While one may accurately hail the new provisions as "a major step forward in simplification,"<sup>72</sup> final judgment must be reserved until the Act has been tested in the crucible of practice.

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<sup>70</sup> See I.R.C. § 667(b); § 701(a)(1) of the Tax Reform Act of 1976. See also H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 185 (1975); Barnett, *supra* note 68, at ¶ 728.

<sup>71</sup> This is especially true of § 644, where Congress fully expects the Department of the Treasury to provide interpretive regulations. See S. REP. NO. 94-938, 94th Cong., 2d Sess. 174 (1976).

<sup>72</sup> See Barnett, *supra* note 68, at ¶ 736.