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Roger Paul Peters

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TAXATION OF ESTATE AND TRUST INCOME
UNDER THE INTERNAL REVENUE CODE OF 1954

INTRODUCTION

New technical terms and devices abound in that portion of the Internal Revenue Code of 1954 which contains the special income tax provisions relative to estates and trusts. Changes of substance, it is true, have been made in the law, but they are hardly of seismic proportions. The principal substantive changes result from a more consistent application in the new law, as contrasted with the old, of the principle that the estate or trust is to be considered as a conduit or pipe line for the distribution of income. That is to say that items of income in the hands of beneficiaries are to be treated as having the same character as in the hands of the estate or trust. Under the old law it was possible for beneficiaries to be taxed on distributions representing items that were not considered income in the hands of the trust (such as, nontaxable stock dividends and “interest” attributable to a mortgage salvaging operation). The new law obviates such results. Whatever else is new in substance will be pointed out in the course of the following discussion. Much of the new detail in the statute is attributable to the fact that many rules formerly contained in regulations are now set forth in the law itself.


2 McCullough v. Commissioner, 153 F.2d 345 (2d Cir. 1946).

3 Johnston v. Helvering, 141 F.2d 208 (2d Cir. 1944), cert. denied 323 U.S. 715 (1945).
The provisions to be considered apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954. These provisions are contained in what is designated as Part I of Subchapter J of Chapter 1 of the new Code.

Estates and trusts, in the commonly accepted meaning of the terms, are dealt with in Subchapter J. Neither “estate” nor “trust” is defined in the Code. Special types of trusts, such as employees’ trusts and common trust funds are not covered by Subchapter J but are governed by other provisions of the Code.

How is the taxable income of the estate of a deceased person to be determined? How is the taxable income of a testamentary or inter vivos trust to be determined? What are the special rules for determining the taxable income of distributees and beneficiaries of estates and trusts? Under what circumstances will the income of a trust be taxable to the grantor of the trust? Under what circumstances will some person other than the grantor, beneficiary, or the trust itself, be taxed on the trust income?

These are the questions to be considered herein. The new law provides detailed rules for arriving at the answers to these questions. These rules will be considered below, for the most part, in the order in which they appear in the statute. Examples of the application of the statutory rules will be drawn or adapted from those found in the Report of the Senate Committee on Finance. References to sections by number are to sections of the Internal Revenue Code of 1954.

Some preliminary observations are in order for the benefit of those approaching for the first time the various problems of the income taxation of estates and trusts. As will

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5 Employees’ trusts are governed by sections 401, 402, 501 (a), 68A Stat. 134, 135, 163 (1954); common trust funds are governed by section 584, 68A Stat. 203 (1954).
be seen again and again in the following discussion, the income of an estate or trust may, on the one hand, be taxed to the estate or trust, or, on the other hand, to beneficiaries or other persons. If the beneficiaries or other persons involved have taxable incomes in a high tax bracket it may be advisable so to arrange the estate or trust that the income of the estate or trust is taxed to the estate or trust rather than the persons in the high brackets. This elementary practical consideration is the basis for many estate and trust arrangements and, in consequence, it is the seed of many of the statutory rules to be considered below.

I

GENERAL RULES APPLICABLE TO ESTATES AND TRUSTS

Estates and trusts are treated as taxable entities. The rates of tax are the same as those used in the case of individual taxpayers. The taxable income of an estate or trust is determined in the same manner as in the case of an individual except as provided in Part I of Subchapter J. The term "taxable income" is, for practical purposes, equivalent to the amount in dollars and cents on which the income tax is computed. It is the gross income minus the deductions, including personal exemptions. (Under the 1939 Code personal exemptions were credits against net income. Under the new Code the term "net income", without modification, has been abandoned.)

The new Code changes in many respects the rules applicable to individuals, but only the basic provisions will be mentioned here.

The concept of gross income is the fundamental one for the computation of the taxable income of any entity.

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8 § 1, id. at 5.
9 § 63, id. at 18.
10 § 61, id. at 17.
tion 61 lists fifteen items of income as illustrative of what is includible in gross income, and the last item on the list is "Income from an interest in an estate or trust." Interest, rents, royalties, dividends, and income from life insurance and endowment contracts are also listed. Of particular importance, however, is the third item listed in Section 61, namely, gains derived from dealings in property. For it must be remembered that, for federal income tax purposes, a trust or an estate which has gains derived from dealings in property must include the amount of such gains in its gross income. This is true even though gains of that character may not be considered income at all under the applicable state law or by the terms of the will or trust instrument.

On the other hand it is essential to note that there are certain items which may be considered income under applicable state law or the governing instrument of the estate or trust but which are specifically excluded from gross income. The items that are specifically excluded from gross income are listed and defined in a series of sections, Sections 101 through 121. Some of these sections are of particular importance in determining what income items are not included in the gross income of an estate or trust. Among the items excluded from gross income are certain proceeds of life insurance contracts payable by reason of death,\(^\text{11}\) certain employees' death benefits,\(^\text{12}\) gifts and inheritances \(^\text{13}\) and interest on state and municipal bonds.\(^\text{14}\) While these exclusions are substantially the same as those provided for under the old Code, Section 116 provides for an entirely new one, namely, the exclusion each year of the first $50 of dividends received (in a taxable year ending after July 31, 1954) from domestic corporations.

\(^{11}\) § 101(a), id. at 26.
\(^{12}\) § 101(b), id. at 27.
\(^{13}\) § 102, id. at 28.
\(^{14}\) § 103, id. at 29.
Gross income, therefore, may embrace some items which are not considered income for purposes other than the federal income tax and, on the other hand, may omit such income items as interest on municipal bonds and $50 in dividends.

The second step to be taken in arriving at the taxable income of an individual is the deduction of the amounts allowable under Sections 141 through Section 216. Certain of these sections are not applicable to estates or trusts. Indeed, as will be pointed out below, specific provisions state that certain deduction items are not allowable to estates and trusts; others provide for deductions in lieu of the deductions allowed to individuals; others for additional deductions allowable only to estates or trusts. The important deductions allowable to individuals and also allowable in the case of estates or trusts include:

- trade or business expenses;\(^\text{15}\)
- interest paid or accrued on indebtedness;\(^\text{16}\)
- taxes;\(^\text{17}\)
- losses;\(^\text{18}\)
- bad debts;\(^\text{19}\)
- depreciation;\(^\text{20}\)
- amortizable bond premium;\(^\text{21}\)
- net operating loss deduction;\(^\text{22}\)
- expenses for production of income.\(^\text{23}\)

The standard deduction for individuals under Section 141 is not available to estates or trusts.\(^\text{24}\)

\(^{15}\) § 162, id. at 45.
\(^{16}\) § 163, id. at 46.
\(^{17}\) § 164, id. at 47.
\(^{18}\) § 165, id. at 49.
\(^{19}\) § 166, id. at 50.
\(^{20}\) § 167, id. at 51.
\(^{21}\) § 171, id. at 61.
\(^{22}\) § 172, id. at 63.
\(^{23}\) § 212, id. at 69.
\(^{24}\) § 142 (b) (4), id. at 41.
In lieu of the personal exemption deduction under Section 151 an estate is allowed a flat exemption of $600. A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300. This $300 deduction is new. All other trusts are allowed a deduction of $100 as under prior law.

In lieu of the charitable contributions deduction allowed to individuals under Section 170, estates and trusts are allowed to deduct charitable contributions and gifts without limitation, that is, without being limited to a percentage of any kind. There are, however, certain qualifications which should be stated. First of all, no deduction is allowable in the case of a trust coming under the special provisions applicable to trusts which distribute current income only, known as "simple trusts". Secondly, as under prior law, an amount allowable to an estate or trust as a charitable contribution deduction must be an amount of gross income, which pursuant to the terms of the will or trust instrument is, during the taxable year, paid or permanently set aside for religious, charitable, scientific, literary, or educational purposes, or the like. It should be noted that a gift or contribution of funds derived from interest on municipal bonds, for example, would not qualify for the deduction. Thirdly, if the amount contributed consists of gain from the sale or exchange of capital assets held for more than six months, the amount that is deductible is the amount contributed reduced by the deduction allowed to the estate or trust under Section 1202, that is, the special capital gains deduction. Finally, in the case of a trust, the deduction may be subject to Section 681, relating to unrelated business income.

The benefit of the deduction for net operating losses is

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26 § 642 (b), id. at 216.
26 § 642 (c), ibid.
27 § 651 and 652, id. at 219.
28 § 642 (d), id. at 216.
to be allowed to estates and trusts under regulations to be prescribed by the Secretary of the Treasury (or his delegate). The Committee Report states that this provision is comparable to Section 170 of the old Code.\textsuperscript{29}

An estate or trust may be entitled to the deduction for depreciation or depletion but only to the extent that the deduction is not allowed to the beneficiaries.\textsuperscript{30} Thus, if a trust holds real property on which depreciation is allowable and pays one-half of the rentals to a beneficiary (and the other half is not distributed), the beneficiary would be entitled to take one-half of the depreciation deduction and the trust one-half.

The deduction for amortization of grain storage facilities must also be apportioned between the income beneficiaries and the estate or trust. The apportionment is to be made under regulations.\textsuperscript{31} This provision is comparable to Section 172 of the old Code.\textsuperscript{32}

Amounts allowed as deductions to an estate for estate tax purposes are not allowed as deductions for income tax purposes. If the amounts are \textit{allowable} as deductions for estate tax purposes, they may be \textit{allowed} for income tax purposes provided a certain statement is filed in accordance with rules prescribed by the Secretary of the Treasury (or his delegate).\textsuperscript{33} This statement is to be to the effect that the amounts in question have not been allowed for estate tax purposes, together with a waiver of the right to have the amounts allowed as deductions for estate tax purposes. This provision is comparable to Section 162 (e) of the old Code.\textsuperscript{34}

Unused loss carry-overs and excess deductions at the time of termination of an estate or trust are made available

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{29} § SEN. REP. NO. 1622, op. cit. supra note 6 at 342.
\item \textsuperscript{30} § 642 (e), 68A STAT. 216 (1954).
\item \textsuperscript{31} § 642 (f), id. at 217.
\item \textsuperscript{32} SEN. REP. NO. 1622, op. cit. supra note 29.
\item \textsuperscript{33} § 642 (g), 68A STAT. 217 (1954)."\textsuperscript{34} SEN. REP. NO. 1622, op. cit. supra note 29.
\end{enumerate}
\end{footnotesize}
under the new Code as deductions for the beneficiaries. The allowance of the deductions is to be made in accordance with regulations to be issued. This provision would apply in the following kind of situation: The estate or trust terminates in 1955. For that year it has deductions other than deductions for personal exemption and charitable contributions in excess of its gross income for the year. Suppose the excess amounts to $9,000 and that there are three beneficiaries who are entitled to equal shares of the income of the estate or trust. Each beneficiary would be entitled to deduct $3,000 for the year 1955 in determining his own taxable income. It is obvious that this provision will in some cases result in affording substantial tax relief to beneficiaries of estates or trusts.

There are three kinds of credits against the tax available to estates and trusts. The first is for partially tax-exempt interest. Suppose the estate or trust holds United States government obligations issued before March 1, 1941, the interest on which is exempt from normal tax. Under the new Code this exemption from normal tax is brought about by providing for a credit against the tax after the taxable income of the taxpayer has been determined and the tax computed thereon. If no part of the interest in question is allocable to any beneficiary the estate or trust is entitled to take the credit against the tax. If the interest is allocable to the beneficiary, the estate or trust is not allowed the credit. If only a portion of the interest is allocable to beneficiaries, the credit may be taken by the trust with respect to that portion of the interest which is not allocable to beneficiaries. The credit consists of a reduction of the tax by three per cent of the interest amount. For example: A trust

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35 § 642 (h), 68A STAT. 217 (1954).
36 § Sen. REP. No. 1622, op. cit. supra note 6 states that under the old Code these unused carryovers and excess deductions are wasted when the estate or trust terminates.
37 § 642 (a) (1), 68A STAT. 215 (1954).
38 § 35, id. at 14. See § 35 (b) for limitation on amount of credit.
holds United States Government obligations issued before March 1, 1941, and in 1955 receives $900 interest therefrom. By the terms of its governing instrument the trust is to distribute one-half of all types of income to certain named beneficiaries and accumulate the remaining one-half of all types of income. The trust would be entitled to a credit against the tax in the amount of $13.50, that is, 3 percent of $450. If the tax computed on the taxable income of the trust is, let us say, $1,200, the trust would be required to pay only $1,186.50. It is assumed in this example that the trust is not entitled to any other credit against the tax.

The second credit against the tax which is available to estates and trusts is the credit for foreign taxes. This credit applies only if the estate or trust is subject to taxes imposed by foreign countries or possessions of the United States. The credit is allowed under Section 901, the requirements of which are the same as under prior law. The estate or trust receives credit on account of only so much of the taxes as is not properly allocable to beneficiaries.

The third credit against the tax which is available to estates and trusts is the credit for dividends received. This amounts to four percent of the dividends which are received after July 31, 1954, from domestic corporations and are included in gross income. The estate or trust may take this credit for only those dividends not properly allocable to any beneficiary. The beneficiary is entitled to the credit for dividends allocable to him. Allocable dividends are to be considered as having been received by the beneficiary at the time they are actually received by the estate or trust. Thus, if one-half of the dividends allocable to the beneficiary are received in 1954 before July 31 and the remainder after that date, the beneficiary will be entitled to the credit with respect to one-half of the dividends allo-

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39 § 642 (a) (2), id. at 216.
40 § 642 (a) (3), ibid.
41 § 34, id. at 13.
cable to him. The same rule concerning time of receipt applies with respect to the $50 exclusion. The credit is limited to the lesser of the following amounts:

(1) the amount of the income tax for the taxable year, reduced by the credit allowable for foreign taxes; or

(2) the following percent of the taxable income for the taxable year:
   (a) two percent, in the case of a taxable year ending before January 1, 1955;
   (b) four percent, in the case of a taxable year ending after December 31, 1954.

An example showing the application of this credit will be given presently.\textsuperscript{42}

The special tax treatment of what are known as capital gains and losses applies to estates and trusts as well as individuals. The same is true as to the time for filing returns, which is one month later than it was under the old law.

The discussion thus far has been concerned with those basic provisions of the new Code containing rules applicable to individuals which are also applicable to estates or trusts. These rules include those concerning gross income, capital gains and losses, deductions, taxable income, and credits against the tax. Next to be considered are the definitions of "distributable net income" and other special terms.

II

DISTRIBUTABLE NET INCOME

In order to apply the estate and trust provisions of the new Code to concrete factual situations it is essential to have a clear understanding of a new concept, "distributable net income." This new term is defined in Section 643 (a), but it has somewhat different meanings in different

\textsuperscript{42} See Part III of the text, \textit{supra}.\textsuperscript{42}
situations, as will be pointed out. Basically, the “distributable net income” of an estate or trust is the taxable income with certain modifications. Before stating what these modifications are it would be well to consider what purposes this new term is intended to serve.

The Committee Report states that the new Code contains the basic principles of prior law under which estates and trusts are treated as separate taxable entities, but are generally regarded as conduits through which income passes to the beneficiary. It is also stated in the Committee Report that the new Code adopts the general principle that to the extent of the current income of the estate or trust all distributions are deductible by the estate or trust and taxable to the beneficiaries. This approach, it is stated, represents a basic departure from the general rule of prior law that taxable distributions must be traced to the income of the estate or trust for the current year.43

It is the expressly avowed purpose of setting up “distributable net income” to provide a maximum amount as the limit to the amounts deductible by an estate or trust for distributions to beneficiaries. Conversely, “distributable net income” serves to limit the amount includable in the gross income of each beneficiary. Hence, the first modification that must be made in the taxable income is to eliminate the deduction (whether under Section 651 or 661) for amounts distributed to beneficiaries.

The second modification is the elimination of the deduction for personal exemptions ($600 for an estate, $300 or $100 for a trust). If this deduction were not eliminated, beneficiaries might receive the equivalent of an additional exemption from tax.

The third modification relates to capital gains and losses. Capital gains are to be eliminated if they are allocated to corpus. However, they are not to be eliminated if paid, credited, or required to be distributed to any beneficiary

during the taxable year, nor are they to be eliminated if paid, permanently set aside, or to be used for the charitable or similar purposes specified in Section 642 (c). Capital losses are also to be eliminated, except to the extent they are taken into account in determining the amount of capital gains which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction for excess of capital gains over capital losses (Sec. 1202) is not to be taken into account. Since "distributable net income" supplies the outside limit for the distribution deduction of an estate or trust and the outside limit for the inclusion of distributions in gross income of the beneficiaries, capital gains not distributed or required to be distributed and capital losses not taken into account in making distributions, must be eliminated to avoid distortion.

The fourth modification is to be made only in case of "simple trusts", to be discussed in the next section below. These are trusts which distribute current income only and make no provision for charitable purposes. In computing the "distributable net income" of these trusts there are to be eliminated those items of gross income, constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of the fiduciary's determination that the dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

Three additional modifications of the taxable income of the estate or trust may have to be made in arriving at its "distributable net income". All three represent additional amounts to be included. These three additional amounts do not apply in determining the limitation on the amount of the distribution deduction in the case of "simple trusts".

The first of these additional amounts consists of any tax-

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44 See Part III of the text, supra.
exempt interest to which Section 103 applies (for example, interest on municipal bonds). The amount of the tax-exempt interest to be included is to be reduced by the amount of disbursements (nondeductible) allocable to the tax-exempt interest.\footnote{§ 643 (a) (5), 68A Stat. 218 (1954).}

The second additional amount relates to foreign income of foreign trusts. Foreign income of a foreign trust (reduced by disbursements allocable to the foreign income) is to be included in the "distributable net income."\footnote{§ 643 (a) (6), ibid.}

The third additional amount consists of the amount of any dividends excluded from gross income. Thus, if the estate or trust has more than $50 of dividend income and has excluded $50 in computing its gross income, for the taxable year, that amount must be included in the distributable net income of the estate or trust.\footnote{§ 643 (a) (7), ibid.}

If the estate or trust is allowed a deduction for charitable contributions (that is, the deduction under Section 642 (c) ) the additional amount mentioned above consisting either of tax-exempt interest or foreign income may require further reduction. The statutory rule is that (in the absence of specific provisions in the governing instrument) the amount of the charitable contribution deduction is deemed to consist of the same proportion of each class of items of income (whether or not tax exempt) as the total of each class bears to the total of all classes. Accordingly, the additional amount, representing tax-exempt interest or foreign income, to be included in "distributable net income," must be reduced proportionately. For example, if one-fourth of the income (including tax-exempt income) of a trust is to be distributed for charitable purposes, only three-fourths of the tax-exempt interest (reduced by disbursements allocable thereto) will be included in "distributable net income." If, however, the trust in-
instrument provides that none of the tax-exempt interest is payable to the charitable institution but only to named individual beneficiaries, the allocation just mentioned is not to be made.

Two other terms are assigned special meanings, namely, "income" and "beneficiary". For the purposes of the subpart dealing directly with the taxation of estates and trusts, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. The Statute further provides that items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not to be considered income. Of course, this provision does not mean that extraordinary dividends and taxable stock dividends are exempt from tax when allocated to corpus. They represent items of gross income of the estate or trust.

For purposes of the entire part dealing with estates, trusts, beneficiaries, and grantors, the term "beneficiary" includes heir, legatee, and devisee.

III

SIMPLE TRUSTS

Before attempting to explain the operations of more complex provisions, consideration should be given to the less intricate provisions applicable in the case of so-called "simple trusts." A simple trust is a trust required by its terms to distribute all of its income currently. Its terms must not provide for charitable purposes, that is, for the

48 § 643 (b), ibid.
49 § 643 (c), ibid.
purposes specified in § 642 (c).

A simple trust is allowed a deduction, in addition to the deductions previously discussed that are allowed in the case of an individual; this additional deduction consists of the amount of the income for the taxable year which is required to be distributed currently.\(^6\) Notice that the deduction is for the amount of the income, not merely gross income. This provision does not apply in any taxable year in which the trust distributes amounts other than amounts of income required to be distributed currently. Therefore, in the final year of a simple trust, when corpus is distributed, the deduction of the entire income of the trust under Section 651 would not apply. Instead the trust would have to avail itself of the deduction under Section 661, to be discussed in the next section of this article.

The additional deduction is limited to the amount of the "distributable net income" of the trust, that is, if the amount of the income required to be distributed is greater than the amount of the "distributable net income," the deduction is limited to the latter amount.\(^7\) In computing "distributable net income" for this purpose, items of income not included in gross income and deductions allocable thereto are not to be included. Suppose, for example, under the terms of a trust, all of the income is to be distributed currently, share and share alike to beneficiaries A and B. The trust instrument also provides that capital gains, extraordinary dividends, and stock dividends (whether taxable or not) be added to corpus and not considered income and that this disposition is in accord with local law. Assume that the trust records for the calendar year 1954 show the following:

| (1) Interest on industrial bonds | $12,000 |
| (2) Interest on municipal bonds | 3,000 |

\(^6\) § 651 (a), id. at 219.

\(^7\) § 651 (b), ibid.
### Ordinary dividends
16,500

### Stock dividends (taxable)
2,000

### Capital gains (assets held more than 6 mos.)
4,000

### Extraordinary dividends
500

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>$38,000</td>
</tr>
<tr>
<td><strong>Less: Expenses</strong></td>
<td>1,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$36,800</td>
</tr>
</tbody>
</table>

The income of the trust to be distributed currently amounts to $30,300, that is, the sum of the first three items above less the amount of expenses. In order to determine the amount of the additional deduction for amounts required to be distributed currently, however, the amount of the "distributable net income" must be computed. No deduction may be taken, it will be recalled, for distributions or for the personal exemptions, and, since the capital gains, stock dividends and extraordinary dividends in this case are to be added to corpus, they must be excluded. Since the municipal bond interest is excluded from gross income, item 2 must also be excluded. No allowance need be made for the $50 dividend exclusion since more than that amount of taxable dividends has been excluded already. Accordingly, the items to be included are items 1 and 3, which amount to $28,500. This amount must be reduced by the amount of expenses not allocable to exempt income. If 1/12 of the expenses is allocable to tax-exempt income, $1,100 would remain to be deducted in computing the "distributable net income" so that "distributable net income", for the purpose of limiting the amount of the deduction, would be $27,400 ($28,500 minus $1,100), and the additional deduction for distributions to beneficiaries would be limited to that amount. The trust would actually be required to pay a tax of $810. This would be determined as follows:
Interest on industrial bonds $12,000
Dividends ($19,000 less $50 exclusion) 18,950
Long-term capital gains 4,000

Less deductions:
Personal exemption $ 300
Expenses 1,100
Capital gains (Sec. 1202) 2,000
Distributions 27,400

$30,800

Taxable income: $ 4,150

Tax $ 859
Less: Credit under Section 34 (4% of $1,225, that is, dividends received after July 31, 1954, not allocable to any beneficiary) 49

Tax payable by trust: $ 810

It is assumed that one-half of the dividends not allocable to beneficiaries was received after July 31, 1954. The credit of $49 is less than two per cent of the taxable income of the trust for the year 1954.

Next to be considered are the rules for determining what is included in the gross income of beneficiaries of simple trusts. The amounts required to be distributed to the beneficiaries are to be included in their gross income, whether distributed or not, but there are two important qualifications to this rule. The first is that the amount to be included in the gross income of the beneficiary is not to

52 § 652 (a), ibid.
exceed the amount which bears the same ratio to the "distributable net income" as the amount of income required to be distributed to the beneficiary bears to the amount of income required to be distributed to all beneficiaries. This qualification applies in those cases in which the amount of income required to be distributed exceeds the amount of the "distributable net income." In the previous example the amount required to be distributed to beneficiary A would be one-half of $30,300 or $15,150. The "distributable net income" of the trust amounts to $31,450. This amount is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on industrial bonds</td>
<td>$12,000</td>
</tr>
<tr>
<td>(item 1 above)</td>
<td></td>
</tr>
<tr>
<td>Ordinary dividends</td>
<td>16,500</td>
</tr>
<tr>
<td>(item 3 above)</td>
<td></td>
</tr>
<tr>
<td>Net municipal bond interest</td>
<td>2,900</td>
</tr>
<tr>
<td>(item 2 less $100 non-deductible expense)</td>
<td></td>
</tr>
<tr>
<td>Dividend exclusion</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$31,450</td>
</tr>
</tbody>
</table>

If, however, the "distributable net income" of the trust were less than $30,300, the qualification would apply. Suppose, for example, that the distributable net income were $28,000. A would include only one-half of that amount, that is $14,000 in his gross income rather than the amount of $15,150.

The second qualification is that amounts required to be distributed are to have the same character in the hands of the beneficiary as in the hands of the trust. Tax-exempt interest in the hands of the trust, for example, remains tax-exempt interest in the hands of the beneficiary; dividends remain dividends, and so forth. The various kinds of income must be allotted to the beneficiaries on a pro rata basis unless the terms of the trust specifically

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52 § 652 (b), ibid.
allocate different classes of income to different beneficiaries. In making allocations, items of deductions are to be allocated among the items of distributable net income in accordance with regulations to be issued. Since in the previous example it was assumed that $100 of administration expense was allocated to the tax-exempt interest of $3,000, each beneficiary should be allotted $1,450 of the net of $2,900 as tax-exempt interest in his hands. Thus the amount distributable to each beneficiary, $15,150, should be reduced by $1,450. The remainder less the $50 dividend exclusion, $14,650, is the amount to be included in the gross income of each beneficiary. It will be observed that such amount is less than the proportionate part of the "distributable net income".

There is one final rule with respect to simple trusts. If the taxable year of the beneficiary is different from that of the trust, the amount which the beneficiary is required to include in gross income is to be based upon the amount of income of the trust for any taxable year or years of the trust ending within or with the beneficiary's taxable year.'

IV

ESTATES AND TRUSTS OTHER THAN SIMPLE TRUSTS

Both estates and trusts (other than simple trusts, discussed above) are entitled to an additional deduction under Section 661 for amounts distributed or distributable to beneficiaries. The amount of this additional deduction is the sum of (1) and (2) as follows: (1) any amount of income for the taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for the taxable year. If an amount required to be distributed may be paid out of income or corpus and is actually paid out of income

\[ § 652 (c), ibid. \]
for the current year it is regarded as an amount falling under (1) above. Amounts falling under (1) will be subsequently referred to as Section 661 (a) (1) amounts. Amounts falling under (2) will be subsequently referred to as Section 661 (a) (2) amounts.

The additional deduction under Section 661 (a) must not exceed the distributable net income of the estate or trust.

As in the case of simple trusts, the character of the income in the hands of the estate or trust remains the same in the hands of the beneficiaries. The different kinds of income items are to be allocated to the beneficiaries on a pro rata basis unless the specific terms of the will or trust instrument allocate the different kinds of income in some other manner. Items of deduction are to be allocated among the items of distributable net income in accordance with regulations to be issued.

The statute provides for a special limitation on the amount of the additional deduction. No deduction will be allowed for distributable amounts not treated as gross income of the estate or trust.\(^5\)

The application of the additional deduction under Section 661 in the case of a trust may be illustrated by the following example:

Suppose a trust instrument provides that three-fourths of income after expenses of the trust (not including capital gains) be paid to a life beneficiary and the remaining one-fourth be set aside for a specified charitable purpose. For the year 1954 the trust records show the following:

\[
\begin{align*}
(1) & \quad \text{Dividends} \quad \$25,000 \\
(2) & \quad \text{Interest on} \\
& \quad \quad \text{industrial bonds} \quad 11,000 \\
(3) & \quad \text{Interest on} \\
& \quad \quad \text{municipal bonds} \quad 6,000
\end{align*}
\]

\(^5\) § 661 (c), id. at 220.
(4) Rental income 16,000
(5) Capital gains 2,000

$60,000

Less:
Administration expense
attributable to taxable income $ 700
Administration expense
attributable to exempt income 75
Depreciation 3,000

$3,775 $56,225

It should be noted that the trust income (before expenses) under the terms of the trust would include the first four numbered items above, totaling $58,000. This amount would be reduced by the amount of the expenses ($775), leaving $57,225 available for distribution to the beneficiary and for charitable purposes. The trust instrument specifically provides for the distribution of all rental income and all exempt interest to the life beneficiary. The beneficiary, as will be shown later, is entitled to the benefit of the deduction for depreciation in respect of the property from which the rental income is derived. The beneficiary will also get the benefit of the exclusion for tax-exempt interest.

The distributable net income of the trust would be computed as follows: No allowance would be made for the additional deduction for distributions to the beneficiary or for the personal exemption of $100. Capital gains ($2,000, item 5) allocated to corpus are not included. Tax-exempt interest ($6,000, item 3) reduced by expenses attributable thereto ($75) would be included ($5,925). It will be recalled that the trust is to be allowed a deduction under Section 642 (c) for an amount set aside for charitable purposes. If the trust instrument did not provide
for the allocation of the exempt income to the life beneficiary, it would be necessary to reduce the amount of $5,925 to three-fourths thereof.) Finally, the dividends ($25,000, item 1) would be included in full without regard to the $50 exclusion from gross income under Section 116. In short, the distributable net income would consist of the sum of items 1, 2, and 4 (or $52,000) plus $5,925 (net tax-exempt interest) less $700 for administration expense and less $14,306.25, the amount set aside for charitable purposes. Distributable net income amounts to $42,918.75. Depreciation is not taken into account because it is not available to the trust as a deduction under the terms of the trust instrument. But the charitable contribution deduction under Section 642 (c) would be reflected in distributable net income since it is an item in the computation of taxable income not included by the terms of the definition of distributable net income.

Next to be determined is the amount actually distributed or distributable to the beneficiary and the amount allowable as a deduction to the trust on account of the distribution amount. The beneficiary is entitled to receive three-fourths of the trust income of $57,225 (the sum of items 1, 2, 3, and 4 ($58,000) reduced by expenses of $775). The beneficiary is entitled to $42,918.75, and the remainder ($14,306.25) is to be set aside for charitable purposes.

Rental income in the hands of the trust would remain rental income in the hands of the beneficiary. The same is true with respect to the tax-exempt interest. Items of distributable net income not included in the gross income of the trust must be taken into account by eliminating from the amount of the additional deduction for distributions the amount of $5,925, consisting of the net municipal bond interest (tax-exempt) so that from the amount distributable to the beneficiary ($42,918.75) there must be deducted $5,925, leaving $36,933.75 as the amount of the allowable deduction for distributions under Section 661.
Accordingly, the taxable income of the trust would be computed as follows:

**Gross income:**
- Sum of items 1, 2, 4 and 5 (reduced by $50 dividend exclusion) $53,950 $53,950

**Less deductions:**
- Personal exemption $ 100
- Expenses 700
- Charitable contributions 14,306.25
- Additional deduction 36,993.75
- Capital gains deduction 1,000 $53,100

$ 850

The tax at 20% would thus be $170.

How much must the beneficiary of an estate or trust include in his gross income with respect to amounts distributed or distributable to him? The beneficiary must include in his gross income the sum of (1) the amount of the income required to be distributed currently and (2) all other amounts properly paid, credited, or required to be distributed to him for the taxable year. Of course, this general rule is subject to important qualifications, which are explained below.

The amount includible is limited by the amount of the distributable net income, computed without regard to the deduction allowed by Section 642 (c) for charitable purposes. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (so computed) the amount included in the gross income of each beneficiary is limited to a proportionate amount of the distributable net income (so computed), that is, in the ratio of the beneficiary's share of the income to that of all beneficiaries. The amount of the in-

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56 § 662 (a), ibid.
come for the taxable year required to be distributed currently includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for the taxable year. Another important qualification (applicable with respect to the amount specified in (2) above) applies when the distributable net income of the estate or trust is less than the sum of (1) the amount of income required to be distributed currently to all beneficiaries and (2) all other amounts properly paid, credited, or required to be distributed to all beneficiaries. In that situation, instead of including all of the amount specified in item (2), (that is all other amounts properly paid, credited, or required to be distributed to all beneficiaries) only a portion is to be included. This portion is an amount which bears the same ratio to distributable net income (reduced by the item (1) amounts, that is the amount of income for the taxable year required to be distributed currently to all beneficiaries) as all the other amounts properly paid, credited, or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

The preceding paragraphs relating to what the beneficiary must include in his gross income require further explanation. A crucial principle has not been stated—concerning the character of the amounts—but the statement and explanation of that principle will be deferred until the operation of the modifications stated in the preceding paragraphs has been explained by means of an example.

Suppose that a trust has accumulated income for a number of years and then in 1955, for example, it is required by its terms to distribute to beneficiary A $7,500 and to beneficiary B $2,500. The trust is required to set aside each year $250 (out of gross income) for charitable purposes. The income of the trust for 1955 consists of tax-exempt interest in the amount of $600 and other interest (fully taxable) of $5,000. The distributable net income of
the trust amounts to $5,280 if no allowance is made for the charitable deduction of $250. How do the statutory formulas operate to determine what is includible in the gross income of each beneficiary? The amount of income for the taxable year required to be distributed to all beneficiaries would be the entire income of the trust except for the amount set aside for charitable purposes ($250) and for the amount of administration expense ($320), or $5,030. Since the amount of income required to be distributed currently to all beneficiaries ($5,030) is less than the amount of the distributable net income without allowance for the charitable deduction ($5,280), the first qualification above does not apply, and no proration of the amount of the distributable net income to the beneficiaries is necessary. Likewise, since whatever remaining amounts payable to the beneficiaries must be paid out of corpus, the special meaning of “the amount of income for the taxable year required to be distributed currently” does not apply. However, other amounts are required to be paid to the beneficiaries in order to make up the amounts of $7,500 payable to A and the amount of $2,500 payable to B. Such amounts would represent the difference between the amount of the income for the taxable year required to be distributed currently to all beneficiaries ($5,030) and the total amount payable in 1955 ($10,000). The remainder ($4,970) represents the amounts payable to the beneficiaries out of accumulations of earlier years. It is evident that the sum ($10,000) of the income amounts required to be distributed currently ($5,030) and all other amounts ($4,970) exceeds the distributable net income. In this situation, the amount includible in the gross income of each beneficiary with respect to the distributions of accumulated amounts must be computed in accordance with the ratio previously stated, that is, an amount which bears the same ratio to the distributable net income ($5,280) reduced by the amounts of income
distributable to the beneficiaries ($5,030) or $250, as the other amounts properly paid, credited, or required to be distributed to the beneficiary (in the case of beneficiary A, three-fourths of $4,970 or $3,727.50) bear to the other amounts paid, credited, or required to be distributed to all beneficiaries (or $4,970). In other words, in the case of beneficiary A, the "other amount" (item (2)) to be included in gross income is three-fourths of $250 (the amount of the distributable net income reduced by distributions out of income) or $187.50. Similarly, beneficiary B will include $62.50 as the "other amount". Accordingly, beneficiary A would be required to include $3,915 ($3,727.50 plus $187.50) in his gross income, and beneficiary B would be required to include $1,305 ($1,242.50 plus $62.50) in his gross income. That is, A and B would be required to include those amounts were it not for the conduit principle, whereby the character of the amounts must be considered.

The amounts determined above as to the beneficiaries of an estate or "complex trust" are to have the same character in the hands of the beneficiary as in the hands of the estate or trust. If the amounts to be distributed are considered tax-exempt interest in the hands of the estate or trust, they are to be considered tax-exempt interest in the hands of the beneficiaries. The same is true with respect to dividends, capital gains, and any other kind of income with respect to which special rules are applicable. In order to carry out this basic principle there must be an apportionment to the beneficiaries of the various classes of income items. Unless the governing instrument specifies otherwise, the apportionment is to be made as follows: The amounts are to be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of

\[§ 662 (b), id. at 221.\]
the estate or trust. The treatment of deductions is left to regulations to be issued. It should be noted that "distributable net income" has a special meaning in this connection. It must be computed without regard to any portion of the charitable deduction which is not attributable to income of the taxable year—in determining the amount of income required to be distributed currently.

Consider again the cases of beneficiaries A and B in the foregoing example. Each one, it will be assumed, is entitled to receive a proportionate part of each class of item entering into the distributable net income of the trust. The only income item requiring special treatment is the amount of $600 representing tax-exempt interest. A problem arises as to the treatment of the deduction of $250 for the amount of gross income (assumed to be current) set aside for a charitable purpose. Presumably regulations to be issued will provide for an allocation of items of income to this deduction. In the simple example used here the amount set aside for charitable purposes will necessarily consist of taxable interest and may be dismissed from further consideration. The amount of the distributable net income ($5,530) includes $600 representing tax-exempt interest, none of which is allocable for charitable purposes. The amount of the tax-exempt income represents slightly more than 11 per cent of the distributable net income. Accordingly, 11 per cent of each beneficiary's share of the income amounts required to be distributed will be treated as consisting of tax-exempt interest. In the case of beneficiary A, 11 per cent of $3,772.50 (three-fourths of $5,030) will be treated as tax-exempt income to be eliminated from A's gross income, that is $414.98. Likewise in the case of B, 11 per cent of $1,257.50 (one-fourth of $5,030) that is $138.33 will be eliminated from B's gross income.

What items will the beneficiaries include? The result is
summarized in the following computation: \(^{58}\)

<table>
<thead>
<tr>
<th></th>
<th>Beneficiary A</th>
<th></th>
<th>Beneficiary B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>$3,915</td>
<td>Less</td>
<td>$1,305</td>
</tr>
<tr>
<td>Less</td>
<td>414.98</td>
<td>Less</td>
<td>138.33</td>
</tr>
<tr>
<td>Amount</td>
<td>$3,500.02</td>
<td></td>
<td>$1,166.67</td>
</tr>
</tbody>
</table>

Amounts included in gross income.

Brief mention must be made of certain additional rules applicable to estates and "complex trusts."

Suppose the taxable year of the beneficiary is different from that of the trust or estate. The beneficiary might report on the basis of a fiscal year, for example, and the estate or trust on a calendar year basis. In such cases the beneficiary must include amounts distributed or distributable to him in accordance with the distributable net income of the estate or trust and the amounts distributed or required to be distributed during the taxable year or years of the estate or trust ending within or with the beneficiary's taxable year.\(^{59}\)

How are bequests or gifts of lump-sums treated for federal income tax purposes in the case of estates or trusts? A lump-sum bequest or gift is not deductible by the estate or trust and is not considered income to the beneficiary. In computing the taxable income of the estate or trust lump-sum bequests or gifts are not taken into account. They are not included as amounts falling within Section 661 (a) (the additional deduction provision of the Code). They are likewise not included as amounts falling within Section 662 (a) (the provision of the Code relating to inclusion of amounts in the gross income of beneficiaries). A lump-sum in this connection means a specific sum of money (or specified property) which is paid or credited all at once or in not more than three in-

\(^{58}\) § See Part V, supra, for the tax treatment of distributions out of accumulations of prior years that are considered "excess distributions."

\(^{59}\) § 662 (c), 68A Stat. 221 (1954).
installments. An amount which can be paid or credited only from the income of the estate or trust is not considered a lump-sum and does not fall within the exclusion rule. The exclusion rule applies only to lump-sum bequests and gifts required by the specific terms of the will or trust instrument.\(^6\)

It will readily be appreciated that the lump-sum exclusion rule is of great practical importance. If it is desired that the income tax burden be borne by the estate or trust (in effect, residuary legatee or remainderman) rather than the beneficiary (specific legatee, life beneficiary, and the like) it is important to take care in the drafting of the will or trust instrument so as to provide that a specific sum be paid in not more than three installments and that it be not paid out of income. For example, a legacy of $1,200 to A, which is payable only out of the income of the estate would fall within the provisions of Sections 661 (a) and 662 (a), but if it is paid or credited all at once or in not more than three installments without regard to the income of the estate, it would be a tax-free bequest to A and not deductible by the estate. A distribution to B upon his attaining the age of 21, of the accumulated income of a trust under the terms of the trust instrument, would not fall within the lump-sum exclusion. This would be true whether the distribution were payable only out of accumulated income or were payable either out of the income or corpus. But if the trust instrument provided that a specific sum be paid or credited to B upon his attaining the age of 21, then the amount paid or credited would not be deductible by the trust and would not be includible in B’s gross income.

Another special rule requiring only brief mention is to the effect that amounts paid or set aside for charitable purposes by an estate or trust are not to be included as amounts falling within Section 661 (a) or 662 (b). The

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\(^6\) § 663 (a), id. at 222.
amounts are to be computed without regard to Section 681, which provides for a limitation on the charitable deduction in exceptional cases.\(^\text{61}\)

It will be recalled that amounts required to be distributed to beneficiaries of an estate or trust in a taxable year qualify for the additional deduction under Section 651 or 661 whether actually distributed in that year or not. The new Code specifically provides that amounts qualifying for deduction in an earlier year may not be included as amounts falling within Section 661 (a) or 662 (a) for the year in which they are actually paid or distributed.\(^\text{62}\)

For trusts in existence before January 1, 1954, there is a special rule concerning distributions made in the first 65 days of a taxable year.\(^\text{63}\) If an amount is properly paid or credited within the first 65 days of the taxable year of the trust, the amount is considered as having been made or credited on the last day of the preceding taxable year. There are certain conditions to be fulfilled before this rule may be applied. First, the trust must have been in existence before 1954. Secondly, the trust, under the terms of its governing instrument, is not permitted to distribute in any taxable year amounts in excess of the income of the preceding taxable year. Thirdly, the fiduciary on behalf of the trust must elect to have the special rule (Section 663 (b)) apply to the trust. The election for the first taxable year beginning after 1953 and ending after August, 1954, must be made in accordance with regulations recently issued.\(^\text{64}\) The election must be made not later than the time prescribed by law for the filing of the return for the first such year (including extensions of time). Once the election is made, the special 65-day rule is to apply to all amounts properly paid or credited within the first 65

\(^{61}\) § 663 (a) (2), ibid.

\(^{62}\) § 663 (a) (3), ibid.

\(^{63}\) § 663 (b), ibid.

days of all subsequent taxable years of the trust.

One more special rule applicable only to trusts having more than one beneficiary should be noted. This special rule is for the sole purpose of determining the amount of distributable net income in the application of Sections 661 and 662. The rule is to the effect that if a single trust with more than one beneficiary meets the requirements of regulations to be issued, substantially separate and independent shares are to be treated as separate trusts. The existence of substantially separate and independent shares and the manner of treatment as separate trusts are to be determined in accordance with regulations to be prescribed by the Secretary of the Treasury or his delegate. The Committee Report states that the effect of this provision is to prevent a beneficiary from being subjected to tax on a distribution which represents distribution from corpus as to him but which would, except for this provision, be treated as a taxable distribution, since the trust income is being accumulated for another beneficiary to whom it will ultimately be made available. Suppose, for example, a trust instrument provides that the trustee may invade corpus to make payments to A, according to A's needs and that trust income is payable to B but may be accumulated for B's benefit or his estate. In the taxable year 1955 the trustee makes a discretionary distribution of corpus to A but accumulates the income for B. Under the special rule, if A and B are deemed to have substantially separate and independent shares in the trust, A would receive the corpus distribution free of tax and the trust income would be taxable to the trust. Otherwise A would be taxable on the distribution to the extent of the distributable net income of the trust.

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65 § 663 (c), 68A Stat. 222 (1954).
V.

TREATMENT OF EXCESS DISTRIBUTION BY TRUSTS

Subpart D contains the rules for the treatment of what are considered "excess distributions" by trusts out of income accumulated in prior taxable years. It should be noted at the outset that these provisions have only prospective application. They deal with allocations to preceding taxable years, but the first preceding taxable year in the case of a trust on the calendar year basis, for example, is the year 1954. Hence, the trust would not be obliged to apply the provisions of Subpart D until after the close of the year 1955.

Suppose a trust accumulates income in the amount of $25,000 in 1954 and pays income tax with respect to that income. In 1955 the trust accumulates $20,000 and pays the tax. Then in 1956, when the income of the trust is only $15,000, the trustee distributes $40,000 to beneficiary A. How is the "excess distribution," that is, the excess of $40,000 over $15,000 to be treated for federal income tax purposes by the trust and by A? That is the kind of situation covered by Subpart D.

The provisions of Subpart D do not apply to estates or "simple" trusts, but only to "complex" trusts distributing income accumulated in years prior to the taxable year. The new Code makes provision for the allocation to five preceding taxable years of what is known as the "accumulation distribution" of a complex trust. To understand what is meant by an "accumulation distribution" and to appreciate the practical application of the "accumulation distribution" provisions, certain technical definitions must first be considered. One of these is the definition of "undistributed net income". A trust has "undistributed net income" only when its distributable net income for the taxable year is greater than the sum of its "distributions"

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and "taxes" for the year. By "distributions" is meant the amounts qualifying for the additional deductions under Section 661 (a), and by "taxes", federal income taxes imposed on the trust. Unfortunately, however, there are further complexities, for the new Code carefully qualifies the meaning of the expression "taxes" as follows: (The special statutory term with respect to "taxes" is "taxes imposed on the trust".) For the purposes of Subpart D (Treatment of Excess Distributions by Trust) this term means the amount of the federal income taxes imposed for any taxable year on the trust under the new Code (without regard to Subpart D) and which, under regulations to be prescribed, are properly allocable to the undistributed portion of the distributable net income.\footnote{§ 665 (c), ibid.} This amount must be reduced by any amount of federal income taxes on the trust allowed under Section 667 and 668 as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year. The provisions of Sections 667 and 668 will be discussed presently. It will be seen that the amount to be used as "taxes" in determining the "undistributed net income" is only the amount of the trust's federal income taxes allocable to the undistributed portion of the distributable net income and that the amount so allocated must be further reduced by amounts allowed as credits to the beneficiaries as a result of the allocation of accumulation distributions to prior years. With these cautions in mind (the operation of which will be explained below), consider the meaning of "undistributed net income." The undistributed net income for any taxable year is the amount by which the distributable net income of the trust for the taxable year exceeds the sum of (1) the amounts specified as "distributions" and (2) the amount of "taxes imposed on the trust."

What are "accumulation distributions"? They are not
any and all distributions of accumulated income. An "accumulation distribution" must, first of all, be an amount in excess of $2,000 for any taxable year. With this qualification, then, the general definition of an accumulation distribution for any taxable year may be expressed by the following formula:

\[
(A) \text{ Section 661 (a) (2) amounts for the taxable year}
\]
\[
\text{Minus}
\]
\[
(B) \text{ Distributable net income (reduced by the Section 661 (a) (1) amount). The excess of the amounts in (A) over the amounts in (B) is the accumulation distribution of the trust for the taxable year.}\]

The Section 661 (a) (2) amounts are amounts (other than income) properly paid or credited or required to be distributed for the taxable year. Section 661 (a) (1) amounts are amounts of income for the taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extend that the amount is paid out of income for the taxable year).

So much for the statement of the general formula for determining the accumulation distribution for the taxable year. But the determination of the amounts in (A) above is subject to the following rules: Those amounts (all amounts (other than income) properly paid or credited or required to be distributed for the taxable year) are to be determined without regard to Section 666, relating to the allocation of the accumulative distribution to five preceding years — and the following amounts are not to be included in the amounts specified in (A) above:

1. Amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of the beneficiary or before the beneficiary attains the age of 21;

2. Amounts properly paid or credited to a beneficiary

\[^{69} \text{§ 665 (b), ibid.}\]
to meet his emergency needs;

(3) Amounts properly paid or credited to a beneficiary upon his attaining a specified age or ages if —

(A) the total number of the distributions cannot exceed four with respect to the beneficiary,

(B) the period between each distribution is four years or more, and

(C) as of January 1, 1954, the distributions are required by the specific terms of the instrument; and

(4) Amounts properly paid or credited to a beneficiary as a final distribution of the trust, if the final distribution is made more than nine years after the date of the last transfer to the trust.

It will be seen that the four classes of items set forth above serve to reduce the amount of the accumulation distribution. The net effect of these provisions is to relieve the beneficiaries of federal income tax on such items. They represent items which are taxable to the trust rather than to the beneficiaries.

One more technical definition applicable to Subpart D (Treatment of Excess Distribution by Trust) must be stated. The term, “preceding taxable year” does not include any taxable year of the trust to which Subpart D does not apply that is, does not include any year before 1954.\(^7\) A special exception to this strict meaning of “preceding taxable year” is made with respect to a preceding taxable year of a trust qualifying as a “simple” trust in a preceding taxable year. Regulations to be issued are to provide for the treatment of such a trust as a “complex” trust. The Committee Report gives as an example of the application of this exception, the distribution of extraordinary dividends accumulated by the trustee of a “simple” trust, which are not treated as income by the

\(^7\) § 665 (d), id. at 224.
trustee in the year in which received by the trust.\textsuperscript{11}

With the technical definitions applicable to excess distributions in mind, let us turn to the income tax treatment prescribed by the new Code. As has been previously indicated, the accumulation distribution of a trust is to be allocated to five preceding years, thus resulting in tax increases to the beneficiaries. The device now provided by law is entirely new and is designed to prevent excessive shifting of income tax burdens from high-bracket beneficiaries to lower-bracket trusts. The new allocation applies in the case of a trust which for a taxable year beginning after December 31, 1953, is considered a “complex” trust, that is, a trust other than a “simple” trust. The amount of the accumulation distribution of a complex trust for the taxable year is treated as if it were a Section 661 (a) (2) amount (an amount other than income) required to be distributed on the last day of each of five preceding taxable years to the extent that the amount exceeds the total of any undistributed net income for any taxable years intervening between the taxable year with respect to which the accumulation distribution is determined and the preceding taxable year. The amount deemed to be distributed in any preceding taxable year is limited to the undistributed net income for the preceding taxable year. The undistributed net income for each of the five preceding taxable years is to be computed without regard to the accumulation distributions.\textsuperscript{12}

These rules are more readily comprehensible if applied to a concrete example. Such an example will be given presently, but a number of additional rules must be stated first.

The rules for the determination of the amount of the accumulation distribution which is to be treated as distributed in a preceding year are supplemented by provisions for additional amounts which are deemed to be

\textsuperscript{11} § SEN. REP. No. 1622 op. cit. supra note 6 at 358.

\textsuperscript{12} § 666, 68A STAT. 224 (1954).
distributed on the last day of five preceding taxable years. These additional amounts consist of the income taxes imposed on the trust and are determined in two different ways. The first method applies in cases where the portion of the accumulation distribution (deemed distributed on the last day of a preceding taxable year) is not less than the undistributed net income for that year. The second method is used in cases where the portion of the accumulation distribution (deemed distributed on the last day of a preceding taxable year) is less than the undistributed net income for that year.

The additional amount in cases where the first method applies is the amount of the taxes imposed on the trust for the preceding taxable year. In other words, the amount of the federal income tax imposed on the trust for the year is considered as an amount distributed as of the last day of that year. In making the computation, the undistributed net income and the taxes imposed on the trust for the preceding taxable year are computed without regard to accumulation distributions.

The second method requires the computation of a fractional amount of the taxes of the preceding taxable year, that is, the amount of the taxes is to be multiplied by a fraction, the numerator of which represents the portion of the accumulation distribution, and the denominator of which represents the undistributed net income of the trust for the year. In making the computation, the undistributed net income and the taxes imposed on the trust are computed without regard to accumulation distributions.

Section 667 specifically provides that no refund or credit is to be allowed to the trust on account of the taxes imposed on the trust which would not have been payable by the trust, had the trust actually made the distributions deemed to have been made in accordance with Section 666, as previously discussed. Credit is to be allowed to the

73 § 666 (b) and (c), ibid.
beneficiaries, however, as will be explained below. The amount of taxes which may not be refunded or credited to the trust is an amount equal to the excess of (1) the taxes imposed on the trust for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over (2) the amount of taxes for that taxable year imposed on the undistributed portion of distributable net income of the trust for that year after the application of the provisions of Subpart D on account of the accumulation distribution determined for that taxable year.

The rules of Subpart D previously stated are all ancillary to the provisions of Section 668, which relates principally to the inclusion in the gross income of beneficiaries of amounts deemed distributed in preceding taxable years. Section 668 also provides for tax credits in the case of beneficiaries, as previously indicated. The total of the amounts deemed distributed by trust in a preceding taxable year are to be included in the *income* of a beneficiary or beneficiaries of the trust. (The amounts may or may not be includible in the *gross* income of the beneficiaries. Tax-exempt income in the hands of the trust, it will be recalled, is considered tax-exempt income in the hands of the beneficiary.) Note that the amounts deemed distributed in preceding taxable years are not includible in the incomes of the beneficiaries for those years, but are includible when actually paid, credited, or required to be distributed. The total of the amounts deemed distributed in a preceding taxable year is to be included in the *income* of a beneficiary or beneficiaries only to the extent that the total would have been included in the income of the beneficiary or beneficiaries under Section 662 (a) (2) and (b) if the total had been paid to the beneficiary or beneficiaries on the last day of the preceding taxable year.

If there is more than one beneficiary involved, the amounts must, of course, be prorated. The portion of the
total included in the income of any beneficiary is to be based on the same ratio to distributable net income (reduced by the amount of income required to be distributed currently) as the other amounts properly paid, credited, or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries. Proper adjustment of this ratio is to be made, in accordance with regulations to be issued, for amounts which fall within paragraphs (1) through (4) of Section 665 (b)—that is, those amounts not included in the accumulation distribution, as previously stated. The tax of the beneficiaries attributable to the amounts treated as received on the last day of the preceding taxable year of the trust is limited to the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiaries on that day.

The final provision of Subpart D relates to the credit for taxes paid by the trust. The tax payable by each beneficiary for the taxable year in which the accumulation distribution is made available to the beneficiary is reduced by a credit. This credit is a pro rata portion of the taxes imposed on the trust for the preceding taxable year which would not have been payable by the trust for that year had the trust actually made distribution to the beneficiaries on the last day of that year in the amounts specified in Section 666, as explained above.

In order to show how the involved provisions of Subpart D will operate, the tax history for several future years must be imagined. Assume that a trust has income of the character and amounts for the calendar years 1954, 1955, and 1956 as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Interest</th>
<th>Tax-exempt Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>$36,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>1955</td>
<td>30,000</td>
<td>6,000</td>
</tr>
<tr>
<td>1956</td>
<td>48,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
The trust has three beneficiaries. It is required to distribute currently one-third of its income to beneficiary A, but the trustee has full discretionary power to distribute the remaining income to beneficiaries B and C in whatever amounts he sees fit.

In 1954 the trustee distributed one-third of the trust income for that year, that is $14,000 (1/3 of $42,000) to A. Nothing was made available to B or C. A would be exempt from tax on $2,000 as his portion of the tax-exempt interest. The trust would be entitled to a deduction of $12,000 under Section 661 and A would include that amount in his gross income. The trust would also be entitled to a deduction of $100 under Section 642(b) so that its taxable income for 1954 would be $23,900 ($36,000 minus $12,100) and the tax imposed on the trust for 1954 would be $9,501. The undistributed net income of the trust as of the close of 1954 is $18,499 ($28,000 minus $9,501).

In 1955 the trustee distributed one-third of the trust income to A and $9,000 to B. A would receive $12,000 and would be taxed on $10,000. A would be exempt from tax on $2,000 of tax-exempt interest. B would be taxed on $7,500. B would be exempt from tax on $1,500 of tax-exempt interest. The trust would be entitled to a deduction of $17,500 under Section 661 and a deduction of $100 under Section 642(b) so that its taxable income for 1955, would be $12,400 ($30,000 minus $17,600). The tax imposed on the trust would be $3,572. The undistributed net income as of the close of 1955 is $11,428 ($15,000 minus $3,572).

In 1956 the trustee distributed one-third of the trust income to A or $18,000 (one-third of $54,000). A would be exempt from tax on $2,000 of tax-exempt interest and would be taxed on $16,000. The trustee also distributed $30,000 to B and $15,000 to C.

\[^{74}\text{§ 668 (b), id. at 225.}\]
B would be considered as having received $24,000 (two-thirds of $36,000, which is the remainder of the trust income for 1956 after A's share of $18,000 has been paid) out of current income. C is considered as having received $12,000 (one-third of $36,000) out of current income. Exempt income must be allocated on the same basis. Two-thirds of $4,000 or $2,666.67 is to be allocated to B, so that $21,333.33 ($24,000 minus $2,666.67) of current income is includible in B's gross income. One-third of $4,000 or $1,333.33 is to be allocated to C, so that $10,666.67 ($12,000 minus $1,333.33) of current income is includible in C's gross income.

For 1956 there would be no tax on the trust since the trust would be entitled to a deduction representing the sum of the taxable amounts distributed to A, B, and C above ($16,000 plus $21,333.33 plus $10,666.67) or $48,000, which is equal to the entire gross income of the trust for 1956.

Now consider the application of Subpart D in the case of beneficiaries B and C for the year 1956.

For 1956 the trust has an accumulation distribution of $9,000. This amount is computed as follows:

Total of all amounts for 1956 falling within
   Section 661 (a) (2)
   (Distributions to B and C) ............... $45,000
Less:
   Distributable net income ($54,000)
   reduced by amounts falling
   within Section 661 (a)
   (distribution to A of $18,000) .......... $36,000
Accumulation distribution: ............... $ 9,000

The accumulation distribution of $9,000 for 1956 is deemed
to have been distributed as an amount specified in Section 661 (a) (2) on the last day of each of the years 1954 and 1955. The amount deemed distributed in 1954 is limited to the excess of $9,000 over the undistributed net income for 1955. Since the undistributed net income for 1955 amounts to $11,428, there is no such excess and, accordingly, no part of the accumulative distribution is allocated to 1954. The amount of the accumulation deemed distributed in 1955 cannot exceed the undistributed net income for 1955 (computed without regard to the accumulation distribution). Since the accumulation distribution does not exceed the undistributed net income, the entire amount of the accumulation distribution ($9,000) is deemed distributed on the last day of 1955.

Since the amount of the accumulation distribution deemed distributed in 1955 is less than the undistributed net income for that year of $11,428, the trust is deemed to have distributed an additional amount with respect to a portion of the taxes imposed on the trust for 1955. The fractional amount is computed by multiplying the amount of the taxes ($3,572) by a fraction the numerator of which is $9,000 (the accumulation distribution) and the denominator of which is $11,428 (the undistributed net income for 1955). This additional amount is $2,813.09.

The trust, then, is deemed to have distributed the following additional amounts on the last day of 1955:

Accumulation distribution: $9,000.00
Portion of taxes imposed on the trust: $2,813.09

Total of amounts treated as distributed in preceding year: $11,813.09

The total of the amounts treated as having been distributed on the last day of any of the five preceding taxable years is to be included in the income of the beneficiaries when in fact paid, credited, or required to be distributed. Accordingly, the additional amounts just computed must
be allocated to B and C for 1956.

B is deemed to have received two-thirds of $11,813.09 or $7,875.39, on the last day of 1955. He includes in his income for 1956, resulting from the application of Subpart D to 1955, $6,562.82, and is exempt with respect to $1,312.57. The amount of the exempt interest ($1,312.57) is computed by taking one-sixth of $7,875.39, the total amount deemed received by B in 1955. One-sixth is the proper amount because exempt interest represented one-sixth of the income of the trust for 1955.

C is deemed to have received one-third of $11,813.09, or $3,937.70 on the last day of 1955. He includes in his income for 1956, resulting from the application of Subpart D to 1955, $3,281.42, and is exempt with respect to $656.28.

B and C are each entitled to a credit against the tax for 1956 for a pro rata portion of the taxes imposed on the trust which, would not have been payable in 1955 had the trust actually made the distributions to B and C resulting from the application of Subpart D.

In 1955 the trust had undistributed net income of $11,428 and the tax was $3,572. After the application of Subpart D, the taxable income of the trust would be $2,555.76 ($12,400 minus the sum of the taxable amounts deemed distributed to B and C, or $9,844.24). The tax on $2,555.76 would be $522.27. The difference between the tax actually paid ($3,572) and the tax resulting from the application of Subpart D ($522.27) is $3,049.73, that is, the taxes imposed on the trust attributable to the additional amounts distributed to B and C. B is entitled to a credit of $2,033.15 (two-thirds of $3,049.73), and C is entitled to a credit of $1,016.58 (one-third of $3,049.73).

75 Helvering v. Clifford, 309 U.S. 331 (1940), and related cases.
TRUST INCOME TAXABLE TO GRANTORS OR OTHERS DEEMED SUBSTANTIAL OWNERS

Congress and the courts have developed in past years a number of rules for attributing the income of trusts to the grantor (or other person deemed the substantial owner) rather than to the trust or beneficiaries. The specific statutory rules were contained in Sections 166 and 167 of the Internal Revenue Code of 1939. The rules developed by the courts were based on the sweeping provisions of Section 22 (a) of the old Code which relate to gross income. The new Code restates these rules with certain modifications which will be discussed below.

The most important modification is that, from now on, the courts will no longer have free rein with respect to the gross income provision, set forth in the new Code in Section 61. Section 671 of the new Code states in part as follows:

No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under Section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

The subpart referred to in the preceding quotation is Subpart E. — Grantors and Others Treated As Substantial Owners. The remainder of this article will be concerned with the rules set forth in Subpart E.

The rules of Subpart E are prefaced by the general rule that where it is specified in Subpart E that the grantor (or another person) is to be treated as the owner of any portion of a trust, items of income, deductions, and credits against the tax of the trust attributable to that portion
of the trust are to be included in computing the taxable income of the grantor or other person. These items (income, deductions, and credits of the trust) are included in computing the taxable income of the grantor (or another person) to the extent that they would be taken into account under Chapter 1 (normal taxes and surtaxes) in computing the taxable income or credits against tax of an individual. Any remaining portion of the trust, that is, any portion not regarded as owned by the grantor (or another person) under Subpart E, is governed by Subparts A through D, previously discussed.\textsuperscript{76}

The terms "adverse party", "nonadverse party" and "related or subordinate party", which will be used in the following discussion have special statutory meanings. An "adverse party" is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property is considered as having a beneficial interest in the trust.\textsuperscript{77} A "nonadverse party" is any person who is not an adverse party.\textsuperscript{78} A "related or subordinate party" is any nonadverse party who is either the grantor's spouse (if living with him) or any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.\textsuperscript{79} In the application of the rules to be set forth below with respect to power to control beneficial enjoyment (Section 674) and administrative powers (Section 675) a "related or subordinate party" is pre-

\textsuperscript{76} § 671, 68A Stat. 226 (1954).
\textsuperscript{77} § 672 (a), ibid.
\textsuperscript{78} § 672 (b), ibid.
\textsuperscript{79} § 672 (c), id. at 227.
sumed to be subservient to the grantor (in respect of the exercise or non-exercise of the powers conferred on him) unless the related or subordinate party is shown not to be subservient by a preponderance of the evidence. Under prior law a power held by the grantor's spouse or by a related or subordinate party could be attributed to the grantor solely by reason of the relationship. Under the new Code, powers so held are not attributable to the grantor unless the related or subordinate party is subservient to the grantor.80

A person is considered as having a power even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.81

VII

REVERSIONARY INTERESTS

Certain reversionary interests in either the corpus or the income of a trust which are held by the grantor have the effect of having the grantor considered the owner of the trust. The grantor is taxable with respect to the income of the trust of which he is considered the owner, in accordance with the rule previously stated. The reversionary interest that has the effect of making the grantor taxable may be in only a portion of the trust. If so, the grantor is to be treated as the owner of that portion.

What kind of a reversionary interest held by a grantor results in his being considered the owner of the trust (or a portion of the trust)? The only kind of reversionary interest that has that effect is one which will or may reasonably be expected to take effect in possession or enjoyment within ten years beginning with the date of the transfer of that portion of the trust in which the grantor has the

81 § 672 (d), 68A Stat. 227 (1954).
reversionary interest.\(^{82}\) Even this rule has two exceptions. The first exception is where income is payable to charitable beneficiaries. The trust (or portion) is not considered as owned by the grantor to the extent that the income is, under the terms of the trust, irrevocably payable for a period of at least two years (beginning with the date of transfer) to a designated beneficiary described in Section 170 (b) (1) (A) (i), (ii) or (iii), that is, a church or a convention or association of churches, an educational organization referred to in Section 503 (b) (2), or a hospital referred to in Section 503 (b) (5).\(^{83}\) The second exception relates to a reversionary interest taking effect at the death of an income beneficiary. If the grantor's reversionary interest is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the trust (or portion) is payable, then the grantor is not to be considered the owner by reason of his having the reversionary interest.\(^{84}\) Suppose, for example, the grantor in 1954 makes a transfer in trust providing for the payment of the income of the trust to A for A's life and for the termination of the trust upon A's death, when the assets are to revert to the grantor. The grantor would not be considered the owner of the trust, and he would not be taxable on the income of the trust, even though A had a life expectancy of only nine years in 1954.\(^{85}\)

Any postponement of the date specified for the re-acquisition of possession or enjoyment of the reversionary interest is treated as a new transfer in trust beginning with the date on which the postponement is effected and terminating with the date prescribed by the postponement.\(^{86}\) If, however, the income for any period would

\(^{82}\) § 673 (a), ibid.
\(^{83}\) § 673 (b), ibid.
\(^{84}\) § 673 (c), ibid.
\(^{85}\) See § 170 (b) (1) (D), 68A Stat. 59 (1954) for denial of charitable deduction in case of certain transfers in trust.
\(^{86}\) § 673 (d), 68A Stat. 227 (1954).
not have been included in the income of the grantor in the absence of the postponement, it is not includible by reason of the postponement. Suppose, for example, a trust is to run for twelve years, but at the end of the ninth year it is extended so that it will have a total term of 14 years. A new five-year trust is considered to have been created but the income of the first three years of the new term is not attributed to the grantor since these years constitute the tenth, eleventh, and twelfth years of the original twelve-year trust.

VIII

POWER TO CONTROL BENEFICIAL ENJOYMENT

The grantor is treated as the owner of a trust if he has a power of disposition over the trust income or corpus exercisable without the approval or consent of any adverse party. This rule also applies to a portion of a trust if the grantor has a power of disposition only with respect to the portion (corpus or income) exercisable without the approval or consent of any adverse party. If the power of disposition is exercisable by a non-adverse party, rather than by the grantor, the rule applies, for a power exercisable by a non-adverse party along or by the grantor together with a non-adverse party, is considered the same as a power exercisable by the grantor alone.87

Exceptions to this rule are provided for in the case of eight separate classes of powers, as follows:88

(1) The grantor will not be treated as owner because of a power to apply income for the support of a dependent (as described in Section 677 (b), to be discussed below) to the extent that the grantor would not be subject to tax under Section 677 (b).

(2) The grantor will not be taxed as owner because of

87 § 674 (a), ibid.
88 § 674 (b), ibid.
a power which may only affect the income for a period beginning after ten years, but the grantor may be treated as the owner after the expiration of the ten-year period unless the power is relinquished.

(3) The grantor will not be taxed as owner because of a power exercisable only by will. This exception does not apply if the grantor has the power to appoint by will the income, where the income is accumulated for disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) The grantor will not be taxed as owner because of a power to determine the beneficiaries of the income or corpus provided that payment must be made for a charitable purpose as defined in Section 170 (c).

(5) The grantor will not be taxed as owner because of a power to invade corpus for a beneficiary or beneficiaries. In order to qualify for exemption the power must be either (A) limited by a reasonably definite standard which is set forth in the trust instrument or (B) exercisable to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. This proportionate share limitation is designed to insure that the grantor, through a power to invade corpus, may not in effect have a power to allocate income.89 A power does not qualify for exemption if any person has a power to add to the beneficiaries designated to receive the income or corpus, except for the purpose of providing for after-born or after-adopted children.

(6) The grantor will not be taxed as owner because of a power to pay income to a beneficiary currently or to accumulate the income for future disposition to the bene-

ficiary. This exception will apply provided that any income which has been accumulated must ultimately be payable either (A) to the beneficiary from whom disposition is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) in a case where the beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate or (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Even though the trust instrument provides for payment to contingent beneficiaries if the primary beneficiary fails to survive the date fixed for distribution, nevertheless accumulated income may be considered to be ultimately payable. It will be considered ultimately payable if the date fixed for distribution may reasonably be expected to occur within the lifetime of the primary beneficiary. Accordingly, a grantor is not taxed on the income if he can postpone payment for a reasonable period of time provided the period is not so long that the effect of the power is the same as though it permitted an allocation of income between the income beneficiary and the remainderman. A power does not qualify for exemption if any person has a power to add to the beneficiaries designated to receive the income or corpus, except for the purpose of providing for after-born or after-adopted children.

(7) The grantor is not taxed as owner because of a power to withhold income during the disability of a beneficiary. The power to withhold must be exercisable only during (A) the existence of a legal disability of any current income beneficiary or (B) the period during which any income beneficiary is under the age of 21 years. The

\[\text{Ibid.}\]
power may be the power to distribute or apply income to or for the beneficiary or to accumulate and add the income to corpus. The power qualifies for exemption even though the accumulated income will not be paid to the beneficiary from whom it is withheld.\(^1\) A power does not qualify for exemption if any person has a power to add to the beneficiaries designated to receive the income or corpus, except for the purpose of providing for after-born or after-adopted children.

(8) The grantor is not taxed as owner because of a power to allocate receipts and disbursements between corpus and income even though the power is expressed in broad language. This exception is designed to insure that a power which is normally vested in the trustee for purposes of conforming to appropriate trust accounting principles may not, if vested in the grantor as trustee, be construed as a power to determine the beneficial enjoyment of income or corpus.\(^2\)

The exempt powers listed above are for the most part the same as those specified in the regulations under the old Code.\(^3\) The last two, ((7) and (8)) are new.

Two other exceptions contained in the regulations under the old Code are now set forth in the Statute. First, the grantor is not taxed as owner because of a power to allocate income or corpus among a class of beneficiaries if the power is held by any person other than the grantor or a person who is both related to the grantor and subservient to his wishes. The rule is not as strict as under the old regulations in that it attributes the power held by another person to the grantor only if that person is subservient.\(^4\) Note that the presumption of subserviency previously stated is applicable. Secondly, the grantor is not taxed as

\(^{1}\) Ibid.

\(^{2}\) Ibid.


owner because of a power exercisable by a trustee or trustees, not including the grantor or spouse living with the grantor, which enables the trustee to apportion income among a class of beneficiaries. The power must be limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not qualify for exemption under this paragraph if any person has the power to add to the beneficiaries designated to receive the income or corpus, except for the purpose of providing for after-born or after-adopted children.  

IX

ADMINISTRATIVE POWERS

The rules in the old regulations concerning administrative powers held by the grantor of a trust (or other person) have been incorporated into the Statute with some slight modifications. The administrative powers held by a grantor which result in his being taxed as the owner of the trust are divided into four categories, which are explained below:

(1) The grantor is treated as owner if the power enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income for less than an adequate consideration in money or money's worth. This rule applies if the power is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(2) The grantor is treated as owner if the power enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest

95 § 674 (d), 68A Stat. 229 (1954).
96 § 675, ibid.
or security. This rule applies if the power is exercisable by the grantor or a nonadverse party, or both. The rule is not as strict as the rule of the old regulations which does not permit the power to be held by the grantor's spouse and does not exempt the power if it permits loans without adequate interest.  

(3) The grantor is treated as owner if he has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including interest, before the beginning of the taxable year. This rule does not apply to a loan which provides for adequate interest and adequate security, if the loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. The exception to the application of the rule just stated did not appear in the old regulations.

(4) The grantor is treated as the owner if a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" has a special meaning for the purposes of this rule. A "power of administration" is any one or more of the following:

(a) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (b) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (c) a power to reacquire the trust corpus by substituting other property of an equivalent value. The Committee Report sums up the significance of

the "power of administration" rule by stating that the grantor will be taxable by reason of a power over investments only where investments are those in which the grantor individually and the trust have significant voting control and then only if the power is exercised in a nonfiduciary capacity, that is, in such a manner as to benefit the grantor individually rather than the beneficiaries.\textsuperscript{98}

X

POWER TO REVOKE

The provisions of Section 166 of the old Code have been carried over into the new Code with certain modifications explained below.

The grantor is treated as owner where at any time the power to revest in the grantor title to the trust (or a portion) is exercisable by the grantor or a nonadverse party, or both.\textsuperscript{99} This general rule, which corresponds to that of the old Code, is subject to a special exception under the new Code. The general rule does not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period beginning after the expiration of a period of time. The period of time is the ten-year period or other period specified in Section 673 concerning reversionary interests. The grantor will be treated as the owner after the expiration of the period unless the power is relinquished.

XI

INCOME FOR BENEFIT OF GRANTOR

The provisions of Section 167 of the old Code have been carried over into the new Code with modifications including one similar to the one provided concerning the power of revocation, previously discussed.

\textsuperscript{98} Ibid.

\textsuperscript{99} § 676, 68A STAT. 230 (1954).
The grantor is treated as owner of any portion of a trust, the income of which without the approval or consent of any adverse party is (1) distributed to the grantor; (2) held or accumulated for future distribution to the grantor; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in Section 170 (c) (relating to definition of charitable contributions)). The rule applies if the trust income may be distributed, held, or applied in the manner specified in (1), (2), or (3) in the discretion of the grantor or a non-adverse party or both, whether or not income is actually used in the manner specified.\footnote{100}

The Committee Report points out that Section 167 of the old Code applies to income which may, in the discretion of the grantor or a nonadverse party, be distributed to the grantor but it does not, by its terms, apply to income which is actually so distributed.\footnote{101}

The grantor is not taxed as owner because of a power the exercise of which can only affect the beneficial enjoyment of the income for a period beginning after the expiration of a period of time. The period of time is the ten-year period or other period specified in Section 673 concerning reversionary interests. The grantor will be treated as owner after the expiration of the period unless the power is relinquished. Suppose a trust provides for the accumulation of income for the benefit of the grantor's son for a period of ten years and that the income of subsequent years must or may be paid to or accumulated for the grantor. The income of the first ten years is not taxable to the grantor.

As under the old Code, income is not to be taxed to the grantor merely because it may be used for the support and maintenance of a beneficiary whom the grantor is legally

\footnote{100} \textsection 677, \textit{ibid.}

\footnote{101} \textit{Sen. Rep. No. 1622, op. cit. supra note 6 at 371.}
obligated to support or maintain, where the income may be so used in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee. This exception does not apply where the income is actually used to support or maintain a beneficiary whom the grantor is legally obligated to support or maintain. In cases where the amounts are paid out of corpus or other than income of the taxable year for the support and maintenance of beneficiaries legally dependent on the grantor for support and maintenance, the amounts are considered as a Section 661 (a) (2) amount (an amount paid or credited within the meaning of paragraphs (2) of Section 661 (a) (relating to deduction for distribution)) and are taxable to the grantor under Section 662 (as an amount distributed).

XII

PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER

New statutory rules are provided for situations where persons other than grantors are treated as substantial owners.

The general rule is that a person other than the grantor is to be treated as the owner of any portion of a trust if the person has a power exercisable solely by himself to vest the corpus or income of the portion in himself. He is also to be treated as the owner if he has previously partially released or otherwise modified the power and after the release or modification retains such control as would, within the principles of Subpart E (previously discussed), subject a grantor of a trust to treatment as the owner.

The person other than the grantor is not treated as the owner if the grantor of the trust is treated as the owner under the provisions of Subpart E.

102 § 677 (b), 68A Stat. 231 (1954).
103 § 678 (a), ibid.
104 § 678 (b), ibid.
The person other than the grantor is not taxed as owner because of a power which enables him, in the capacity of trustee or co-trustee, merely to apply the income to the support and maintenance of a person whom the holder of the power is obligated to support and maintain except to the extent that the income is actually applied for that purpose. In cases where the amounts applied for that purpose are paid out of corpus or out of other than income of the taxable year, the amounts are considered to be a Section 661 (a) (2) amount (an amount paid or credited within the meaning of paragraph (2) of Section 661 (a) (relating to deductions for distributions)) and are taxed to the holder of the power under Section 662 (as amounts distributed).\textsuperscript{108}

If a person other than the grantor renounces or disclaims a power within a reasonable time after he first becomes aware of its existence, the person is not treated as owner.\textsuperscript{108}

XIII

SPECIAL LIMITATION ON CHARITABLE DEDUCTION AND INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE

Only brief notice will be made of two remaining Sections, 681 and 682. The first of these corresponds to Section 162 (g) of the old Code, relating to the denial of the charitable deduction to trusts having unrelated business income and to trusts which entered into certain prohibited transactions. Only the changes from the old law will be noted. A limitation of 20 per cent of the taxable income of the trust is provided if the trust has engaged in a prohibited transaction as defined in the Statute. Under the old

\textsuperscript{105} § 678 (c), ibid.

\textsuperscript{108} § 678 (d), \textit{id.} at 232.
law the limitation is 15 per cent of the net income of the trust. The new law also specifically provides that the denial of the unlimited deduction under Section 642 (c) will not apply to income attributable to property transferred to a trust created under the will of a decedent dying before January 1, 1951, and that in the case of a trust created by the will of a decedent dying on or after January 1, 1951, if the terms of the will require income to be accumulated pursuant to the mandatory terms of the will creating the trust, the denial of the unlimited deduction will apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

Section 682 corresponds to Section 171 of the old Code, which provides rules for taxing the income of trusts as between persons who are divorced or legally separated under a decree of divorce or separate maintenance. The only substantial change contained in the new law is to extend the application of the Section to persons separated under a written separation agreement.

Roger Paul Peters*

* Professor of Law, University of Notre Dame