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Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code

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Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code

LOUIS A. DEL COTTO * AND KENNETH F. JOYCE **

Introduction

THE interests of the beneficiaries in a trust are usually expressed in terms of income and principal. Thus, the current beneficiary normally has an interest in the income of the trust, and future beneficiaries in the principal. The different interests involved compete with one another and create a conflict of interest between the income beneficiary and the remainderman. This conflict causes serious problems, such as:

1. An allocation of receipts and expenditures between income and principal is required. In the conventional trust, because of the conflicting interests of the income beneficiary and remainderman, the trustee is under a duty to allocate receipts and expenditures fairly between principal and income. Such allocations depend to a substantial degree on difficult legal principles and may require lengthy and expensive fact finding processes.

2. Investment policy is distorted. Under present law, trustees must invest so as to assure the income beneficiary a reasonable income. This shapes investment policy in favor of assured income investments, such as bonds and mortgages, rather than growth investments, such as corporate stock. Such a policy is the reverse of one that would be pursued by the individual investor who wants the higher return and tax advantage of stocks.

3. Expensive accountings are required. The conflict of interest between the income beneficiary and the remainderman requires the trustee to submit regular and complicated accounts, which are time consuming and expensive, thus depleting both the energies of the trustee and the assets of the trust.

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The troublesome factor which creates these problems—the conflict of interest between the remainderman and the income beneficiary—would be removed if the interests of the beneficiaries were not in the competing funds of principal and income, but were, rather, in exactly the same fund. This result may be accomplished by giving current shares in the nature of an annuity, rather than an interest in income.

The most sophisticated proposal along these lines has been made by Robert M. Lovell who has presented the unitrust as a solution to the problems created by conflicting interests in the same fund.[1] Under a unitrust instrument, all income as received would be combined with principal in a single fund and there would be no distinction between income and principal. All items received, whether they be dividends, rents or splits, would be termed "receipts," and all items paid out would be termed "payouts." The payout would be directed in fractions or in specific dollar amounts—for example, five per cent of the market value of the total fund as of the first day of the fiscal year, but no more (or less) than a specific dollar amount—and no one interested in the trust would have merely an interest in income or principal.

The unitrust thus removes any conflict of interest between the parties benefically interested in the trust. Many advantages result. There is no longer any need to allocate receipts and expenditures between principal and income since these separate funds are irrelevant to any purpose or need of the trust or its beneficiaries. Accounting requirements are simplified and time and money are saved. Most important, any requirement that the trustee must invest for yield is eliminated; the trustee is no longer required to produce a reasonable income. Since the current beneficiary's interest is expressed as a share of the value of the entire fund, both income and principal, the trustee may invest for growth and obtain the highest return on invested capital to the benefit of *all* persons interested in the trust.

Lovell also contends that the unitrust provides a more favorable vehicle for tax savings than does the conventional trust. By avoiding high yield investments for the growth variety, substantially more of the income of the trust will be in the form of capital gains rather than ordinary income. And, Lovell emphasizes, the usual

[1] Lovell, *The Unitrust*, 105 TRUSTS & ESTATES 215 (1966). Robert M. Lovell is retired Senior Vice-President, Manufacturers Hanover Trust Company, New York. A similar suggestion was made in Carpenter, *A Modernized Trust Plan*, 64 TRUST COMPANIES 421 (1937).

advantage of the trust as an additional tax paying entity remains. Although the existence of this last advantage is somewhat glibly assumed by Lovell, his conclusion is substantially, if not entirely, verified in the capital gains portion of this article.

There can be little quarrel with Lovell's analysis respecting problems revolving around conflict of interest. Removing this conflict would most certainly simplify trust administration in the principal-income area, largely eliminate difficult problems of accounting, and promote an investment policy leading to the largest long run return on invested capital. The burden of this article is not to illuminate any dark corners which may lurk in these areas, but rather to make a thorough investigation of the tax problems surrounding the unitrust, including an examination of the power of Congress to tax a unitrust payout under the sixteenth amendment of the Constitution. These problems, it would seem, are the most important and most difficult problems surrounding the unitrust.

An examination of the tax aspects of the unitrust will also serve to indicate the areas where this trust form is of value and when it is of limited usefulness. For example, the unitrust would appear to be a most advantageous form to use for the common inter vivos trust in which the grantor does not retain an interest, and for the testamentary trust which is the second part of a "two trust" plan. It is not, however, an unmixed blessing. As this discussion will show, even in the trust where the grantor retains no interest, difficult problems arise concerning the tier system of trust taxation. And a grantor trust in the form of a unitrust can raise almost insoluble problems of tax law because the applicable provisions of the Internal Revenue Code are couched in terms more appropriate to the ordinary income-principal dichotomy than that of the unitrust. Also, the unitrust raises unique problems concerning the taxation of capital gains realized by the trust. And, where a trust provides for a gift to charity, the unitrust may be a somewhat clumsy vehicle. Valuations of interests passing in trust are necessary to establish the amount of any transfer to charity, yet such valuations are normally made in terms of income and remainder interests. But the unitrust form will have eliminated such interests. Thus, the unitrust may create serious valuation problems. The unitrust also may have limited usefulness as a marital deduction trust since it may not entirely qualify under the life estate, power of appointment exception to the nondeductible terminable interest rule.

The authors wish to point out most emphatically that the unitrust is essentially an annuity trust. The only real difference between it and the conventional trust is that the unitrust will be *exclusively* an annuity trust, whereas today the trust annuity, where used at all, is used in a more limited manner. This difference should not mislead the reader and he should understand that the ensuing discussion has application to the trust annuity even when it is coupled with more conventional trust provisions.

Taxation of the Unitrust Share: Constitutional, Legislative and Decisional Background

THE NATURE OF THE UNITRUST SHARE

The unitrust share can be regarded as the beneficiary's right to receive an amount, either in terms of a specific number of dollars, or, perhaps more commonly, in terms of a sum equal to a particular percentage of the value of the trust corpus after the addition of current income. Under the provisions of the Internal Revenue Code regarding taxation of trusts, such a share, whether expressed in dollars or as a percentage, would seem to be taxed as an annuity, payable at all events and without regard to income. Where the share is expressed in a specific dollar amount, there is no question under the decided cases that it is such an annuity.[2] This follows from the usual definition, as expressed by these authorities, that an annuity is a fixed amount to be paid absolutely and without contingency.

Where the share is expressed as a percentage of corpus there is little doubt but that it also creates an annuity. It is true that generally an annuity is expressed in terms of a fixed number of dollars which does not vary with the value of the trust or estate. It does not appear, however, that the number of dollars must be fixed in order that a gift or bequest be classified as an annuity. The crucial point would seem to be that there must be a grant of an amount which is a charge against the whole estate and payable at all events, regardless of income. The fact that the amount may vary from year to year would seem to be irrelevant. Thus, a bequest in terms of an amount equal to a particular percentage of the value of the corpus of a trust, after adding net income thereto, would seem to satisfy the definition of an annuity, since, the grant of "an amount," etc., is the same as a grant of a particular number of dollars measured by the percentage of the principal of the trust. This is the holding of the cases in the marital

2 *E.g.*, Helvering v. Pardee, 290 U.S. 365 (1933); Burnet v. Whitehouse, 283 U.S. 148 (1931).

deduction area where a marital deduction grant, whether outright or in trust, is in terms of "an amount equal to one-half of the adjusted gross estate," or "an amount equal to the maximum amount of the marital deduction allowable to my estate for federal estate tax purposes."[3] The grant is one that simply measures the dollar amount or value of the gift. It creates a specific dollar amount measured by one half the value of the adjusted gross estate at death, and this dollar amount is a fixed amount which will not vary with appreciation or depreciation in the value of the estate. Accordingly, where the unitrust share is expressed in terms of an amount equal to a percentage of the value of trust corpus, it should be held to be an annuity. This is because, after application of the formula, the claim of the beneficiary is to a dollar amount payable at all events and without regard to the presence of income. Indeed, it is hard to imagine how else the share could be taxed.

The purpose of the above discussion has been to determine the nature of a unitrust share as a preliminary step in determining how a beneficiary should be taxed on a distribution in satisfaction of such a share. However, the following discussion does not deal with problems concerning realization of gain or loss to the trust or to the beneficiary because the distribution may effect a sale or exchange of property. These problems will be discussed later.[4] It should also be noted here that it has been assumed that the unitrust beneficiary has been given a pecuniary or dollar amount share and not a so-called "fractional share" whereby the beneficiary would receive a direct interest in every asset of the trust. The tax implications of a fractional share will also be discussed later.[5]

TAXATION OF AN ANNUITY UNDER THE INTERNAL REVENUE CODE

The 1942 Amendments

Prior to the 1942 amendments to the Internal Revenue Code, the Supreme Court, in *Burnet v. Whitehouse*[6] and *Helvering*

[3] Polasky, *Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations*, 63 MICH. L. REV. 809, 813 (1965) [hereinafter cited as Polasky]; *In re* Gilmour's Estate, 18 App. Div. 2d 154, 238 N.Y.S.2d 624 (3d Dept. 1963); *In re* Estate of Gauff, 27 Misc. 2d 407, 211 N.Y.S.2d 583 (Sur. Ct. N.Y.C. 1960). *Cf.* Belle Goldstine Frankel, 3 T.C. 231, *aff'd*, 144 F.2d 1023 (8th Cir. 1944). See Coleman v. Comm'r, 151 F.2d 235, 239 (3d Cir. 1945) for a criticism of the *Frankel* case.

[4] *See* text accompanying notes 64 to 75 *infra*.

[5] *See* text accompanying notes 72 to 75 *infra*.

[6] 283 U.S. 148 (1931).

v. Pardee,[7] held that an annuity was not income to the beneficiary of a trust. Although the payments received by the trust beneficiary were in fact made from income, the Court held that the amounts were received as a tax-exempt bequest since they were payable at all events and without regard to the presence of income.[8] In 1942, however, Congress changed the law to provide that a gift, payable at intervals regardless of income, would be taxable to the donee if paid out of income.[9] In addition, the law was changed to treat any distribution, regardless of its source, as if paid out of income if the trust had current income.[10] These changes were intended to reverse the result of *Whitehouse*,[11] and, after 1942, annuities payable regardless of the availability of income were taxed to the beneficiary pursuant to the 1942 amendments.[12]

Smith v. Westover

Since the 1942 solution for the annuity problem—*i.e.*, to tax the beneficiary of current distributions to the extent that there is trust income of the current year regardless of the source of the distribution—was adopted by section 662(a) of the 1954 Code, it is appropriate to analyze the provisions of the 1942 amendments in certain respects. The focus for this analysis will be the case of *Smith v. Westover*,[13] in which the instrument provided that net income was to be added to corpus and thereafter "be considered as principal of the trust," and that the trustees were to pay to the taxpayer annually five per cent of the market value of the trust corpus as determined upon appraisal. As can be seen, this case considered what we now call a unitrust, and appears to be the only reported case dealing with such a trust.

Smith v. Westover considered a situation where, in 1944, when the net income of the trust was $24,000, $18,000 was distributed to

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7 290 U.S. 365 (1933).

8 Burnet v. Whitehouse, 283 U.S. 148, 150–51 (1931). *Whitehouse* was consistently followed in cases involving annuities payable at all events. *See* Coleman v. Comm'r, 151 F.2d 235 (3d Cir. 1945) and cases therein cited.

9 Revenue Act of 1942, ch. 619, § 111, 56 Stat. 798, 809–10 (amending §§ 22(b)(3) and 162 of the Internal Revenue Code of 1939).

10 *See* SURREY & WARREN, FEDERAL INCOME TAXATION 906–07, n.3 (1960 ed. integ. with 1961 supp.) [hereinafter cited as SURREY & WARREN].

11 S. REP. No. 1631, 77th Cong., 2d Sess. 69–70 (1942) reprinted at 1942-2 CUM. BULL. 504; Coleman v. Comm'r, 151 F.2d 235 (3d Cir. 1945).

12 Mary R. Milleg, 19 T.C. 395 (1952); Alice M. Townsend, 12 T.C. 692 (1949), *aff'd per curiam*, 181 F.2d 502 (6th Cir. 1950); Milleg v. United States, 94 F.Supp. 658 (E.D. N.Y. 1950); Dunn v. United States, 86 F.Supp. 861 (E.D. Pa. 1949).

13 89 F.Supp. 432 (S. D. Cal. 1950), *aff'd per curiam*, 191 F.2d 1003 (9th Cir. 1951).

the taxpayer as five per cent of the value of the entire trust assets. Taxpayer argued that she was not taxable on the distribution, contending that, under the sixteenth amendment, section 162(d)(1) of the 1939 Code, the predecessor of section 662(a) of the 1954 Code, could not be constitutionally applied to tax the distribution as income because the distribution was an annual payment of a certain percentage of the corpus of the trust. The Ninth Circuit responded:

> The contention proceeds on the assumption that the power of Congress is limited by the nomenclature used by the testator. Both parties agree that in the year in question the trust received net income. To say that Congress was without power to prescribe that a portion of that income should be taxed to the appellant beneficiary is manifestly untenable.[14]

The Legislative History

There is little question that the facts of *Smith v. Westover* caused the case to fall squarely within the language of section 162(d)(1) of the 1939 Code, as amended in 1942. Since the trust had net income of $24,000, and the beneficiary received distributions from the trust of $18,000, with no other beneficiary being present, the fact that under *Burnet v. Whitehouse* the amount may have been payable without regard to the presence of income was irrelevant under a statute which provided that the distribution to the beneficiary was treated as income of the trust provided the trust income was equal to or in excess of the distribution.[15] Section 162(d)(1) went even further than necessary to change the result of *Burnet v. Whitehouse.* In that case, at least according to the Commissioner's contention, payments were directed to be paid out of income, and corpus was to be invaded only if income were inadequate. The legislative history makes it perfectly clear that it was the intent of Congress not only to tax the beneficiary in such a case

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[14] 191 F.2d 1003, 1004 (9th Cir. 1951).

[15] After the 1942 amendment, section 162(d)(1) of the Internal Revenue Code of 1939 provided, *inter alia:*

> [W]here the amount paid . . . can be paid . . . out of other than income, the amount paid . . . during the taxable year of the . . . trust shall be considered as income of the . . . trust which is paid . . . if the aggregate of such amounts so paid . . . does not exceed the distributable income of the . . . trust for its taxable year. If the aggregate of such amounts so paid . . . during the taxable year of the . . . trust in such cases exceeds the distributable income of the . . . trust for its taxable year, the amount so paid . . . to any . . . beneficiary shall be considered income of the . . . trust for its taxable year which is paid . . . in an amount which bears the same ratio to the amount of such distributable income as the amount so paid . . . to the . . . beneficiary bears to the aggregate of such amounts so paid . . . to . . . beneficiaries for the taxable year of the . . . trust.

but also to tax him where the payments were directed to be made solely from corpus to the extent the trust income was equal to or in excess of the distribution.[16]

Apparently then, the 1942 amendments which added section 162(d) were intended to deal not only with the problem of *Burnet v. Whitehouse, i.e.,* cases where an annuity was payable out of income with principal to be used only to the extent income was unavailable, but with any case where an annuity was payable, whether out of either income or corpus, or even solely out of corpus. This result seems to have been premised upon the notion that the result under the *Whitehouse* and *Pardee* cases allows "tax avoidance by the beneficiary and in some cases results in hardship to other beneficiaries whose share of trust income is reduced by the taxes paid for the benefit of another."[17]

This statement in the Senate Finance Committee report is a curious one at best. Taken together with the position of the Ninth Circuit in *Smith v. Westover,* to the effect that it is untenable to argue that Congress has no power to tax current distributions as income, there seems to be an underlying assumption that there is something about the nature of current distributions from a trust which makes them inherently income. This assumption is difficult to understand. If the grantor or settlor of a trust intends that the current beneficiary be a beneficiary of corpus payments and that income be accumulated for the benefit of the remainderman, there is certainly nothing inherently impossible about the arrangement. Nor will it do to say, as the Senate Finance Committee report suggests, that hardship may result to other beneficiaries whose share of the trust is reduced by the income taxes paid by the trust. If the intent of the grantor is that the income be the remainderman's, then the remainderman should in effect bear the income taxes through the trustee. This arrangement merely expresses the intention of the grantor as to who shall bear the expense of the tax.

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[16] S. REP. No. 1631, 77th Cong., 2d Sess. (1942), reprinted at 1942-2 CUM. BULL. 504. The Senate Finance Committee report states:

> Section 162(d)(1) applies to all cases in which the executor or trustee can or must . . . pay the whole or any part of a gift . . . out of other than income . . . . It applies in all cases of annuities where any deficiency in the amount to be paid can be made up by a payment out of corpus of the trust. It also applies in cases where amounts are to be paid or credited at intervals and the executor or trustee has discretion whether to pay or credit such amounts out of income or corpus, regardless of the source (income or corpus) to which the executor attributes such amount.

S. REP. No. 1631, 77th Cong., 2d Sess. 72, reprinted at 1942-2 CUM. BULL. 504, 560.

[17] S. REP. No. 1631, 77th Cong., 2d Sess. 70, reprinted at 1942-2 CUM. BULL. 504, 558-59.

Since there is nothing inherently impossible about this arrangement, and since no inequities result if that arrangement is the intent of the grantor of the trust, there must be some other reason, if there is a reason at all, for the treatment provided by the 1942 amendments and the 1954 Internal Revenue Code. A possible ground is the statement in the Senate Finance Committee report that the rule of *Burnet v. Whitehouse* and *Helvering v. Pardee* furnish an instrument for tax avoidance by the beneficiary. This statement seems to suggest that as a matter of substance the current beneficiary is really receiving income and is avoiding the tax thereon simply by reason of the form in which the transaction is cast. There is certainly ample authority that form will not be allowed to control substance in matters of taxation, and that income will be taxed to him who receives its economic benefit regardless of niceties of legal title or the form in which the transaction is cast.[18]

The Character of a Trust Annuity and a Unitrust Share

Who, then, is the real beneficiary of the income? Taking the situation of *Burnet v. Whitehouse,* where the fixed sum annuity is payable first out of income and then out of principal to the extent necessary, the remainderman and not the current beneficiary appears to receive the benefit of the income. This is so because the annuity is payable at all events. Therefore the presence of income is irrelevant to the current beneficiary and any income which is earned by the corpus necessarily can benefit only the remainderman. Hence it is only proper that the current beneficiary not be taxed and that the trust, and of course eventually the remainderman, bear the burden of the income tax. This was the holding of the Court in *Burnet v. Whitehouse.* This analysis, however, would seem to have validity only to the extent that the total of the annuity payments to the current beneficiary do not exhaust the initial principal of the fund. For example, if in *Burnet v. Whitehouse* a $5,000 yearly annuity was to be paid solely out of initial corpus, and if in the year of the payment prior payments had exhausted the corpus, then the annuitant would have had the benefit of income. Even if in that year sufficient corpus remained to pay the annuity, if payments would exhaust corpus before the end of the life expectancy of the annuitant, arguably some portion of the annuity would be income. The problem then becomes whether to

[18] *E.g.,* Helvering v. Clifford, 309 U.S. 331 (1940).

exempt from tax all distributions up to the amount of the initial corpus and thereafter tax to the annuitant the remainder of the distributions, or to treat some portion of each distribution as taxable depending upon the life expectancy of the beneficiary and the amount of corpus in the trust.[19] The point to be made here is that, in all events, at least some part, if not all, of the current distribution will be a distribution of corpus. This is because it can be paid, and it is directed to be paid, without regard to current or accumulated income. The income, or at least a large part of it is, in effect, directed to be held for the benefit of the remainderman. There would seem to be no reason why this is not the substance of the transaction in *Whitehouse* and not merely its form.

In the case of the unitrust, where the beneficiary's share is expressed as a fixed sum annuity, the analysis is identical. Where the share, however, is expressed in terms of a percentage of the value of trust corpus after addition of current income thereto, it seems clear that the beneficiary is the beneficiary of income to some extent. Since the share is a percentage of every trust asset, the distribution received is a benefit in the nature of income to the extent that it is based upon the value of trust income for the year and accumulated income from prior years. Hence, it would seem that the percentage share unitrust beneficiary is, in substance, the beneficiary of income in the ratio that trust income, current and accumulated, bears to the value of all trust assets. This portion of the distribution to him is income, but the balance of the distribution is, in substance, a distribution of corpus only. This treatment, of course, is different from that suggested for the distribution involved in *Burnet v. Whitehouse,* where the annuity was a stated number of dollars. A stated number of dollars can be allocated, both theoretically and practically, first to corpus. However, where the share is stated as a percentage of the total value of trust corpus, including income, then it would seem to be not only the intention of the testator that the share be allocated ratably to both corpus and income, but also a necessary result from the fact that each trust asset is utilized in computing the beneficiary's share. Such utilization, in substance, makes one the recipient of the item utilized so that the beneficiary is properly treated as receiving a pro rata por-

[19] This problem merely parallels that encountered by the Congress and the Treasury since the inception of the income tax as to how to tax the payment of commercial annuities. *See generally* Egtvedt v. United States, 112 Ct. Cl. 80 (1948); 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 6A.05 (1962); Magill, *The Income Tax Liability of Annuities and Similar Periodical Payments,* 33 YALE L.J. 229 (1924).

tion of each trust asset.[20] Even if the instrument directed that the entire share be paid first from corpus, the substance of the transaction would remain the same. Such a direction would indeed be labelled "form" instead of "substance," and would involve what the Senate Finance Committee called "tax avoidance by the beneficiary," since the "corpus distribution," to the extent that it represents the value of income, does not actually deplete corpus, because, to this extent, corpus is restored simultaneously by the transfer of income to it.

The suggested method of taxing a percentage unitrust share, that is, to tax the distribution as if received ratably from income and corpus, seems to accord with the substance of the transaction and with the intention of the testator that there be no distinction between income and principal and that all beneficiaries share in both funds alike. Thus, the trust, and hence the remainderman, bears the income tax burden of the income from which the current beneficiary does not benefit. In substance, then, under *Burnet v. Whitehouse,* the current beneficiary can be said really to receive the benefit from a pro rata share of all trust assets, and hence to receive only a pro rata share of the income, current and accumulated, rather than all of the income up to the amount of the distributable net income, and the remainderman likewise to have received the benefit of ratable shares of income and corpus.

The Constitutional Problem

Under the above analysis of the fixed sum and the percentage unitrust share, the effect of the 1942 amendment adding section 162(d), and the effect of section 662(a)(2) of the 1954 Internal Revenue Code, is to do more than merely disallow the gift and inheritance exemption for gifts and inheritances of income. In the situation of *Smith v. Westover* and in the case of the unitrust, the exemption would also be removed for gifts of *corpus* where distributions thereof are periodic, whether the gift be by way of a fixed dollar annuity, or a percentage share annuity. This directly raises the constitutional issue of whether Congress has the power, under the sixteenth amendment, to tax, without apportionment, a gift, bequest, devise, or inheritance of principal.[21] This constitutional issue

[20] *See* Reg. Sec. 1.643(a)-3 (1956).

[21] The constitutional issue also can arise in the case of the conventional trust since all distributions, even of corpus, not exempted by section 663 of the Internal Revenue Code, can be taxed up to the distributable net income of the trust. The issue, however, seems never to have been raised in the case of the conventional trust. This is understandable

has been discussed by one of the authors elsewhere and it was there concluded that:

> . . . Congress [has the power] to impose the income tax, without apportionment, upon receipts of gifts and inheritances of principal. The receipt is in the nature of "income" and the sixteenth amendment dispenses with apportionment of a tax upon income although it be a direct tax. In all events, such a tax would probably be held to be indirect, a tax requiring no apportionment although the receipt is not "income." Hence, both the 1942 amendments to the Internal Revenue Code of 1939, and the provisions of the 1954 Internal Revenue Code, which abolish the rule of *Burnet v. Whitehouse* and tax an annuity paid to a trust beneficiary without regard to its source, would appear to be constitutional exercises of congressional power. In the case of such an annuity, which is in effect a charge on corpus, the exclusion from income provided in section 102 for gifts and inheritances of principal has been rendered inapplicable. The provisions of the Internal Revenue Code of 1954 may be applied to the trust annuity without limitation.[22]

Taxation of a Unitrust Share Under the Provisions of the Internal Revenue Code of 1954

The Statutory Pattern

In General

The taxation of trusts and their beneficiaries is governed by subparts A through D of subchapter J. Under these provisions, the trust is treated as a conduit. Although it is a taxable entity under section 641, the trust is given a special deduction for amounts of income required to be distributed to the beneficiary, and for all other amounts distributed or required to be distributed, but the deduction may not exceed the distributable net income of the trust.[23] The beneficiary is required to include these amounts in his income.[24] The top limit of income to the beneficiary is thus distributable net income,[25] and each item of trust income retains its original character in the hands of the beneficiary.[26]

Under section 643, distributable net income is the taxable

since the current beneficiary generally receives income rather than an annuity. Also, where there is more than one beneficiary, the separate share rule of section 663(c), allowing separate shares to be treated as separate trusts under certain circumstances, tends to prevent taxation of corpus as such.

22 Del Cotto, *The Trust Annuity as Income: The Constitutional Problem of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231, 256 (1968).

23 I.R.C. §§ 643(a), 651, 661(a) (1954). All citations to sections in this article are to sections of the Internal Revenue Code of 1954, as amended to date of publication, unless otherwise indicated.

24 I.R.C. §§ 652(a), 662(a).

25 I.R.C. §§ 652(a), 662(a)(2).

26 I.R.C. §§ 652(b), 662(b).

income of the trust for the year with minor modifications. The function of the distributable net income concept is to prevent the beneficiary from being taxed upon a distribution of corpus. This protection is a function of the exemption from income tax for gifts and bequests, provided under section 102(a). This exemption is not, however, extended to income from property, nor to gifts or bequests of such income. Section 102(b) specifically limits the exemption so that it does not protect such income. The provisions of section 102(b) resulted from an amendment in 1942 to incorporate the rule of *Irwin v. Gavit*.[27] There the Supreme Court held that the income of a trust was not entitled to the gift exemption, and required the income beneficiary to pay the tax on the income in his hands. Thus no part of the gift exemption was allocated to the income interest, and the corpus received the benefit of the entire exemption. This result avoids the difficulties inherent in a division of the exemption, and, in effect, places the current beneficiary into the income shoes of the remainderman, as if a single person owned both the income and the remainder interest.

For purposes of the corpus-income distinction, section 102 provides that any amount included in the income of a beneficiary under subchapter J shall be treated as a gift of income. Section 273 prevents any amortization of this interest. Subchapter J requires the beneficiary to include as income all amounts either distributed or required to be distributed, up to distributable net income. Thus, all these amounts are treated as income without regard to their source, and even though in fact they may be a charge upon corpus. Gifts of a specific sum of money or specific property which are paid in not more than three installments are excepted from this treatment by section 663(a).

The Simple Trust

The foregoing describes the general pattern of trust taxation. However, the Code distinguishes between simple trusts—trusts in which all of the income must be currently distributable to the beneficiaries, with no distributions of corpus in the present year, and no charitable beneficiaries—which are taxed under subpart B, and complex trusts—trusts in which the trustee must or may accumulate some income instead of distributing all of it currently, trusts which distribute some corpus amounts, and trusts which have charitable beneficiaries—which are taxed under subparts C and D. The basic pattern of trust taxation is established by subpart B

[27] 268 U.S. 161 (1925).

together with subpart A. As indicated above, where all of the trust income is to be distributed, the beneficiary is taxed upon that income and the trust, because of its special deduction, is not. Under section 643(b), the income to be distributed by the trust to the beneficiary is the income of the trust required to be distributed under the terms of the trust instrument and local law. The amount taxable to the beneficiary is no more than the distributable net income of the trust, and, under the conduit principle, the character of the amounts received by the beneficiary is the same as in the hands of the trust. Thus, for example, tax-exempt interest retains its character in the beneficiary's hands.[28] The measuring rod of distributable net income, which determines the maximum amount taxable to beneficiaries and deductible to the trust, is defined in section 643(a) as the trust taxable income with some minor modifications. The most important of these modifications is that capital gains and losses are excluded in determining distributable net income. This is because such gains and losses are normally allocable to corpus and not to income under terms of the governing instrument or state law. Hence, capital gains are excluded from distributable net income and are taxed not to the beneficiary, but to the trustee, unless they are in fact distributed or required to be distributed to the beneficiary.

The Complex Trust

In the case of the simple trust where all the income is required to be distributed currently, the problem of allocating the trust income between the trust and the beneficiary, or beneficiaries, is a relatively easy one. The beneficiaries as a group are taxed to the full extent of the distributable net income of the trust, and any amounts distributed in excess of such distributable net income are protected from taxation by the exemption for gifts and bequests. The same result follows for the complex trust where all the income is required to be distributed currently, or is in fact distributed. However, since a complex trust will generally be allowed or required to accumulate income, distributions from such a trust may be of such accumulated income. If there is only a single beneficiary, the problem of allocation of income between the beneficiary and the trust is relatively minor. It is merely a quantitative problem and is solved by the quantitative measuring rod of the current distributable net income. But where there are several beneficiaries and various types of distribution which go to different beneficiaries,

[28] I.R.C. §§ 652(b), 662(b).

then in each beneficiary's hands the distribution may have a different quality and the qualitative problem is introduced. To solve this problem, the 1954 Code provides for a tier system. Basically, there is a two tier system of priorities, supplemented by certain exclusions, for the application of the distributable net income measuring rod.

Under sections 662(a)(1) and 643(b), the first tier is the trust income (as defined by the instrument and local law) for the taxable year which is required to be distributed currently. This income has the highest taxable priority, so that beneficiaries who receive first tier income are taxable to the extent of the distributable net income of the current year.

Section 662 (a)(2) describes the second tier which includes any amounts, other than first tier distributions, which are distributed, whatever their nature. This tier catches all discretionary distributions of current income, all distributions of accumulated income whether discretionary or mandatory, and all corpus distributions whether discretionary or mandatory, except for amounts excluded under section 663. The distributions falling in this tier are taxed proportionately to the beneficiaries to the extent of the distributable net income remaining after deducting therefrom the first tier income.

Excluded from the tiers are amounts which qualify for the gift exemption, because they are basically distributions of corpus. Under section 663, distributions which are nonperiodic in nature are not included as income within any of the tiers. Thus, under section 663(a)(1), an amount distributed in satisfaction of a gift or bequest of either a specific sum of money or of specific property, is tax-free to the beneficiary if payable out of accumulated income or corpus and if paid in not more than three installments. However, if the amount can be paid only from income, it is not protected by the exemption for gifts and bequests. Thus, a bequest or devise of an amount other than income, such as a general dollar bequest or a devise of a parcel of real property, would qualify for the gift exemption.[29]

The Problem of Accumulated Income: The Five-Year Throwback Rule

Although the distributable net income measuring rod both eliminates problems of tracing and taxes beneficiaries up to the amount

[29] For an excellent example of how the tier system operates, see SURREY & WARREN at 908–09.

of distributable net income regardless of the source of the payment, there is still an avoidance possibility in the use of the year and a day trust. This is the so-called Dean trust, which, as in *Commissioner v. Dean,*[30] will accumulate its income in one year and distribute that accumulation, together with current income, in the next year. In this way the beneficiary would not be taxed on more than the distributable net income in the second year and the rest of the income would have been taxed to the trust in the prior year. The 1954 Code attempts to meet this problem in sections 665 to 668. These sections apply to complex trusts but not normally to simple trusts, and not to estates in any case. In general, if the distribution to the beneficiary exceeds the distributable net income of the year of distribution, then the excess is treated as having been distributed in the preceding year. Therefore, if the trust had accumulated income in the previous year, the effect of the accumulation is eliminated and the beneficiary will be required to include that excess in his income for the preceding year. If there had been no accumulation in the preceding year, the distributable net income for that year will have been used up and no amount could then be taxed to the beneficiary on the excess received in the current year, as income of the preceding year. However, any excess of the distributable net income of the current year is treated as having been distributed in the second preceding year, and this process is repeated for the third, fourth and fifth years preceding the taxable year. Thus, if in any of the preceding five years there has been an accumulation of income, then the beneficiary is taxed as if the amount accumulated had been distributed to him in the year of accumulation up to the amount of the excess. Thus the Code provides the same tax result where income is being distributed currently and where it is accumulated for one to five years and then distributed. The effect is to average the accumulated income of up to five years, the beneficiary thereby paying at the same tax rates as if the distributions had been made currently.[31]

Application of the 1954 Code Provisions to the Unitrust

The Tier System

The unitrust will normally direct payments to be made to beneficiaries in terms of a percentage of the market value of the unitrust assets, or in terms of a certain number of dollars. Under such

[30] 102 F.2d 699 (10th Cir. 1939).

[31] *See generally* Surrey & Warren at 916–25.

directions, the trust cannot be a simple trust since its terms do not provide that all of its income is required to be distributed currently. In any year in which the trust distributes amounts other than amounts of income in the trust accounting sense, it would also be precluded from being a simple trust. The unitrust, therefore, will not be controlled by sections 651 and 652, but by sections 661 to 669 (subparts C and D) which govern complex trusts.

Where there is only one current beneficiary of a unitrust, the application of the Code provisions is relatively simple. Under section 662 such beneficiary will be taxed on all distributions to the extent they do not exceed the distributable net income of the trust.

Where, however, there are several current beneficiaries, consideration must be given to the application of the tier system. Under the provisions of sections 661 and 662, "the amount of income for the taxable year required to be distributed currently to such beneficiary" will be included in the income of the beneficiary as a first tier distribution. Since the direction in the unitrust is one to pay what amounts to an annuity, the taxation of the distribution would be controlled by the last sentence of section 662(a)(1):[32]

> For purposes of this section, the phrase "the amount of income 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 such taxable year.

Thus, where an annuity is payable out of income or corpus, under a literal reading of the statute it would not be a first tier distribution, that is, it would not be payable out of "income," unless it was actually paid out of income for trust accounting purposes. This would require a tracing to the actual source of the distribution, and an annuity would not be a first tier distribution unless in fact paid out of income. The regulations, however, in section 1.662(a)-2(c), and the examples in section 1.662(a)-2(e), seem to indicate that the amounts payable as an annuity out of income or corpus are first deemed to be paid out of income if there is enough trust income to support taxation of the distribution as income.[33] Under this interpretation of the regulations, amounts distributed as an annuity would be a first tier distribution to the extent of trust income, regardless of the source of the distribution.

Where the shares paid to the various unitrust beneficiaries are of the same quality, the result will be the same under both the

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[32] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A200 (1954), reprinted at 3 U.S. Code Cong. & Ad. News, 4025, 4339-40 (1954); Surrey & Warren at 907.

[33] *See* Surrey & Warren at 909.

statute, read literally, and the regulations. Suppose, for example, that the trust is funded with $200,000 worth of assets, and has three beneficiaries, A, B, and C, each of whom is entitled to a current distribution of two per cent of the value of the corpus after addition thereto of all income. Further, suppose that the trust at the end of the first year is worth $210,000 and has taxable income of $5,000, which is also the amount of its distributable net income. Each beneficiary is entitled to a distribution of $4,200 and each will pay a tax upon $1,667, one-third of the distributable net income. Since all beneficiaries receive shares of the same quality, it does not matter whether the distributions are in the first or second tier:

(1) If the distributions are in the first tier to the extent of the income of the trust, then the first tier distribution to each beneficiary will be $1,667, which will exhaust the distributable net income of the trust so that nothing will be taxed in the second tier. This would seem to be the result required by the regulations.

(2) If the last sentence of section 662(a)(1) is read literally, then the amount which is first tier income will be only the amount which is in fact distributed from income for trust accounting purposes, and tracing will be required to determine this fact. Assuming the trustee distributes pro rata from income and principal, then each beneficiary will receive two per cent of the income and two per cent of the principal. In other words, each beneficiary will receive $100 out of income, and $4,100 out of the corpus of the trust. Only the $100 distribution to each beneficiary would be considered a first tier distribution and the balance would be a second tier distribution. However, since all beneficiaries take the same qualitative shares, they will still each pay tax on $1,667, $100 as a first tier distribution, and $1,567 as a second tier distribution.

(3) If the distributions were considered to be made entirely from corpus, which is theoretically possible if the trustee charges the payments to corpus for trust accounting purposes, then there would be no first tier distributions to deplete distributable net income and all amounts would be taxed in the second tier. Each beneficiary would still be taxed on $1,667 since each receives the same qualitative share.

But, assume that each beneficiary receives a required distribution of two per cent, or $4,200, and also that in the current year the trustee makes a discretionary payment to A (under a power to sprinkle trust assets, or a similar discretionary power), whereby A receives an additional share of $4,200. Since the second share received by A is not required to be distributed, it is clearly not a first tier distribution and hence will fall into the second tier. Now the shares received by A, B and C are not all of the same quality and different treatment will result depending upon in which tier the required payments are taxed:

(1) If the required payments are in the first tier to the extent of the available income, then A, B and C will each pay a tax on $1,667. The discretionary share of $4,200 received by A will bear no part of the tax since the first tier distributions will exhaust distributable net income.

(2) If the required payments are paid ratably from income and principal, and are so treated for trust accounting purposes, and taking the last sentence of section 662(a)(1) literally, then $100 of each required payment will be a first tier distribution and $4,100 will be a second tier distribution. In this situation, $300 of distributable net income will be used up in the first tier, leaving $4,700 available for taxation in the second tier. B and C each have second tier distributions of $4,100, and A has second tier distributions of $8,300—$4,100 remaining from his required share, and $4,200 from his discretionary share. Since A has received slightly over 50 per cent of second tier distributions, he will pay tax on slightly over one-half of $4,700, and B and C will each pay tax on slightly under one-quarter of $4,700. Thus, A will pay tax on a little over $2,400 in the second tier, and B and C will each pay tax on a little under $1,150 in the second tier. This means that A pays tax on a total of a little more than $2,500, while B and C each pay tax on a total of a little less than $1,250.

(3) If the required distributions are all in the second tier, as where the trustee charges the payments to corpus, A will pay a tax on $2,500, and B and C will each pay a tax on $1,250.

In a situation where distributable net income is less than current income, the second tier rather than the first tier beneficiaries may obtain the advantages of the reduced distributable net income. Assuming, in this example, that there had been a $1,000 commission expense allocable to corpus, the reduction of distributable net income of $4,000 benefits only the second tier were amounts taxed in the first tier are $4,000 or less.

Other examples can be imagined, but the above clearly illustrate the problem. The question becomes whether the last sentence of section 662(a)(1) is to be read literally so as to require tracing of the source of a distribution which is payable out of income or corpus, or whether any distribution so payable is deemed to be paid out of income to the extent available, which is the position taken by the regulations. The question is fundamental and can perhaps best be approached by a review of the development of the tracing concept under the various revenue acts.

Prior to 1942, under the 1939 Code, trust beneficiaries were generally taxed on only those amounts that were distributed or distributable out of *current income* of the trust. In the Revenue Act of 1918 the beneficiary was taxed on his "distributive share" of the net income of the trust.[34] In the Revenue Act of 1921, the act under which *Burnet v. Whitehouse* was decided, the language was changed so as to tax the beneficiary on "income of the . . . trust for its taxable year which . . . is distributable to such beneficiary, whether distributed or not." [35] Under section 162 of the 1939 Code, the beneficiary was taxed on the amount of income of the trust for its taxable year which was currently distributable and also on amounts which were properly paid or credited to the beneficiary for the year.[36] This scheme of taxation required distributions which could not be traced to trust income for the year of distribution to be treated as payments from corpus, not taxable to the beneficiary and not deductible to the trust. This result followed from section 22(b)(3), which provided an exemption for gifts and bequests of corpus (except for income from property given or bequeathed), and from sections 162(b) and (c), which allowed the fiduciary a deduction and taxed the beneficiary on amounts to be distributed currently or properly paid or credited to a beneficiary, if these amounts were current income of the trust.

In 1942, Congress passed the Revenue Act of 1942, section 111 of which amended section 22(b)(3) of the 1939 Code to provide that if a gift, bequest, devise or inheritance is to be paid at intervals, then to the extent it is paid out of income from property, it is taxable to the recipient. In order that section 162(b) or (c) would be applicable if an annuity were paid from corpus of an estate or trust, section 162(d) was added. Subsection (d) in effect provided that, where an amount was paid or payable out of other than income, the amount distributed (unless it was a gift or inheritance which was not to be paid or distributed at intervals) "shall be considered as income of the estate or trust which is paid, credited, or

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[34] Revenue Act of 1918, ch. 18, § 219(d), 40 Stat. 1057. *See* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 36.14 (1957).

[35] Revenue Act of 1921, ch. 136, § 219(d), 42 Stat. 227. *See* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 36.14 (1957).

[36] *See* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 36.14 (1957).

to be distributed if the aggregate of such amounts so paid, credited, or to be distributed does not exceed the distributable income of the estate or trust for its taxable year." Thus, the beneficiary was taxed to the extent that there was trust income in the year of distribution. The tracing concept was abandoned for corpus distributions and the distribution was treated as one of current income regardless of the actual source. This solution for the annuity problem is essentially the solution adopted in the 1954 Code for all cases.[37]

The net result of the 1942 amendments was to create a three tier system of taxation in which all current income distributions, whether required or discretionary, were in the first tier; annuities and other nonexcepted principal distributions were in the second tier; and past accumulated income distributed after the first 65 days of the year were in the third tier.[38] Although the effect of section 162(d) was largely to eliminate a requirement to trace to current income, *tracing was still required for purposes of the tier system—i.e.,* whether a distribution was from current income or corpus—and also to determine whether prior years' accumulations were being distributed.[39]

With the adoption of the 1954 Code, the necessity for tracing was even further abandoned. In its place there was substituted a general rule which taxes the beneficiary upon a distribution whether or not its source is trust income of the current year, but limits the amount taxable to the distributable net income of the year of distribution. This principle is embodied in section 662(a)(2) which includes in the beneficiaries' income "all other amounts" distributed. The use of this phrase eliminates any problem of tracing to current income.

The committee reports for the 1954 Code show clearly the intent of Congress to eliminate tracing as a general requirement.[40] The

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[37] *See generally* SURREY & WARREN at 906–07; SURREY & WARREN, FEDERAL INCOME TAXATION 676–79 (1953 ed.); Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries,* 54 COLUM. L. REV. 1237, 1246–48 (1954); Holland, Kennedy, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft,* 53 COLUM. L. REV. 316, 338–39 (1953).

[38] I.R.C. § 162(d) (1939); MICHAELSON, INCOME TAXATION OF ESTATES AND TRUSTS 13 (1966 rev. ed.).

[39] *See* Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries,* 54 COLUM. L. REV. 1237, 1242 (1954).

[40] H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954), reprinted at 3 U.S. CODE CONG. & AD. NEWS 4025 (1954) states:

detailed discussion of section 662, however, also makes it clear the tracing requirement was not entirely to be abandoned. Here the committee reports state that it is:

> possible largely to avoid the necessity for tracing of income which exists generally under existing law. . . . This principle is similar to the determination of whether a dividend has been distributed, i.e., that every distribution made by a corporation is deemed to be out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits.[41]

Note that the language is "largely to avoid" the tracing requirement and not "entirely to avoid" it. This seems to indicate that all tracing was not intended to be eliminated. The last sentence of section 662(a)(1) would seem to retain a tracing requirement *for purposes of the tier system.* This is confirmed by the language of the report:

> Included within the provisions of this paragraph is an annuity which is required to be paid at all events (either out of income or corpus) but only to the extent that it is satisfied out of income.[42]

In other words, such an annuity is a first tier distribution only to the extent it is satisfied out of income. This interpretation is reinforced by the statement in the report's discussion of second tier distributions that included in the second tier is:

> an annuity which is required to be paid at all events but which is payable only out of corpus [which] is treated as an "other amount * * * required to be distributed."[43]

> This approach represents a basic departure from the general rule of the existing law that taxable distributions must be traced to the income of the estate or trust for the current year.
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> . . . .
>
> The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year. The simplicity of this general principle makes it possible to eliminate the so-called 65-day and the 12-month rules of existing law. Under the bill, except to the limited extent provided under the throwback rule (discussed later) which is designed to eliminate a loophole of existing law, amounts distributed in 1 year will not be considered to have been distributed in a preceding year, and the source of a distribution, whether made from the income of the current year or of a preceding year, is immaterial in determining the taxability of the distribution in the hands of the beneficiary. Furthermore, amounts not included in the gross income of the estate or trust will generally not be taxable to the beneficiaries.

Id. at 60–61, reprinted at 4086–87.

41 H.R. REP. No. 1337, 83d Cong., 2d Sess. A199 (1954), reprinted at 3 U.S. CODE CONG. & AD. NEWS 4339 (1954).

42 *Id.* at A200, reprinted at 4339.

43 *Id.* at A200, reprinted at 4340. This rule is adopted by Reg. Sec. 1.662(a)-3(b) (1956).

Thus, although tracing as a requirement was generally abandoned by the 1954 Code, section 662(a)(1) appears to have retained the tracing requirement, as regards payment of annuities, for purposes of the tier system. The 1954 Code provisions shift discretionary income distributions from the first to the second tier and place in the first tier the amount of an annuity which is actually paid out of income for the year. As noted above, the regulations, section 1.662(a)-2(e) and the examples in section 1.662(b)-2(e), seem to abandon tracing even as to annuities when they are payable out of income or corpus, but this treatment appears to have no support either in the statute or the legislative history.

Assuming that these regulations are invalid, it would seem that whether the distribution of a unitrust share will be a first tier or second tier distribution will depend upon the trustee's accounts, and if the distribution is charged only in part to income, only that part would be considered as a first tier distribution. When, however, these principles are applied to the unitrust share, difficulties arise because the trust instrument does not make the traditional distinction between corpus and income. All receipts are added to principal and since each beneficiary shares in the entire fund, there is no purpose to be served by labeling the fund in the usual way. No purpose, that is, except a tax purpose. If a label is necessary for tax purposes, the fund is most likely to be labeled "corpus." Perhaps this would be the result under local law regardless of whether the instrument provides a label. In such case, all distributions of unitrust shares would be in the second tier, there would be no qualitative difference among them, and the beneficiaries would share ratably in the distributable net income. This result follows because, as we have noted, the operation of the tier system depends upon the definition of income provided by the trust instrument and applicable local law.[44] There may be some doubt, however, whether for tax purposes the trust instrument can depart so radically from normal concepts of income and define it out of existence by labeling every part of the fund corpus. Regulation section 1.643(b)-1 provides, to the contrary, that "[t]rust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose." When, therefore, a required annuity is payable from income (as the word normally is used), or from corpus, tracing is required by section 662(a) to determine the source of the

[44] I.R.C. §§ 643(b), 662(a).

payment. Thus, for tax purposes the trustee would have to keep traditional income-principal accounts and records of the source of all distributions.

If, on the other hand, the courts uphold section 1.662(a)-2(c) of the regulations, which provides that a required annuity payable from income or corpus is deemed to be paid from income to the extent income is available, then tracing will have been largely eliminated even for purposes of the tier system. In such case, in the above examples, assuming the trustee had discretion as to the source of payment, the discretionary distribution would be received free of tax because distributable net income would be exhausted by first tier distributions of required annuities. This result can be prevented only if the instrument requires the annuity to be charged to corpus, in which case, even according to the regulations,[45] such required distributions would be in the second tier.

Application of the Throwback Rule to the Unitrust

The throwback rule will apply in any year where there is an "accumulation distribution" within the meaning of section 665(b) and there is "undistributed net income" for any of the five prior taxable years.[46] In any year where the trust distributes less than its distributable net income, there will be "undistributed net income" for that year in the amount by which the distributable net income exceeds the distributions to beneficiaries plus the amount of taxes imposed upon the trust. If within five years of that year the trust makes an "accumulation distribution"—the amount (if in excess of $2,000) by which the amounts distributed, with certain exceptions specified in section 665(b), exceed distributable net income—that accumulation distribution is allocated back to the preceding years to the extent of the undistributed net income for those years. The accumulation distribution is matched against the undistributed net income of each preceding year in succession and treated, until it is exhausted, as a distribution in each successive preceding year.[47] Thus the beneficiary pays the tax on the amounts as if received in the preceding year.[48] The beneficiary is also treated as having received as part of the accumulation distribution the taxes paid by the trust in the preceding year,[49] the trust is denied a re-

[45] Reg. Sec. 1.662(a)-3(b) (1956).
[46] I.R.C. § 666.
[47] I.R.C. § 666(a).
[48] I.R.C. § 668.
[49] I.R.C. § 666(b).

fund for such taxes,[50] and the beneficiary is given a credit for the taxes against his tax liability.[51]

The results of the throwback are not serious since the total of the distributions which would have been included in the beneficiary's income for the preceding years are to be included in his income for the current year. However, the character of the items is determined by reference to the composition of the distributable net income of the particular year in question, and the current year's tax attributable to this added income cannot exceed the tax that would have been imposed had the distribution actually been made in the preceding years.[52] Thus bunching is eliminated. However, as can be seen, the application of the throwback provisions may involve very serious tracing questions and considerable work and trouble for the parties involved.

The instances in which this problem will arise in the case of the unitrust are problematical. If the unitrust share is a percentage high enough to cover the normal return on the trust corpus, the problem will not normally arise since the distribution of income would generally equal or exceed the distributable net income of the trust, and thus prevent the presence of undistributed net income. This would be especially true in the case of the unitrust where growth investments and not income investments are emphasized. However, if the shares are relatively small percentages as compared to the normal return on the trust corpus, or if there is a large amount of income to the trust in a single year, then there is the possibility of having amounts which could be taxed in later years under the throwback provisions.

This problem could perhaps be solved by requiring that in no event shall the total distribution of the trust be less than the distributable net income of the trust. This, however, may create problems since it makes the trust begin to look like the conventional trust rather than the unitrust. In other words, the current beneficiary may attempt to surcharge the trustee for not investing in a high yield investment as such investments could produce distributable net income in excess of the amount otherwise distributable.

Capital Gains

In General. Under the scheme of the Code, the critical question in determining where the burden of the tax on capital gains falls is

50 I.R.C. § 667.
51 I.R.C. § 668(b).
52 I.R.C. § 668(a).

whether a given capital gain is included in the distributable net income of the trust. It is the trust's distributable net income which measures the maximum amount includable in the gross income of the beneficiaries (and deductible by the trust) by virtue of distributions to the beneficiaries. Thus, to the extent that capital gains are excludable from distributable net income they are taxed to the trust and not to the beneficiary.[53]

Section 643 of the Code defines distributable net income as the taxable income of the trust with certain "modifications." The modification which concerns us is contained in section 643(a)(3) which provides, in pertinent part:

> Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited, or required to be distributed to any beneficiary during the taxable year . . . .

A preliminary question under the above provision arises from the fact that in a unitrust no distinction is drawn between trust corpus and trust income. All receipts constitute one fund and the beneficiaries are given a share in that fund either by way of a percentage of the total value of the fund at a certain date or by way of a fixed dollar amount.

Since in a unitrust capital gains and ordinary income constitute one fund, will the proceeds of capital gains be considered to have been allocated to corpus within section 643(a)(3)? Note that the trust indenture would not, *in haec verba,* allocate such gains to corpus. This, of course, is because for accounting purposes in a unitrust no such provision is necessary, a direction concerning allocation to corpus being meaningful only where the trust distinguishes between trust corpus and trust income. Section 643(a)(3), however, was drafted in terms of this distinction. Nevertheless, it is not to be thought that this section was designed to mandate the use of trusts which recognize the distinction. It would seem that, properly construed, all this section provides is that if a trust, as is commonly the case, is based on the corpus-income dichotomy, capital gains are not excluded from distributable net income if they are allocated to income rather than corpus. This construction is supported by the regulation which provides that capital gains are "ordinarily excluded" from distributable net income unless (aside

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[53] A beneficiary may still escape tax on capital gains (or ordinary income) which are included in distributable net income if his distribution is protected under section 663(a) as "a gift or bequest of a specific sum of money or of specific property . . . which is paid or credited all at once or in not more than 3 installments."

from the utilization concept of paragraph (a)(3), discussed below) they are:

> (1) Allocated to income under the terms of the governing instrument or local law . . . ,
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year . . . .[54]

Of course, it would be possible to insert provisions in the unitrust indenture to the effect that (a) "all receipts are to be allocated to corpus,"[55] or (b) "capital gains (and certain other items) are to be allocated to corpus, other receipts being allocated to income." Perhaps language to this effect would offer some protection against a very literal interpretation of section 643(a)(3). Such provisions, however, are meaningless, given the nature of a unitrust, for the operative provisions of such a trust, those determining the interest of the beneficiaries and the amount of their distributions, do not depend to any degree on the corpus-income dichotomy.

The more important question with respect to section 643(a)(3) and the unitrust is whether capital gains will be considered "paid, credited or required to be distributed" to the beneficiary of a unitrust share. The proper interpretation of this statutory provision has been discussed elsewhere by one of the authors.[56] There it was concluded that the statute should be interpreted to include capital gains in distributable net income (1) if the trust instrument requires that the proceeds of a capital gains transaction be distributed currently to a beneficiary, (2) if a discretionary distribution is traceable to a capital gain realized during the same taxable year as the distribution, or (3), in accordance with paragraph (a)(3) of regulation section 1.643(a)–(3), if, and to the extent that, the pro-

[54] Reg. Sec. 1.643(a)–3(a) (1956).

[55] Section 643(b) provides that for the purposes of subparts A, B, C and D, "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." Reg. Sec. 1.643(b)–1 (1956) provides that:

> Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to "simple" trusts).

Aside from the question of the validity of this regulation, it would seem inapplicable to the suggested trust provision to which this material is footnoted, since the word income is not used in section 643(a)(3).

[56] *See* Joyce, *The Income Taxation of the Capital Gains of a Trust*, 23 TAX L. REV. 361 (1968).

ceeds of a current capital gain have been "utilized" by the fiduciary in making the distribution.

Of these three tests, the only one which would seem to have applicability to a unitrust is the last, *i.e.*, the test of utilization. The tests of required distributions of capital gains and tracing to a current capital gain would not be relevant since they presuppose that the trust instrument creates a distinction, for trust accounting purposes, between corpus (including original corpus, accumulated income, accumulated capital gains, or current capital gains) and income, whereas the unitrust makes no such distinction. Since in a unitrust all receipts are allocated to, and all disbursements and distributions are charged to, one fund, it is not meaningful to speak of mandatory distributions of current capital gains or distributions which are charged by the trustee to current capital gains.

In applying the test of utilization it is necessary to give separate consideration to the various kinds of shares which a beneficiary could have in a unitrust.

The Percentage Share. Assume that the trust provides that each year A is entitled to two per cent of the value of the fund valued as of a particular date. On that date the fund is worth $500,000 of which $5,000 is due to ordinary income and $10,000 is due to a capital gain realized by the trust during its taxable year. A is paid $10,000. As indicated above, A is taxed on only that amount which does not exceed distributable net income. Distributable net income begins with taxable income of the trust; here that amount is $15,000 ($5,000 ordinary income plus $10,000 capital gain). Is the amount of capital gain excluded under section 643(a)(3)? If so, distributable net income is only $5,000, which becomes the amount taxable to A. If is it included, in whole or in part, distributable net income will exceed, and A will be taxed on more than, $5,000.

If, as appears to be the case, paragraph (a)(3) of regulation section 1.643(a)-(3) is justified by the statute, it would seem that part of the capital gain will be considered paid under section 643(a)(3). Since the $10,000 gain was part of the fund to which A's two per cent was applied, it would seem clear that the gain was, in the words of the regulation, "[u]tilized (pursuant to the terms of the governing instrument . . .) in determining the amount which is distributed or required to be distributed."

A contrary argument can be made that none of the capital gain is paid to A because his share in no way depends upon the *realization* of the gain and would be the same without regard to the realization. This argument, however, in no way defeats the rationale of the "utilization" principle, since that principle does not depend on notions of realization. True, prior to realization, the gain cannot enter distributable net income of the trust and there can be no tax thereon. However, the unrealized gain is no less utilized when an amount is distributed because of its value. When the gain is realized, the only other effect is that a taxable event will have occurred. This taxable event, coupled with the fact that the realized gain is "utilized" to determine the amount distributable to the beneficiary, will cause the gain to enter distributable net income so that the beneficiary must pay part of the tax on the gain.

This would not mean, however, that all of the $10,000 is included in distributable net income. Under section 643(a)(3), gains are excluded "*to the extent*" that they are not "paid, credited, or required to be distributed." In terms of the regulation they are excluded to the extent they are not "utilized" in determining the amount distributed. In a certain sense, of course, all of the $10,000 gain is "utilized" since it all goes into the fund to which A's two per cent is applied. But realistically only two per cent of the gain is "utilized" since A is benefited during the taxable year only to the extent of his percentage share. It must be kept in mind that the utilization concept is, in the last analysis, dependent on the word "paid," and it would seem beyond serious argument that A here has in no sense been "paid" the total $10,000 capital gain.[57]

Consequently, on the basis of the above analysis, distributable net income would be $5,200 ($5,000 of ordinary income and $200 of capital gain) and A would be taxed on only $5,200 of the $10,000 distributed to him. In effect, A is taxed on only two per cent of the capital gain.

Fixed Amount Share. Suppose in the above example A was entitled to a fixed amount of $10,000 a year. In such a case, it would seem that none of the capital gain would be included in distributable net income. Since A is to be paid $10,000 a year in any event, whether or not there are capital gains (or ordinary income) it cannot be said that the gain was "utilized" in determining the amount to be distributed to A. The regulations contain an example to this very effect.[58]

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[57] Suppose in our example that the fund, without the addition of the $15,000 income of the taxable year, was valued at $435,000. A's distribution then would be $9,000 (two per cent of the sum of $435,000 and $15,000). Again the gains have been utilized, but it would be somewhat difficult to argue that A who had received only $9,000 had been "paid" $10,000 of capital gains.

[58] Reg. Sec. 1.643(a)-3(d) *Ex. (2)* (1956).

Combination of Percentage Share and Fixed Amount Share on a Sliding Scale. Suppose that the trust provides that the beneficiary shall receive:

(1) a certain percentage of the fund but no less than a certain amount, or

(2) a certain percentage of the fund but no more than a certain amount, or

(3) a certain amount but no less than a certain percentage of the fund, or

(4) a certain amount but no more than a certain percentage of the fund.

The problem common to all four possible situations is to determine under what circumstances the percentage is an operative factor since then, and only then, would the capital gains be "utilized" in determining the amount to be paid to the beneficiary.

(1) Where the share is a percentage of the fund but no less than a certain amount. Suppose that the trust provides that A shall be paid two per cent of the value of the fund but no less than $10,000.

(a) Assume the value of the fund is $510,000 which includes a $10,000 capital gain. The amount to be paid to A is $10,200, which is determined partially through the application of the percentage to the capital gain. The capital gain has thus been utilized and two per cent of it, under the prior analysis, would be included in distributable net income.

(b) But suppose the value of the fund is $490,000, again including a $10,000 capital gain. Here, two per cent of this value gives A less than $10,000. The operative factor, here, therefore, is not the percentage but the fixed amount. A gets $10,000 in any event, and he is in no way benefited by the presence of the capital gain.

Thus, in this category, part of the capital gains will be included in distributable net income only where the application of percentage to a fund whose value includes current capital gains will result in an amount greater than the fixed amount.

(2) Where the share is a percentage of the fund but no more than a certain amount. Suppose the trust provides that A is to be paid two per cent of the value of the fund but no more than $10,000.

(a) Assume the value of the fund is $490,000, including a $10,000 capital gain. Here the amount to be paid to A is $9,800, the result of applying the percentage to the fund, including the gain. The gain is thus utilized and in part enters distributable net income.

(b) But suppose the fund is worth $510,000, including a $10,000 capital gain. Since A can be paid no more than $10,000 and since he would have been paid $10,000 even if there had been no capital gain, the operative factor here is the fixed amount and the gain, not having been utilized, is not included at all in distributable net income.

In this category, therefore, part of the capital gains will enter distributable net income only if the capital gains must be included in valuing the fund in order to give the beneficiary, by applying the percentage, the equivalent of the fixed amount.

(3) Where the share is a fixed amount but no less than a percentage share. Suppose the trust provides that A is to be paid $10,000 but no less than two per cent of the value of the fund.

This category is really the same as number (1) above. In both catergories the beneficiary is to get the greater of the percentage or the fixed amount. Thus, in this category, as in number (1), part of the capital gains will enter distributable net income only where the application of the percentage to the total value of the fund, including the capital gains, will result in an amount greater than the fixed amount.

(4) Where the share is a fixed amount but no more than a certain percentage of the fund. Suppose the trust provides that A is to be paid $10,000 but no more than two per cent of the fund.

(a) If the fund is worth $510,000 including a $10,000 capital gain, the operative factor is the fixed amount since $10,000 is not more than two per cent of the fund ($10,200). The gain is thus not utilized and does not enter distributable net income.

(b) But suppose the fund is worth $490,000, including a $10,000 capital gain. Here the fixed amount is more than the percentage and so the amount distributed is $9,800 (two per cent of $490,000). Since the gain here is part of the fund to which the percentage was applied, it would seem at first blush that it has been "utilized" and thus enters into distributable net income.

But the percentage here is a limiting factor with respect to A's share and can only operate to reduce his distribution. The factor that benefits A is the fixed amount which does not depend on the presence of capital gains. Thus although the gain was utilized in computing A's share, it in no way benefited him and should not be considered "utilized" within the meaning of paragraph (a)(3) of regulation section 1.643(a)-(3) or "paid, credited, or required to be distributed" as those terms are used in section 643(a) of the Code.

The Significance of the Taxable Year. As has been discussed elsewhere by one of the authors,[59] there is an apparently permissible method of insuring that capital gains are always excluded from distributable net income. Under section 643(a)(3) capital gains realized by a trust during its taxable year are excluded from distributable net income "to the extent that such gains are allocated to corpus and are not . . . paid, credited, or required to be distributed to any beneficiary *during the taxable year* . . . ."[60] Thus, if, for example, a capital gain is realized by a trust in its first taxable year, but is "paid" to a beneficiary on the first day of the second taxable year of the trust, it would seem that the gain would not be included in distributable net income for either year. It would not be included in distributable net income for the first taxable year since it was not "paid" during that year. It would not be included in distributable net income for the second taxable year since it was not realized during that year.[61]

In terms of a unitrust, since capital gains are considered "paid" when the beneficiary is paid an amount in the determination of which the gains were utilized, it would always be possible to keep capital gains out of distributable net income. This would be done by providing that, in calculating the amount to be paid to the beneficiary during a certain taxable year of the trust, the amount of the capital gains for that taxable year are to be excluded in determining the value of the fund to which the beneficiary's percentage is to be applied.

To illustrate, assume that both the trust and the beneficiary report on a calendar year basis and that the trust has realized a capital gain in its first year. If, under the terms of the trust, the beneficiary's share for the first year is calculated by applying his percentage to the value of the fund, *including the capital gain of the*

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[59] *See* Joyce, *The Income Taxation of the Capital Gains of a Trust,* 23 TAX L. REV. 361, 394–95 (1968).

[60] I.R.C. § 643(a)(3) (emphasis added).

[61] These results are not affected by section 662(c) which provides that:

> If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

This section depends on distributable net income, and capital gains are in distributable net income only if realized and paid during the same taxable year of the trust. Thus, the fact that the trust and the beneficiaries may have different taxable years will not render capital gains includable in distributable net income for any year as long as they are not paid to the beneficiary during the same taxable year of the trust in which they were realized.

first year, but is distributed, or is required to be distributed, on January 1 of the second year, the capital gain for the first year will not enter into distributable net income. The capital gains of the second year will not affect this distribution since they will not have been utilized with respect to any payment during the second year.[62]

This device is similar to that used in the so-called "Dean trust" under the 1939 Code prior to the 1942 amendments in which accumulated income of the trust's taxable year was paid a day after that taxable year ended. Prior to the 1942 changes a beneficiary was taxed only on amounts which were paid to him (or as to which he had the right to be paid) during the trust's taxable year out of the trust's income for that same year. Thus, any income distributed to a beneficiary in the succeeding taxable year of the trust was taxable to the trust in its prior taxable year and could be distributed taxfree to the beneficiary. With respect to ordinary income this device was no longer available after the 1942 amendments and cannot be used under the 1954 Code. Under the analysis set forth above, however, it would still appear to be available with respect to capital gains.[63]

Distributions Effecting Sales or Exchanges

The purpose of the discussion under this heading is not to exhaust the topic of when a distribution from a trust results in a realized gain or loss by the trust or a beneficiary; rather, it is to investigate the extent, if any, to which the applicability of general principles may be altered because of the differences presented by the unitrust share.

Before analyzing distributions of a unitrust share, we will consider the general principles which control sale or exchange consequences of trust and estate distributions.

On a distribution in kind in satisfaction of a fractional share in all assets, where the beneficiary receives exactly the assets bequeathed, the trust or estate will recognize no gain or loss and the beneficiary acquires a carryover basis in the property distributed.[64]

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62 Note that it is not necessary to value the trust at the beginning of the trust's succeeding fiscal year, but only to pay the amount at that time.

63 The throwback rules of sections 665 to 668 do not affect this device, since they apply only to the distribution of prior undistributed net income which is defined generally as the excess of distributable net income over distributions. Thus where distributable net income does not include capital gains, the presence of capital gains cannot contribute to undistributed net income.

64 Reg. Sec. 1.661(a)-2(f) (1956); Reg. Sec. 1.1014-4(a)(2) (1957); Rev. Rul. 55-117, 1955-1 Cum. Bull. 233; O.D. 667, 3 Cum. Bull. 52 (1920); Polasky, 862-63.

Where, however, such a distribution is in satisfaction of a fixed dollar amount gift or bequest, the trust or estate will realize gain or loss and the beneficiary will take the fair market value of the property as his basis.[65] The difference in result arises because a transfer of the property in kind in satisfaction of the fixed dollar claim is treated as a sale or exchange of the property, resulting in realization of gain or loss to the trust or estate.[66]

However, no sale or exchange is involved where a distribution in kind is made of a fractional share. In such case, the beneficiary receives exactly what he was given—an interest in specific assets.[67]

Applying these principles to the unitrust share, where the share is a fixed dollar annuity, it is clear that the beneficiary has a fixed dollar claim. A distribution of property in kind in satisfaction of the claim will be a sale or exchange of the property for the claim and the trust will realize gain to the extent the property has appreciated, and loss to the extent it has depreciated. The beneficiary, of course, will have received a distributive share of any trust income, rather than a tax-exempt gift or bequest, because the annuity is payable annually in more than three installments.[68] To the extent the share is not taxed to the beneficiary under section 662(a) because it exceeds distributable net income, the receipt is tax-free to the beneficiary since he will have exchanged a claim for money with a basis equal to the value of the property received, and there is thus no gain or loss. In either case, the beneficiary's basis in the property is its fair market value.[69]

Where the unitrust share is described as an "amount equal to" or a "sum equal to" a certain percentage of the fund, the tax consequences of a distribution in kind in satisfaction of the share should be exactly the same as those just described for the fixed dollar annuity. In other words, such a percentage share also gives to the beneficiary a fixed dollar claim because each time the formula is applied, *i.e.*, annually, the result is a claim fixed and payable in dollars.

Note that here the fixed dollar claim of the beneficiary will be determined *annually* by application of the constant percentage to

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[65] Reg. Secs. 1.661(a)-2(f)(1), (3) (1956); Reg. Sec. 1.1014-4(a)(3) (1957); Polasky, 860-62. *See also* Rev. Rul. 67-74, 1967-10 I.R.B. 15 (March 6, 1967).

[66] Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 573 (1936); Polasky, 814, 862.

[67] Polasky, 862-63.

[68] *See* I.R.C. § 663(a).

[69] Reg. Sec. 1.661(a)-2(f)(3) (1956); Reg. Sec. 1.1014-4(a)(3) (1957); Kenan v. Comm'r, 114 F.2d 217, 220 (2d Cir. 1940). *See* Polasky, 860-61. *See also* Rev. Rul. 67-74, 1967-10 I.R.B. 15 (March 6, 1967).

the total fund. It might be argued, therefore, that no dollar amount claim is ever fixed; that the amount ultimately to be received by the beneficiary at any future time cannot be determined until that time, and that, in reality the beneficiary takes a fractional share. The argument, however, is illusory since the giving of an "amount" or "sum," as we have seen,[70] is the gift of a pecuniary legacy and carries with it no interest in the specific assets in the fund. The fact that the number of dollars given is determined by a formula does not change the pecuniary nature of the gift; nor is its nature affected by the fact that the annual dollar claim will always reflect the appreciation and depreciation of the fund. Although this is a characteristic of the fractional share, since the beneficiary has no interest in the assets of the fund as such, the other vital characteristic of such a share is lacking. The value of the assets in the fund is merely an annual measuring stick to determine the only thing the beneficiary has a right to—a number of dollars. Therefore, on a distribution of property in kind in satisfaction of the unitrust percentage share a realizable event occurs.[71]

It has been assumed that the unitrust share will not be expressed so as to give the beneficiary a fractional share. Presumably, there would be no desire to give the beneficiary a direct interest in the assets of the trust fund and to make distributions in kind in satisfaction of the share. This would present an unworkable arrangement for periodic payments. Furthermore, in such case, any distribution of cash in satisfaction of such a claim would effect a sale by the *beneficiary* of the interest in the specific asset for cash, and and the beneficiary would realize gain or loss. For example, suppose the fund was comprised only of Blackacre, value $100 and basis $50, and cash of $100. If a beneficiary with a 10 per cent fractional share were given $20 of cash in discharge of his claim, he would have, in effect, sold his interest in Blackacre, value of $10 and basis of $5, for $10, thus realizing a gain of $5 on the transaction.[72] Also, the transferor of the $10 will have purchased 10 per cent of Blackacre for the cash and have a cost basis of $10 in that portion of Blackacre.[73] Note also that if the trust assets had been Blackacre and Whiteacre, each with a value of $100 and a basis of $50, and the

[70] *See* text accompanying notes 2 and 3 *supra*.

[71] Lindsay C. Howard, 23 T.C. 962 (1955); Brinckerhoff v. Comm'r, 168 F.2d 436 (2d Cir. 1948); Anderson v. Wilson, 289 U.S. 20, 26–27 (1933). *See also* Rev. Rul. 67-74, 1967-10 I.R.B. 15 (March 6, 1967). *Cf.* Reg. Sec. 1.663(a)-1(b)(1) (1956).

[72] *See* Rouse v. Comm'r, 159 F.2d 706 (5th Cir. 1947), *affirming* 6 T.C. 908 (1946); Polasky, 863–64.

[73] *See* Polasky, 864.

beneficiary had distributed to him a 20 per cent interest in Whiteacre, the beneficiary would have sold his 10 per cent interest in Blackacre for 10 per cent of Whiteacre, again realizing a gain of $5. In turn, the trust would have sold a 10 per cent interest in Whiteacre for 10 per cent of Blackacre and would also have realized a gain of $5.

Although this result would seem clear where the beneficiary receives a distribution in satisfaction of a gift or bequest of principal which, if received in kind, is exempt from tax under sections 102(a) and 663(a), there may be a different result as to the beneficiary where the periodic unitrust share is satisfied. Although such a share is a fractional share, it is not within the exemption provided by sections 102 and 663 because it is a periodic gift under section 663(a). Under the regulations it is taxed as an annuity so that it will be taxed to the beneficiary as a distributive share of trust income and the beneficiary receives a basis in the property equal to its fair market value.[74] Thus, although the periodic nature of the fractional share would not seem to affect the tax consequences of the distribution in kind as far as the trust is concerned, the beneficiary is not treated as if he had both sold his interest for cash and also received a distribution of ordinary income. Here, the gain on the "sale" seems to be disregarded. The result to the beneficiary then is the same as if his interest were a dollar amount share.

An argument can be made, however, that this treatment is too liberal to the beneficiary of a fractional share, the value of which has appreciated. The fact that a distribution is taxable to such a beneficiary under section 662 because of presence in the trust of distributable net income in no way negates the fact that there is also present gain due to appreciation of the beneficiary's interest. Thus if, as in the above example, the beneficiary had exchanged his 10 per cent interest in Blackacre for a 10 per cent interest in Whiteacre, he would have sold his interest in Blackacre, basis $5, value $10, for a gain of $5. If the trust had no distributable net income for the year of distribution so as to preclude taxation of the taxpayer as a trust beneficiary, he presumably would still be taxable on the gain of $5 since that result does not depend on the presence of distributable net income in the trust. By the same token, the presence of unrelated distributable net income should not preclude taxation of the gain from the exchange. But, in this

[74] Reg. Sec. 1.663(a)-1(b)(2) (1956); Reg. Sec. 1.661(a)-2(f)(3) (1956).

latter situation, under regulation section 1.661(a)-2(f)(3) the beneficiary appears to obtain a basis in Whiteacre equal to its fair market value, thus precluding further taxation of the gain due to appreciation of the beneficiary's interest. The seeming anomaly of the suggestion that the beneficiary be taxed on more dollars than he actually receives does not arise from the taxing of the gain on the exchange of the fractional interest, but rather from the principle of section 662 which deems what is in reality a distribution of corpus to be a distribution of income to the extent of the distributable net income of the trust. Such legislative tinkering, at least in this instance, has failed to achieve consistency with more legitimate tax principles.

If it is determined, under the principles discussed above, that a trust has realized a capital gain by a distribution in kind in satisfaction of a fixed dollar claim, then a further question would arise as to whether the gain, or some portion thereof, had been "paid" to the beneficiary within the meaning of section 643(a)(3), thereby increasing distributable net income.

Here reference must be made again to the principle of utilization (or benefit) and the difference in this respect between a percentage share and a fixed annuity unitrust. In the case of a fixed annuity unitrust, the gain realized by a distribution in kind should not be considered paid to the beneficiary because the presence of the gain is irrelevant in determining the amount to be distributed to the beneficiary. On the other hand, in the case of a percentage share unitrust, it would seem that such percentage of the gain should be considered paid to the beneficiary and thus included in distributable net income, since, to the extent of the percentage, the gain is utilized to determine the amount distributed to the beneficiary. In this respect, it should again be noted that the concepts of utilization and realization must be kept distinct. In a percentage share unitrust capital gain will be utilized whether realized or not. However, the question of determining where the tax burden is imposed does not arise until the gain is realized. (It also bears repeating that under section 643(a)(3) a capital gain is excluded from distributable net income unless it is realized and paid in the same taxable year of the trust.)

In the case of a unitrust which gives a beneficiary a fractional share, a gain realized by the trust by virtue of a distribution of an asset different from that in which the beneficiary has the fractional interest would seem clearly to be excluded from distributable net income. In such a case, just as in the case of a fixed sum annuity, the gain realized by the trust would not be utilized in determining the beneficiary's share and would thus not be "paid" within section 643(a)(3).

The fact that capital gains enter distributable net income does not necessarily result in their being taxed to the beneficiary of an "in kind" payment. If the distribution to the beneficiary is excluded from the beneficiary's income by section 663(a) as a "gift or bequest of a specific sum of money or of specific property . . . which is paid or credited all at once or in not more than three installments," no part of the tax is paid by the beneficiary in spite of the fact that he receives the gain. In such a case, under the principles of section 662(b), all beneficiaries receiving taxable distributions (up to distributable net income) will share the tax, and if all the distributable net income is not distributed or distributable, the trust will share the tax with the beneficiaries.[75] If, on the other hand, the distribution in kind is not protected by section 663(a), under section 662(b) the beneficiary of the "in kind" payment is treated as having received a ratable portion of the capital gain together with other beneficiaries.

The Marital Deduction and the Unitrust

In General

The value of property passing from a decedent to his surviving spouse is deductible from the gross estate as a marital deduction under section 2056(a) of the Internal Revenue Code. With limited exceptions, the deduction is available only for interests in property which are not nondeductible "terminable interests" under section 2056(b). A terminable interest is defined as an interest in property which will terminate or fail due to lapse of time or on the occurrence or nonoccurrence of some event or contingency. Such an interest is not deductible if an interest in the same property also passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than the surviving spouse or her estate, by virtue of which such person may possess or enjoy the property after termination of the surviving spouse's interest. Thus, for example, a bequest by decedent

[75] It should be noted that the fact that the distribution in kind is excluded from the beneficiary's income by section 663 does not prevent the capital gain from being included in the trust distributable net income. Section 663(a) provides only that the exempt distribution "shall not be included as amounts falling within section 661(a) or 662(a)."

of a property interest in trust, with the income payable to his surviving spouse for her lifetime and remainder to his children, will be a nondeductible terminable interest. The interest terminates on lapse of time and an interest in the same property has passed to the children who may enjoy the property after the surviving spouse's death.

A trust, however, can qualify for the marital deduction under section 2056(b)(5). This most important exception to the nondeductible terminable interest rule provides, in effect, that an interest passing from the decedent, whether or not in trust, will be a deductible interest if the surviving spouse is entitled for life to all the income from the entire interest or a specific portion thereof, and if the spouse is given a power to appoint the entire interest or such specific portion to herself or her estate. In such a case, the statute provides that the entire interest in the property from which the surviving spouse is entitled to the income, and over which she has the power of appointment, passes to the surviving spouse and no interest passes to any other person. Thus, the interest of the surviving spouse is not a nondeductible terminable interest because no one other than the surviving spouse acquires an interest in the property in question. Also, since the entire interest in the property passes to the surviving spouse, the full value of the property qualifies for the marital deduction.

The elaborate provisions of section 2056(b)(5) are exhaustively interpreted by the regulations [76] which list five conditions that must be satisfied to meet the Code provisions regarding the surviving spouse's income interest and her power to appoint.[77] Under both the Code and the regulations, the surviving spouse is required to be the beneficiary for life of all the income of the entire trust property, or a specific portion thereof. In order to have that right, the surviving spouse must have:

> substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.[78]

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[76] Reg. Sec. 20.2056(b)-5 (1958).

[77] Reg. Sec. 20.2056(b)-5(a) (1958).

[78] Reg. Sec. 20.2056(b)-5(f)(1) (1958).

To protect the surviving spouse's right to income, the regulations contain elaborate rules disqualifying trusts where the trustee may accumulate income, or may retain unproductive property or where the trustee has unusual powers regarding the allocation of receipts and expenses between income and corpus.[79]

THE FRACTIONAL SHARE REQUIREMENT

There may be some difficulty in qualifying a unitrust for the marital deduction under the life estate power of appointment exception to the terminable interest rule. Although the spouse can be given the requisite power to appoint the trust property in favor of herself or her estate, under the regulations the entire trust would be disqualified because the surviving spouse would not be entitled to all of the income from the entire trust property, or from a specific portion thereof. Whether the current share be expressed as a fixed dollar annuity or as a percentage share, there is no guarantee that the spouse will receive all the income. The spouse would not, under the regulations, have an income interest in a specific portion of the trust property. For an interest to qualify under the specific portion language of the statute, the regulations require that the rights over the income and the power of appointment must coexist as to the same interest in property, and that the rights over income and the power constitute a "fractional or percentile share of a property interest so that such interest or share in the surviving spouse reflects its proportionate share of the increment or decline in the whole of the property interest to which the income rights and the power relate."[80] Thus, for example, the regulations would allow a marital deduction for one-half of the property passing in trust where the surviving spouse was entitled to one-half the income and had the requisite power of appointment over at least one-half of the trust property. The deduction is entirely disallowed by the regulations if the annual income of the surviving spouse is limited to a specific sum, or she has power to appoint only a specific sum.

The fractional share test would prevent any part of the assets of a unitrust from qualifying for the marital deduction. If the surviving spouse's current interest is expressed as a fixed dollar share, even though this is considered to be an income interest it will not meet the test of the regulations which requires a fractional or percentage interest in income. The percentage unitrust share

[79] Reg. Secs. 20.2056(b)-5(f)(1) to (5) (1958).
[80] Reg. Secs. 20.2056(b)-5(b), (c) (1958).

would not appear completely to meet this test since the percentage is not in income, but in all trust assets, both income and corpus. The percentage does not appear to bear any necessary relationship to a percentage of income alone; the full amount that will be payable under it each year cannot be translated into a percentage of income. It is arguable that where the percentage equals or exceeds the normal return on the trust assets it is equivalent to an interest in all the income and the *entire* interest should therefore qualify for the marital deduction. The same argument could, of course, be made where the fixed dollar share would equal or exceed such return, but the regulations would not allow the deduction for the fixed dollar share, nor, presumably, for the percentage share.

THE *Northeastern Pennsylvania National Bank* RULE

The portion of the regulations requiring that the income interest be in a fractional share of the property was rejected by the Supreme Court in *Northeastern Pennsylvania National Bank & Trust Co. v. United States,*[81] where the decedent's will gave an interest in trust of one-half the residue of the estate from which the surviving spouse was to be paid out of "income and corpus" the sum of $300 per month and over which the spouse was given the requisite power of appointment. The district court allowed a marital deduction for an amount equal to the value of a $300 monthly annuity for the surviving spouse.[82] The Third Circuit reversed,[83] holding there was no acceptable method of computing the specific portion. The Supreme Court agreed with the Third Circuit that annuity tables could not be used to compute the specific portion, but reversed the court of appeals and held that the marital deduction was allowable for the amount of trust corpus required to produce income in the amount of the fixed monthly stipend of $300. This specific portion was to be determined by use of an estimated realistic rate of return available to a trustee under reasonable investment conditions. The fractional share test of the regulation, the Court held, "in the context of this case . . . improperly restricts the scope of the Congressionally granted deduction."[84]

The test for a "specific portion" set forth in *Northeastern* would appear to be met whenever the amount of corpus necessary to

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[81] 387 U.S. 213 (1967).

[82] Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 235 F. Supp. 941 (M.D. Pa. 1964).

[83] Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 363 F.2d 476 (3d Cir. 1966).

[84] 387 U.S. at 218.

produce the payments to the surviving spouse can be calculated with reasonable accuracy. Thus, under the *Northeastern* rule, the unitrust share which is expressed as a dollar amount, or a percentage share with a dollar minimum, will qualify for the marital deduction in an amount of corpus which will produce the dollar amount (assuming the presence of the requisite power to appoint). In the case of a percentage unitrust share, where the percentage is the same as or greater than any rate of return to be used in applying the *Northeastern* rule, then the entire value of the corpus should be allowed as a marital deduction, up to the amount subject to the requisite power to appoint. If the percentage is stated in an amount lower than such rate of return, then the specific portion should be approximately the percentage of corpus which the rate of the percentage share bears to the rate of return. Thus, if the rate of return is four per cent and the share is three per cent, the specific portion would be slightly more than three-fourths of the corpus. This is only an approximation because, where the percentage is applied to the total fund at the end of the fund's year, the beneficiary will normally be entitled to more than the stated percentage of the original fund because of the presence of earnings.

The above analysis assumes that what the beneficiary receives from the fund is income so as to receive the income from a specific portion of the corpus within the meaning of section 2056(b)(5). The holding and reasoning of *Northeastern* appear to support this analysis, because there the $300 per month was payable to the surviving spouse from income or corpus. Under the reasoning of *Burnet v. Whitehouse,* this is an annuity which is payable without regard to income and is therefore a charge on principal. Nevertheless, the Court in *Northeastern* treated the annuity as if payable from income. A percentage share should receive the same treatment even though the beneficiary theoretically benefits from the stated percentage of the value of each trust asset, whether income or corpus. The Commissioner may take the position, however, that a percentage share gives an interest in the income only in the amount of the percentage. Thus, a five per cent share would give the surviving spouse a five per cent interest in income and the balance of any distribution to her would be an invasion of corpus. Such invasion for the benefit of the spouse would not disqualify the trust,[85] but a marital deduction would be allowed for only five per cent of the corpus since that is all the income the spouse receives. The limited utility of this possible result would obviously

[85] Reg. Sec. 20.2056(b)-5(j) (1958).

discourage the use of the percentage share unitrust for the marital deduction until such time as the law is clarified in favor of the taxpayer.

Another problem in using a unitrust for the marital deduction is that the spouse's power of appointment should be limited to only so much of the corpus as is the specific portion from which the income is payable. Unless the power is so limited, more of the trust corpus will be included in the estate of the surviving spouse on her death than was allowed as a marital deduction to the estate of the spouse dying first. For example, if the surviving spouse is entitled to $10,000 per year out of a trust of $400,000, and if a five per cent rate of return is a reasonable rate of return, it would follow from the *Northeastern* decision that the specific portion of the corpus which can qualify for the marital deduction is $200,000. In order to so qualify, the spouse need have the required power of appointment only over such specific portion, *i.e.*, the same specific portion from which the income is payable, rather than over the entire corpus. Therefore, it would seem to follow that the power need not be given over the entire trust corpus, and should be limited to such part of the trust corpus as is necessary under the *Northeastern* rule to produce annual income of $10,000—in our example, $200,000. Otherwise, the surviving spouse would have included in her estate more than was allowed as a marital deduction.

In considering the above example, it is important to note that in *Northeastern* the surviving spouse had the power to appoint the entire trust corpus by will and the Court did not have to pass on the fractional share test as it relates to the power to appoint. The Court's holding, however, appears to upset the fractional share test as it applies both to the income interest, which was before the Court in *Northeastern*, and the power to appoint. In the above example of the $10,000 fixed annuity, *Northeastern* would hold that $200,000 was the specific portion of the corpus from which the spouse was entitled to all the income at five per cent. If the dollar amount, $200,000, constitutes a specific portion from which the income of $10,000 is payable, it can hardly avoid being a specific portion for purposes of the power of appointment.

Although *Northeastern* logically seems to require that a power of appointment over a stated sum qualifies as a power to appoint a specific portion, nevertheless, there is some language in the Court's opinion which has a different, if not an opposite, thrust. For example, the Court refused to concede that the issue is the same where a power to appoint rather than an income interest is involved. Indeed, the Court specifically distinguished *Gelb v. Commissioner*,[86] in which the Second Circuit had held that the marital deduction was allowable for that dollar amount of trust assets which could be calculated actuarially as being subject to the surviving spouse's power of appointment. The spouse had been given all the income from the trust for her life and had the requisite power to appoint the remainder. However, the trustees could invade corpus for the support of decedent's minor daughter to the extent of $5,000 per year. This power, contended the Commissioner, prevented any part of the trust from qualifying for the marital deduction because the surviving spouse's income right and her power extended neither over the entire trust property nor over a fractional or percentile interest in the property. The court, however, rejected the fractional share test and held that the dollar amount of trust assets which could be computed actuarially as not subject to the power to invade was a specific portion. The court computed the deduction by substracting from the total value of the trust property the maximum actuarial value of the power of invasion ($5,000 per year multiplied by the combined average life expectancies of the spouse and child). The remaining corpus qualifed for the marital deduction as a specific portion.

The *Northeastern* Court may have felt *Gelb* was distinguishable because the qualifying portion of the trust in *Gelb* was not a stated sum. But the opinion also showed a greater awareness that the problem of the power to appoint may involve considerations different from those of the income interest. The Court noted a government argument involving the *Gelb* facts and pointing out the possibility of substantial tax avoidance if the *Northeastern* rule were applied, and then dismissed it as involving a "quite different problem, which is not before us." Here the Court may have been mindful of the tax avoidance technique described by the dissent:

> Assume a trust estate of $200,000, with the widow receiving the right to the income from $100,000 of its corpus and a power of appointment over that $100,000 .... Now suppose that when the widow dies the trust corpus has doubled in value to $400,000. The wife's power of appointment over $100,000 applies only to make $100,000 taxable to her estate. The remaining $300,0000 passes tax free to the children.[87]

This example deserves some expansion. If the dissent is correct that the holding of the majority will apply to qualify for the mari-

[86] 298 F.2d 544 (2d Cir. 1962).

[87] Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 387 U.S. 213, 227 (1967) (footnote omitted).

tal deduction a power to appoint a stated sum, then the marital trust can be funded in the maximum amount by use of the formula clause, the widow can be given all the income, but her power to appoint can be limited so as to reach the entire principal of the trust at her death, *but no more than the number of dollars that were originally used to fund the trust*. In this way the maximum marital deduction is obtained and if the trust fund appreciates there is substantial tax saving at the death of the surviving spouse because the appreciation is not subject to her power to appoint and will not be included in her estate. This problem arises, of course, because of our constantly expanding economy and the high probability of long run appreciation of trust assets. The problem could be solved by discounting the dollar amount originally subject to the power to appoint in order to allow for the projected rate of appreciation of trust assets over the life span of the surviving spouse.[88] Thus, if the marital trust contains $100,000 and appreciation of 100 per cent is projected over the spouse's life span, the deduction would only be allowable for $50,000—the present value of what will eventually be included in the estate of the surviving spouse.

The device discussed by the dissent was not involved in *Northeastern* because the surviving spouse had the power to appoint the entire trust corpus and all of it was subject to tax in her estate. The majority of the Court may have felt, therefore, that there was no tax avoidance problem when only a fixed dollar income interest is involved rather than a power to appoint a specific sum. It is submitted, however, that there is a similar problem even when only a fixed dollar income interest is in issue. Under *Northeastern,* the right to the fixed dollar annuity is a right to all the income from a specific portion of the corpus necessary to produce that amount. The question is whether a right to income from a stated number of dollars of corpus is a right to *all the income* from that number of dollars. The answer would appear to be "no," since all the income from those dollars would seem to include the income from future growth of that dollar amount of corpus, which will never be received by the trust beneficiary. In this sense, even in *Northeastern* the surviving spouse did not have a right to all the income from the amount of corpus which would currently produce $300 a month because as the beneficiary of a fixed dollar annuity, limited to $300 a month, she could not receive the income from any appreciation of that amount of corpus. Therefore, the marital deduction should

[88] *See* Fisher & Kohl, *Supreme Court Interprets "Specific Portion" for Marital Deduction Purposes,* 27 J. TAXATION 12 (1967).

be allowed for only some lesser amount of corpus which would, over the life of the widow (taking into consideration additional income yield from future appreciation of corpus), produce an average of $300 a month. The holding of *Northeastern* was not, however, so refined and would seem to allow the deduction for the full corpus currently necessary to produce the stated annuity.

In summary then, although the logic of *Northeastern* would compel a holding that the power to appoint a stated sum is a power over a specific portion, that issue was not involved in the facts of that case, and the logic may be thus restricted because of the obvious tax avoidance possibilities in such a holding. Therefore, when a power to appoint a stated sum is involved, the stated sum may be denied status as a specific portion. This may occur even though *Northeastern* itself appears to open the door to avoidance of the statutory requirement that the surviving spouse receive all the income.

The Estate Trust

A kind of trust that would seem fully and safely to qualify for the marital deduction as a unitrust is the so-called "estate trust," whereby property is bequeathed in trust solely for the benefit of the surviving spouse during her lifetime and with remainder over to her estate. Even though the surviving spouse's life estate is a terminable interest, it is not a nondeductible interest since no one other than the surviving spouse or her estate takes an interest in the property.[89] And, under the regulations, the entire interest is considered as having passed from the decedent to the surviving spouse.[90] Hence, the entire value of the property passing in trust qualifies for the marital deduction without having to meet the terms of section 2056(b)(5), and the conditions imposed by the regulations for the life estate power of appointment marital deduction trust may be ignored. The surviving spouse need not be given the income payable annually. Nor need she be given the requisite power to appoint to herself or her estate. Indeed, the regulations, in effect, provide that a bequest in trust qualifies for the marital deduction if the trust income is to be accumulated for a term of years or for the surviving spouse's life and the augmented fund is to be paid to the surviving spouse or her estate.[91] There need be no con-

89 I.R.C. § 2056(b)(1)(A).

90 Reg. Secs. 20.2056(e)-2(b)(1), (b)(2) (1958).

91 Reg. Sec. 20.2056(e)-2(b)(1)(iii) (1958). The regulation does not state explicitly that such a bequest will qualify for the marital deduction. This, however, is its effect

cern with the effect of administrative powers of the trustee concerning allocation of receipts and expenses between principal and income, nor with retention in the trust of unproductive property. Thus, the unitrust, when it is an estate trust, may hold assets like growth stocks or unproductive land and still qualify for the marital deduction.

Gifts to Charity and the Unitrust

Gifts of Charitable Remainders

The gift or bequest of a remainder interest to a charity after a prior estate is deductible under the estate tax, the gift tax, and the income tax if the remainder is not subject to any contingency other than the natural termination of the prior estate.[92] The amount of the deduction for a remainder to charity after a life estate or a term for years is determined by valuing the remainder on the basis of the Treasury tables in sections 20.2031-7(f) and 25.2512-5(f) of the regulations. These tables measure the value of annuities, life estates, and remainder interests on the assumption of a three and one-half per cent rate of return, compounded annually.[93]

If the gift to charity is subject to a contingency, the regulations provide that it is not deductible under the income, estate, or gift taxes, even though the gift is susceptible of actuarial valuation, unless the possibility that the charity will not take is so remote as to be negligible.[94] The Supreme Court has approved the Treasury position in *Commissioner v. Sternberger's Estate*,[95] which held that a remainder to charity, which was contingent upon the death of testator's 27 year old divorced and childless daughter dying

since it provides that the *property so bequeathed* in trust is considered to have passed from the decedent to his surviving spouse. This provision, coupled with the Code provision of section 2056(b)(1)(A) that precludes a nondeductible terminable interest when no one other than the surviving spouse or her estate takes an interest in the property bequeathed, makes the entire value of the property qualify for the marital deduction.

See also section 20.2056(b)-5(j) of the regulations, which allows an invasion of corpus for the benefit of the surviving spouse without disqualifying the trust for the marital deduction. Although this regulation is concerned only with power of appointment trusts, its rationale seems broad enough to include any trust which qualifies for the marital deduction.

92 Reg. Secs. 20.2055-2(a), 25.2522(a)-2(a), 1.170-2(d)(2), 1.170-1(e), 1.170-1(d) (1958). *See generally* Lowndes, *Tax Advantages of Charitable Gifts*, 46 Va. L. Rev. 394, 416 (1960). *But cf.* section 170(f), which in certain cases postpones the deduction of a remainder interest in tangible personal property.

93 *See* Reg. Sec. 1.170-2(d)(2) (1958).

94 Reg. Secs. 1.170-1(e), 20.2055-2(b), 25.2522(a)-2(b) (1958).

95 348 U.S. 187 (1955), *reversing* 207 F.2d 600 (2d Cir. 1953) and 18 T.C. 836 (1952).

without issue, was not deductible. Both the Tax Court and the Second Circuit had allowed a deduction holding that the charity's interest could be valued actuarially. The Supreme Court held, however, that no deduction was allowable unless the charity was assured of receiving the property.[96]

The deduction for a gift of a charitable remainder may also be barred where the remainder is subject to a power of invasion in favor of a noncharitable beneficiary. The regulations contain the extreme language that the deduction "will be limited to that portion, if any, of the property or fund which is exempt from the exercise of the power." [97] This language, however, loses much of its force when read in light of the rest of the regulations which allow the deduction where the chance of the charity's interest being defeated is "highly improbable" or "so remote as to be negligible." The regulations, therefore, would seem to accord with the cases which allow the deduction where the power to invade is limited by an ascertainable standard, which, under the circumstances of the particular case, makes it virtually certain that the charity will take an ascertainable amount of the property.[98] The deduction is allowed for the ascertainable amount.

If the power to invade is not limited by a fixed standard which is capable of measurement, then the amount passing to the charity is not ascertainable and the deduction is disallowed. This was the holding in *Merchants National Bank v. Commissioner*,[99] in which the Supreme Court denied a deduction for a charitable remainder where the trustee was authorized to invade the principal of the trust for the "comfort, support, maintenance and happiness" of the income beneficiary. In so doing, the Court approved and applied the language presently in the regulations that the charitable bequest, to be deductible, must have, at the testator's death, a value "presently ascertainable and hence severable from the non-charitable interest." [100] Although the Court recognized that invasion of principal was extremely unlikely in view of substantial trust in-

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[96] 348 U.S. at 199. If at the testator's death his daughter had no issue and was incapable of having issue, the remainder to charity would be deductible. United States v. Provident Trust Co., 291 U.S. 272 (1934). There, of course, the contingency lacked substance, and, in the words of the regulations, was "so remote as to be negligible."

[97] Reg. Secs. 20.2055-2(b), 25.2522(a)-2(b) (1958).

[98] Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595 (1949); Merchants Nat'l Bank v. Comm'r, 320 U.S. 256 (1943); Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). *See generally* LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 363-65 (1962).

[99] 320 U.S. 256 (1943).

[100] Reg. Secs. 20.2055-2(a), 25.2522(a)-2(a) (1958).

come and the age and independent means of the income beneficiary, it nevertheless denied the deduction because the possibility of invasion of corpus was not limited by a fixed standard. The same result was reached by the Court in *Henslee v. Union Planters National Bank & Trust Co.,*[101] where the trustee was authorized to invade corpus for the "pleasure, comfort and welfare" of the life beneficiary. No fixed standard was established and the amount passing to the charity could not be accurately measured.

Applying these general principles to a unitrust, the major problem in its qualifying for a charitable deduction is establishing the amount the charity is assured of receiving. Two requirements must be met to receive the deduction: the value of the charitable interest must be presently ascertainable, and any possibility that the charity will not take must be so remote as to be negligible. In applying these tests to the unitrust, let us begin with a share limited by a dollar amount. Here, any invasion of corpus would appear to be limited by a fixed standard. The charitable remainder could be valued as if charged with a yearly annuity for the life expectancy of the current beneficiary so as to establish the present value of the minimum interest that would pass to charity. This is the method sometimes followed by the Internal Revenue Service and sustained in a number of decided cases.[102] However, apparently only one circuit court of appeals has allowed the deduction for such an interest over the objection of the Service. In *Estate of Schildkraut v. Commissioner,*[103] a surviving spouse was bequeathed a yearly annuity of $12,000 with remainder of the trust property to go to a charity. Assuming a three and one-half per cent rate of return, the court held that a direction to invade principal to make up the difference between actual income and $12,000 a year was a fixed standard, capable of being stated in a definite amount of money. For this purpose, the court held that the widow's life expectancy would be determined under the usual tables unless the Commissioner could prove actual life expectancy was materially different. In so holding, the court found not only that the value of the charitable gift was presently ascertainable but also that the remoteness test of the regulations did not apply. Therefore, the court rejected the Commissioner's argument that the widow could live long

[101] 335 U.S. 595 (1949).

[102] Rev. Rul. 54-285, 1954-2 Cum. Bull. 302; Estate of Jean S. Alexander, 25 T.C. 600 (1955); Estate of Helen Stow Duker, 18 T.C. 887 (1952); Estate of Ben F. Sternheim, 2 CCH T.C. Mem. Dec. 311 (1943), *rev'd on other grounds sub nom.* Wells Fargo Bank & Union Trust Co. v. Comm'r, 145 F.2d 132 (9th Cir. 1944).

[103] 368 F.2d 40 (2d Cir. 1966), *cert. denied,* 386 U.S. 959 (1967).

enough (to age 84, 11 years beyond her life expectancy) for annual corpus invasions to wipe out the trust principal, and that this possibility was not so remote as to be negligible. The remoteness test did not apply because, according to the court:

> [T]his is not an "either-or" situation in which the happening of an event, whose probability has to be ascertained, wipes out the charitable interest entirely. Rather, this is a case with a series of non-volitional possibilities of corpus invasion, e.g., surviving to age 72, to age 73, etc., each of which tends to diminish, but does not eliminate, the charitable remainder. . . . we do not read the Supreme Court decisions as requiring use in these circumstances of the "so remote as to be negligible" test at all.[104]

Thus the court stressed two facts in rejecting the remoteness test: a non-volitional power to defeat the charitable gift, and lack of an "either-or" situation. It is true that these facts distinguish *Sternberger's Estate* where the charitable bequest took effect only if the decedent's unmarried, childless 27 year old daughter died without descendants. There the charitable gift could be entirely eliminated (*either-or situation*) by the *volitional act* of the life beneficiary.

The distinction does not, however, justify rejection of the remoteness test in a situation where yearly invasion of principal is required to pay an annuity. Although the non-volitional nature of one outliving his life expectancy may make it less likely to occur than a volitional act, the "remoteness" thereof may still not be negligible. In *Schildkraut,* the possibility of the widow surviving her life expectancy did not appear so remote as to be negligible. Nor is the holding justified by the "either-or" distinction. Here the remoteness test would properly require a determination of a time to which the widow's chance of living was so remote as to be negligible. In *Schildkraut,* if this were less than 84 years of age but more than 73 years, then only a partial deduction should have been allowed. By no means does the "either-or" distinction require an "all or none" deduction.

In the case of the dollar amount unitrust share, *Schildkraut* would allow a deduction for a gift of a charitable remainder based on the present actuarial value of the remainder less an allowance for invasion of corpus necessary to make up the difference between the trust income and the annuity. There is, however, substantial contrary authority which would deny the deduction entirely where

104 368 F.2d at 48.

yearly invasion of corpus is possible and the annuitant has a more than remote chance of living long enough to exhaust trust corpus.[105] These cases appear to be better reasoned on the remoteness issue.

The value of a charitable remainder could be deductible even where the unitrust share is not subject to a maximum dollar limit but is expressed only in terms of a fixed percentage of trust assets, or in terms of such a percentage with a minimum dollar payment. The value could be computed by projecting the income buildup over the life expectancy of the current beneficiary, reduced by an annual charge in the amount of the stated percentage. If the percentage share would not exceed annual trust income, then the value of the remainder would be computed under the usual tables whereby the principal is multiplied by the factor for remainders. Since no diminution of corpus is likely here, both the ascertainable and remoteness tests of the regulations are met and a deduction should be allowed. The situation here appears to be no different than the usual case of a gift of remainder to charity after a simple life estate. Where the percentage would exceed annual trust income, the amount of corpus diminution per year would appear to be measurable after allowing for a declining amount of income per year. The full present value of the remainder would not be deductible, but, under the reasoning of *Schildkraut,* could be allowed for the amount the charity would take, after allowing for corpus diminution over the life expectancy of the current beneficiary.[106] Again, however, since diminution of corpus is likely and could extend beyond the life expectancy of the current beneficiary, the taxpayer would be faced with the substantial authority contrary to *Schildkraut* on the remoteness issue.

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[105] Estate of Choffin v. United States, 222 F. Supp. 34 (S.D. Fla. 1963); Florida Nat'l Bank v. United States, 62-2 U.S.T.C. ¶ 12,082 (S.D. Fla. 1962) (20 per cent chance charity would not take); Estate of George M. Moffett, 31 T.C. 541 (1958) (20 per cent chance), *aff'd* 269 F.2d 738 (4th Cir. 1959); United States v. Dean, 224 F.2d 26 (1st Cir. 1955) (1 chance in 11); Estate of Jean S. Alexander, 25 T.C. 600 (1955) (8.6 per cent chance). *But see* Estate of Helen Stow Duker, 18 T.C. 887 (1952) where the deduction was allowed although the chances that the beneficiary would live to consume the entire corpus were greater than 1 in 10.

[106] *See* Estate of Ben F. Sternheim, 2 CCH T.C. MEM. DEC. 311 (1943), *rev'd on other grounds sub nom.* Wells Fargo Bank & Union Trust Co. v. Comm'r, 145 F.2d 132 (9th Cir. 1944). *See also* Rev. Rul. 60-162, 1960-1 CUM. BULL. 376, where failure to provide for depletion of subsurface resources sufficient to keep the corpus intact resulted in a diversion of corpus each year to the life beneficiary, so that a deduction for a gift of the remainder to charity depended upon ascertaining the maximum feasible rate at which subsurface resources would be withdrawn.

GIFTS OF PRESENT INTERESTS TO CHARITY

Transfers of income interests in trust for the benefit of a charity also qualify for favorable tax benefits. Under the income tax, a deduction is allowed for the value of the income interest, subject to the percentage limitations of section 170(b)(1).[107] The deduction, however, is disallowed where the grantor retains a reversionary interest in the corpus or income of the trust which is worth more than five per cent of the trust property.[108] Where no such reversionary interest is retained, the extra 10 per cent allowance of section 170(b)(1) may be disallowed where the transfer is in trust since the contribution must be made "to" and not merely "for the use of" the designated charity.[109] The value of a charitable gift of income is deductible under the estate and gift taxes without limitation.[110] No deduction at all is allowed, however, where the charity may not receive the beneficial enjoyment of the interest. The regulations under the income, estate and gift taxes identically provide:

> The deduction is not allowed in the case of a transfer in trust conveying to charity a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in trust by the donor [decedent] consists of stock in a corporation the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's [decedent's] family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not members of the donor's [decedent's] family but have no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.[111]

Where a charity is given a current share in a unitrust, the deduction for its value appears to be in no way controlled by this portion of the regulations. The share given will not depend in any way on the presence of income and the charity will have the bene-

[107] Reg. Secs. 1.170-1(d); 1.170-2(d)(2) (1958).

[108] I.R.C. § 170(b)(1)(D).

[109] John I. Appleby, 48 T.C. No. 33 (1967); Reg. Sec. 1.170-2(b)(1) (1966). *See* Lowndes, *Tax Advantages of Charitable Gifts*, 46 VA. L. REV. 394, 414 (1960); Sorlien, *Charitable Transfers in Gift and Estate Planning*, PROCEEDINGS OF NEW YORK UNIVERSITY TWENTY-FOURTH ANNUAL INSTITUTE ON FEDERAL TAXATION 191, 215, 218-20 (1966). *See also* Alice Tully, 48 T.C. No. 24 (1967).

[110] I.R.C. §§ 2055, 2522.

[111] Reg. Secs. 1.170-1(e); 20.2055-2(b); 25.2522(a)-2(b) (1958).

ficial enjoyment of the interest given irrespective of whether the unitrust holds such property as shares of stock in a family corporation, unproductive real property, or marketable securities.

However, there appears to be no reason why the portions of these regulations embodying the remoteness and ascertainable principles do not apply. The deduction for the current share would not be allowed if the value of the interest passing was not presently ascertainable, or if any possibility that the charity would not take is not so remote as to be negligible.

An example of an interest that would be clearly deductible is a gift to a charity of a dollar annuity for a term of years. The value is presently ascertainable and there is no condition present which could defeat the gift. But suppose such an annuity were given for the life of an individual. Although its value could be ascertained, is the remoteness test satisfied, *i.e.*, is there not more than a remote possibility that the measuring life will expire prior to the end of its expectancy, indeed, at any time after the gift? *Schildkraut* might be applied to reject the remoteness test, but certainly cautious planning would require the gift to last at least as long as the life expectancy of the individual. Although the Commissioner does not appear to have raised the remoteness test in this area, his failure to do so may be due to the infrequency of gifts of current interests and the resulting de minimis nature of the problem.[112]

If the charity is given a current percentage share rather than a dollar annuity, the interest passing would appear to be presently ascertainable as an income interest. Thus, for example, if the percentage equalled the current rate of return on trust property, it could be valued as an ordinary income interest. If it exceeded or were less than such rate, appropriate adjustment would be made. The remoteness test would also be satisfied if the gift were for a term of years, but would give difficulty if it were for the life of an individual.

Revenue Ruling 67-195, however, appears to deny the deduction of a percentage interest given to a charity.[113] There, the decedent established a testamentary trust which provided that the net income up to 3½ per cent of the value of the trust property be paid annually to a charity for a term of five years. An estate tax charitable deduction, computed under the 3½ per cent tables of regulation section 20.2031-7, was denied on the ground that these tables apply only where the beneficiary has a right to receive the entire

112 *See* Martha F. Mason, 46 B.T.A. 682 (1942).

113 1967-25 I.R.B. 6 (June 19, 1967).

income, or a specific fraction of the entire income. "Moreover," states the ruling, "no generally acceptable formula is known by which the value of charity's interest may be determined."

Aside from the irony involved in disqualifying a gift of income equal in amount to the income factor used by the tables, the revenue ruling appears wrong under the rationale of *Northeastern Pennsylvania National Bank*. There the Court held that a specific portion under section 2056(b)(5) could be computed by use of an estimated realistic rate of return under reasonable investment conditions. Thus there could be found the amount of trust corpus which was necessary to produce income in the amount of the fixed annuity payable to the surviving spouse, and which accordingly qualified for the marital deduction. There appears to be no reason why this rationale should not be applied to the charitable deduction. In Revenue Ruling 67–195, a deduction could have been given in the ratio which 3½ per cent bore to a reasonable rate of return.

Grantor Trusts and the Unitrust

In General

Taxation of the so-called "grantor trust" is controlled by sections 671 to 678, subpart E of subchapter J. Such a trust, to be distinguished from the true trust, which is controlled by subparts A through D, is one in which the grantor reserves the power to revoke or the right to receive income or is a so-called "Clifford trust." [114] This latter term embraces trusts in which the grantor retains a reversionary interest in income or corpus, or in which he retains certain broad powers of enjoyment or control over the beneficial enjoyment of others in the trust assets. Also taxed under these provisions are persons other than the grantor of a trust where that person has a beneficial power to take for himself income or corpus.[115]

Where the grantor or another is treated under subpart E as the owner of all or a portion of a trust, section 671 provides that there is included in computing the taxable income of the grantor or the other person:

> those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D.

[114] I.R.C. §§ 673, 674, 675, 676, 677.

[115] I.R.C. § 678.

Under the above language it seems clear that income taxable to the grantor under subpart E is treated as if received directly by him, and is not treated as if received by the trust and taxable to the grantor as a beneficiary of the trust. This construction is borne out by the regulations, the legislative history, and Treasury rulings,[116] with a minor exception present with respect to support of dependents.[117] Thus, where any amount is taxable to the grantor or another under subpart E, the trust merely excludes this amount from the gross income of the trust, and the computation of the distributable net income of the trust is not affected by that amount.[118]

Where the grantor or another is treated as the owner of any "portion" of a trust, section 671 provides he is taxable on the "income attributable to that portion." Nowhere in the Code, however, is there a definition, for purposes of subpart E, of the terms "portion" and "income." Thus, with respect to the term "income," no distinction is drawn between its meaning for local law or trust accounting purposes and its meaning for income tax purposes. This distinction is clearly recognized for purposes of subparts A through D by section 643(b) which gives the word income its local law meaning when it is used alone, thus generally excluding from its meaning any item of capital gains or losses. This definition was made applicable to subparts A through D which govern the taxation of true trusts, but was not extended to subpart E which deals with grantor trusts. Hence, in subpart E, the word income would seem to be used in its broad tax sense and thus to include not only items of ordinary income, but also capital gains and losses. This construction of the statute is supported by the regulations which employ the term "income" to denote tax income, and the term "ordinary income" to denote income for trust accounting purposes.[119]

Definition of the word income, however, leaves unsolved the connected problem of the meaning of "portion." Income from a portion of the trust cannot be determined unless somehow the latter term is defined. Construed literally, that term as used in subpart

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[116] Reg. Secs. 1.671-2(c), (d), 1.671-4 (1956); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A211-12 (1954), reprinted at 3 U.S. Code Cong. & Ad. News 4025, 4351-52 (1954); Rev. Rul. 60-370, 1960-2 Cum. Bull. 203; Rev. Rul. 61-175, 1961-2 Cum. Bull. 128. This was also held to be the rule under the 1939 Code. Welch v. Bradley, 130 F.2d 109 (1st Cir. 1942). *But see* Sarah A. W. Coursey, 33 B.T.A. 1068, 1072 (1936).

[117] I.R.C. §§ 677(b) (second sentence), 678(c); Reg. Secs. 1.677(b)-1(b), 1.678(a)-1(b) (1956).

[118] *See* Note, *Taxation of Capital Gains Realized by Trusts*, 12 Tax L. Rev. 99, 104 (1956).

[119] Reg. Sec. 1.671-2(b) (1956). *See also* Reg. Sec. 1.677(a)-1(g) (1956).

E would seem to mean only some specific trust property, a fractional interest in the trust, whether divided or undivided, or perhaps an interest represented by a dollar amount. It would not seem to extend merely to a right, for example, to the capital gains of the trust, or to its ordinary income, neither being a definite part of the corpus.[120] The regulations, however, construe "portion of a trust" liberally to include *powers and interests* confined to income or corpus.[121] Indeed, under the regulations the word portion appears to be unnecessary to the statutory scheme. The effect of the regulations is to tax the grantor only upon ordinary income where he has a power to control, or an interest in, only ordinary income.[122] Likewise, only income allocable to corpus is includable by the grantor where he has an interest in, or a power over, corpus alone, and if satisfaction of the interest or exercise of the power would not affect ordinary income in a manner which would cause such income to be included.[123] On the other hand, if the grantor retains an interest in, or power over, both ordinary income and corpus, or an interest in, or power over, corpus alone which has the effect of a taxable interest in, or power over, ordinary income, both the ordinary income and the capital gains of the trust are taxable to the grantor.[124] These provisions of the regulations construing the terms "income" and "portion" are best illustrated by the examples in regulation section 1.677(a)–1(g).

The application of the above provisions to a unitrust is not immediately apparent. Where the grantor retains an interest in, or

[120] *See* Note, *Taxation of Capital Gains Realized by Trusts,* 12 TAX L. REV. 99, 108 (1956).

[121] Reg. Sec. 1.671–3 (1956).

[122] Thus, if a grantor is treated under section 673 as owner by reason of a reversionary interest in ordinary income alone, capital gains of the trust will not be included in his income. Likewise, a power over ordinary income only which is a taxable power under sections 674 to 678 will subject the grantor to tax only upon the trust ordinary income and not upon its capital gains. Reg. Sec. 1.671–3(b)(1) (1956).

[123] Thus, the grantor-owner of a reversionary interest in the corpus of a trust, which interest is not affected by the provisions of section 673, will be taxed, under section 677(a)(2), on capital gains of the trust since they will be accumulated for future distribution to him, but the trust ordinary income will not be taxed to him. Reg. Sec. 1.671–3(b)(2) (1956).

[124] For example, a reversionary interest in corpus which is taxable under section 673 requires inclusion of both ordinary income and capital gains in the income of the grantor. Similarly, a power over corpus which can affect income received within a period such that the grantor would be taxed under section 673 if the power were a reversionary interest, will make taxable to the grantor both trust ordinary income and trust capital gains. Sections 674, 676. Likewise, a grantor or another person is taxed on both ordinary income and capital gains of the trust if he has a power over corpus under section 675 or section 678. Reg. Sec. 1.671–3(b)(3) (1956).

power over, assets of a unitrust, the retained interest or power cannot conveniently be labeled as one in, or over, income or corpus. This problem is aggravated by the fact that there is no provision in subpart E, such as that in section 662(a)(2) of subpart C, which in effect treats trust distributions as proceeding first from income, to the extent of distributable net income. Thus, for example, a distribution of a unitrust share to the grantor raises the problem of whether to trace to the source of the distribution, or to apply some other rule of allocation of trust receipts and expenses. Similar problems of allocation arise where the grantor is to be taxed under subpart E because of control over beneficial enjoyment of trust income or corpus. These problems are best considered in the context of the specific statutory provisions.

SECTIONS 673, 677 AND 662: THE GRANTOR WHO IS A CURRENT BENEFICIARY

Section 673(a)

Under section 673(a), the grantor is treated as the owner of any portion of a trust if, because of a retained reversionary interest, the corpus or the income therefrom "will or may reasonably be expected to" revert to the grantor's possession or enjoyment within ten years of the inception of that portion of the trust. When this section applies, a reversionary interest in the income alone will cause the grantor to be taxed only on the ordinary income of the trust.[125] If the reversionary interest is in the corpus of the trust, all income, including capital gains, is taxed to the grantor.[126]

In the context of the unitrust of which the grantor is a current beneficiary, there will always be present a reversionary interest within section 673. This proposition will shortly be examined in detail; for now it is sufficient to note that whether the grantor's share is a percentage share or a fixed dollar share, he will recover an amount of the corpus of the trust within ten years of its inception.

Sections 677(a) and 662(a)

Where the grantor creates a trust under which trust income is or may be paid to him currently, or accumulated for future distribution to him, such income is taxed to the grantor currently under

[125] Reg. Sec. 1.671-3(b)(1) (1956).
[126] Reg. Sec. 1.671-3(b)(3) (1956).

section 677(a). Where the grantor is a current beneficiary of a percentage unitrust share, amounts of current income are both currently paid, and amounts are also accumulated for future distribution to him because of the application of the percentage to all items of trust assets, including current and accumulated income. This proposition will also shortly be examined in detail. Here it should be noted that the amount of income that will be considered currently paid, and the amount that will be considered accumulated for future distribution to the grantor, will be affected by the principle stated in section 1.671-3(a)(3) of the regulations:

> If the portion of a trust treated as owned by the grantor . . . consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion.

Where the grantor retains a conventional interest in income, such as a cumulative right to receive ten per cent of trust income in the discretion of the trustee, the application of the regulation is clear. To the extent the income is paid, or accumulated for future distribution, to the grantor, the grantor will take into account as his own ten per cent of all items of income, deductions and credits (excluding capital gains and losses to the extent they are not considered income). In the case of the percentage share unitrust, however, the application of the regulation would seem to require modification because of the application of the percentage not only to current income, but also to accumulated income. Also, in the case of the fixed dollar annuity, the principle of the regulation seems to be avoided by reason of the application of the rule of *Burnet v. Whitehouse*.[127]

Another problem of general applicability to be noted here is the relationship between subparts A to D, which govern the taxation of the trust and its beneficiaries, and the provisions of subpart E, which govern the taxation of the grantor. If we assume there are other beneficiaries of the trust besides the grantor, a problem of priority is raised: If subparts A to D are first applied, and assuming distributions to nongrantor beneficiaries exhaust the distributable net income of the trust, it could be argued that no amounts are accumulated for future distribution to the grantor, and that section 677(a)(2) will therefore have no application to him. This is not, however, the result because income taxable to the grantor under subpart E is treated as if received directly

[127] 283 U.S. 148 (1931). See discussion in the text beginning at note 147 *infra*.

by the grantor and is excluded from the income of the trust.[128] Only items of income which are not taxable to the grantor under subpart E are subject to the provisions of subparts A to D.[129] As we shall see, where the grantor has received a distribution, this principle can lead to him being taxed under both subpart E and subparts A to D.

The Grantor-Beneficiary of a Percentage Share

Assume that G, who has a life expectancy of ten years, creates a trust whereby he is to receive five per cent of the value of the fund each year for his life, remainder over. The original value of the fund is $10,000. In the first taxable year of the trust the tax income is $1,000 (ordinary income) increasing the value of the fund to $11,000 and thus entitling G to a distribution of $550.

How much of the $1,000 tax income will be taxable to G? In order to answer this question, four separate sections must be considered: 673, 677(a)(1), 677(a)(2), and 662(a).

1. *The Amount Taxable to G Under Section 673.* Since $500 of the distribution to G is due to the application of the five per cent to the value of original corpus, G has in substance regained five per cent of the original trust corpus. Moreover, in succeeding years part of G's distributions will continue to be due to the application of the percentage to the declining balance of the original corpus. Although it is mathematically impossible for G to recapture all of the corpus in this manner, he will, if he lives for ten years, regain about forty per cent of it.[130] This amounts to the retention by G of a reversionary interest in the trust corpus and thus brings into play section 673 which provides that:

> The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.[131]

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[128] Reg. Secs. 1.671-2(c), 1.671-4 (1956).

[129] Reg. Sec. 1.671-2(d) (1956).

[130] The forty per cent figure is merely an approximation (off by about 3/20 per cent). The exact percentage of original corpus to be regained, in terms of decimal fractions, can be calculated by using the formula: $P=1-(1-X)^n$, where P is the percentage to be regained, expressed as a decimal fraction, X is G's percentage, expressed as a decimal fraction, and n is the number of years. Thus, to find the percentage of original corpus that G will regain over ten years, we calculate: $P=1-(1-.05)^{10}$.

[131] Note that in our hypothetical there is no direction to the trustee to pay any of G's distribution out of original corpus. Indeed, such a direction would not be meaningful

Under this section, assuming as we have that G's life expectancy is ten years on the date the trust is created,[132] it would seem that he would be considered to have a reversionary interest in about forty per cent of the original corpus, which interest will take effect in possession or enjoyment within ten years of the inception of the trust. In the first year, therefore, G would be taxed on the income from $4,000, *i.e.*, $400.[133]

2. *The Amount Taxable to G Under Section 677(a)(1): The Oppenheimer Principle.* Since G is entitled each year to five per cent of the total value of the fund, $50 of the $550 distributed to G is due to the application of his percentage to the increase in value to

in a unitrust which does not distinguish between corpus and income. This factor, however, should not change the result under section 673. Certainly, this section does not depend on the grantor's recapturing the identical property placed in trust. For example, if G establishes a five year conventional trust whose income is payable to A and whose corpus will revert to G at the trust's termination, G will be taxed under section 673 from the inception of the trust on all the tax income even though the corpus, on termination, contains different property than that originally placed in trust. Indeed, this would be so even if the trust directed the trustee to pay the value of the annual income to the beneficiary out of original corpus assets so that at the end of five years G might be receiving assets which constituted trust and tax income at the time they were received.

The grantor should be considered to have retained a reversionary interest in the original corpus whenever he has retained the right to regain part or all of *the value of the original corpus*, whether he regains this value in the form of the specific assets of the original corpus or a substitute therefor. The purpose of section 673 is to treat a grantor who will, within ten years, get back what he placed in trust as though the grantor had never placed it in trust. If G places $10,000 in trust and directs the trustee to pay him back one-tenth of the corpus each year, G will receive back within ten years exactly what he gave away, whether or not he receives the same $10,000 he placed in trust. These same principles are applicable in our case as to the amount of G's distribution due to the application of the five per cent to the value of the original corpus.

[132] *Cf.* Reg. Sec. 1.673(a)-1(c) (1956).

[133] In future years G will not be taxed under section 673 only on the income from $4,000, *i.e.*, only on the income from forty per cent of the *original value* of the *original corpus*. To do so would be to ignore the possibility that the value of the original corpus may fluctuate during that period. If, for example, the value of the original corpus appreciated over the ten years, the dollar value of the amount distributed to G by virtue of his forty per cent recapture of corpus will be more than $4,000. To reflect any fluctuation G should be taxed each year on the income from forty per cent of the original corpus at its *current* value. *See* Reg. Sec. 1.671-3(a)(3) (1956). This cannot be accomplished, however, by taxing G each year on forty per cent of the entire income since to do so would be to tax G not only on the income from forty per cent of the original corpus (in which he has a reversionary interest) but also on the income from forty per cent of the accumulated and undistributed income of prior years (in which G has no reversionary interest). (Some of the income of each year is accumulated for G but that is taxed to him under section 677(a)(2), see *infra.*)

It is possible to calculate the income due from forty per cent of the original corpus each year by using the following formula:

$$2/5 \text{ (forty per cent)} \times \left(\frac{\text{value of the total fund} - \text{value of accumulated income}}{\text{value of total fund}}\right) \times \text{current tax income.}$$

the original corpus represented by the tax income of $1,000. G has in effect been paid $50 of current tax income. This would seem to bring him squarely within section 677(a)(1) which provides that:

> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or an adverse party, or both, may be . . . distributed to the grantor . . . .

G would appear to be taxable on $50 of income under this section.[134]

[134] Note that section 677(a)(1) taxes to a grantor not only tax income which *is* distributed to him but also income which *may be* distributed to him. Since our hypothetical trust does not indicate that the trustee is required to pay G's distribution out of original corpus, it may seem that the entire $550 is taxable to G under the "may be" portion of section 677(a)(1). This would be on the ground that the entire $550 distributed to G could have been distributed to him out of the current tax income. However, even aside from the fact that a direction to pay out of original corpus has no meaning in a unitrust context, this position would be inconsistent with the previous finding that G has a section 673 reversionary interest. The latter finding was based on the theory that $500 of G's distribution is a recapture of part of the original corpus because that part of his distribution is the result of the application of his percentage to the value of the original corpus. In fact, the argument on section 677(a) here is no more than a restatement of the argument, previously discussed, that there is no section 673 reversionary interest since the amount determined by applying the percentage to the original corpus need not be paid out of original corpus. It is submitted, however, that the prior analysis resulting in a section 673 reversionary interest is proper and that the "may be" portion of section 677(a)(1) has no applicability here. It is, to be sure, literally true that $500 of the $1,000 income may be distributed to G in satisfaction of that much of his distribution, where no direction is given to pay out of original corpus. The purpose of section 677(a)(1), however, does not reach our situation and to apply it literally here would distort the pattern of subchapter E. As discussed above, the purpose of section 673 is to treat a grantor as not having transferred property which he will regain in less than ten years. The result of so treating him is that the income *from* said property is taxed to him from the outset. The result is *not* to tax him on an amount of income equal to the value of what he will regain. This is so even though, as stated previously, the $4,000 reversion may not be paid in the form of the same assets placed in trust, and indeed, may be paid from what was, when received, tax income (*e.g.*, if the beneficiary's trust income was to be paid out of original corpus).

The above analysis regarding the design of section 673 is essentially the same as that with respect to the relationship between sections 676 and 677. For example, if instead of retaining a $4,000 reversion, G had retained the power to revoke $4,000 of original corpus, G should again be taxed only on the income from $4,000 and not on $4,000 of the income. To tax G on $4,000 of income under section 676 would be to treat G as having retained the right to revoke more than $4,000, *i.e.*, the right to revoke an amount sufficient to generate $4,000 of income. The purpose of section 677(a)(1), on the other hand, is to treat the grantor as not having transferred *any part of corpus*, whether or not it will revert to him or can be revoked by him, *whose income will or may inure to the benefit of the grantor.*

If G creates a trust of $100,000, income to himself for life, remainder to A, and there is $5,000 of tax income during the first year, G is treated under section 677(a)(1) as not having transferred any of the $100,000 with the consequence that the entire $5,000 is taxed to G. The same result would occur if the trustee had discretion to pay G the income

This literal application of section 677(a)(1) raises the question whether this amount is to be added to the amount taxable to G under section 673. Or, on the other hand, may G successfully argue that the $50 is subsumed in the amount taxable to him under section 673? A similar argument was rejected by the Tax Court in *Ruth W. Oppenheimer.*[135] There the taxpayer was the life beneficiary of the income from an undivided one-third of the corpus. She also had the right to take "property of the corpus . . . of a value not to exceed [$25,000] in any one calendar year." Taxpayer conceded that she was taxable on the income from $25,000 a year but argued that since the income from one-third of the corpus (which she had reported) was in excess of the income from $25,000 of corpus, "no additional amount is to be added to her income by reason of her right to take corpus." The Tax Court, however, held that:

> [O]f the income which was . . .[the taxpayer's] by reason of her right to take corpus, only one-third thereof may be said to have been reported by her when she reported the income distributed to her by reason of . . . [her life interest in the income from one-third of the corpus]. The remaining two-thirds of the income attributable to the $25,000 . . . was over and above the income received and reported by her . . . .[136]

Thus, the court held the taxpayer taxable not only on the income from one-third of the entire corpus, but also on two-thirds of the income from $25,000. The propriety of this holding can be seen by assuming that the taxpayer withdrew the $25,000 from the trust and invested it elsewhere. All of the income from that $25,000 would be taxable to her and she would still receive one-third of the income from the diminished corpus. This is the same amount of income as was taxed to her in *Oppenheimer*, one-third of the income from all of the corpus together with two-thirds of the income from $25,000.

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or accumulate it and add it to corpus for remainderman A. If G or a nonadverse party retains the right to receive or the right to determine whether to receive, the income from corpus placed in trust, it is not improper to treat G, for income tax purposes, as never having created the trust.

To be distinguished, however, is the section 676 (and 673) situation. If G has irrevocably surrendered the benefit of the income from say $95,000 of $100,000 placed in trust, but retained the right to the benefit of the income from $5,000 of the $100,000 by virtue of a reversion in, or a right of revocation over, $5,000 of corpus, it is clearly improper to treat him as having retained the benefit of the income from any more than $5,000 merely because his reversion or his revocation *may be* satisfied by assets which, when received, constituted tax income.

135 16 T.C. 515 (1951), *reviewed by the court* (2 dissents).

136 16 T.C. at 526.

Similarly, in our hypothetical, G is treated, under section 673, as having retained ownership over $4,000 and is taxable on all of the income attributable to that amount. The *additional* benefit that is his by virtue of the application of five per cent to current income is five per cent of the income from the *remaining* corpus. In terms of the *Oppenheimer* analysis, if G had retained the $4,000, as he is deemed to have done under section 673, he would be taxable on (1) all the income from that $4,000, plus (2) five per cent of the income of the remaining $6,000—*i.e.*, under our hypothesis, $400 plus $30 (five per cent of $600 which is considered the income from $6,000). Thus, of the $50 of income originally considered, only $20 is subsumed in the $400 taxable under section 673.

3. *The Amount Taxable to G Under Section 677(a)(2).* The application of sections 673 and 677(a)(1) does not exhaust G's interest in the current income of $1,000. To be sure, in the year the income was realized G received, in effect, only $50 of it, five per cent of the income. He will, however, in each of the succeeding years of the trust receive five per cent of the declining balance of this $1,000. Thus, in the second year he will receive five per cent of ($1,000—$50); in the third year, five per cent of ($1,000—[5% ($1,000—$50)]), and so on. Hence, in the first year, the trust is accumulating income for future distribution to G. This makes applicable to G section 677(a)(2), which provides that:

> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or an adverse party, or both, may be . . . held or accumulated for future distribution to the grantor . . . .

The amount of the remaining income which will be taxable to G under section 677(a)(2) will not be the full $950 since the application of G's percentage to the declining balance will never exhaust the original amount. The exact amount G will receive over any given number of years can be calculated by using the same formula employed to determine his reversionary interest under section 673.[137] The problem is to determine the number of years over which G will receive distributions of the accumulated current income. Certainty can be obtained by using G's life expectancy. For example, using an expectancy of ten years from the inception of the trust, the above formula would result in about thirty-five per cent of the $1,000 current income being accumulated for future distribu-

[137] *See* note 130 *supra.*

tion to G. There is, however, a possibility G will live longer than his life expectancy. The significance of such a possibility under section 677(a)(2) will be discussed under another heading.[138] It is sufficient to note here that, unless a time is chosen beyond which G has only a remote chance of surviving, it is impossible to calculate the precise amount that will be considered accumulated for G under section 677(a)(2) since it is impossible to tell how long G will live beyond his life expectancy. The only other alternative (and this would seem to be a logical extension of the Treasury's position, later discussed) would be to treat G as immortal so that he would be taxed as though he would receive all but the tiniest fraction of the current income in the future.[139]

In order to assure a limit on the amount that will be held accumulated for future distribution to G, the trust indenture should include a provision to the effect that G's percentage will be applied to the increase in value of the trust corpus represented by current tax income only for that number of years which constitute his life expectancy as of the inception of the trust. Such a provision would both limit the amount includable to G under section 677(a)(2), and allow it to be precisely calculated.[140]

Assuming that G's life expectancy of ten years will control the accumulation question, because of the presence of the suggested provision or otherwise, the application of the formula would result in a section 677(a)(2) accumulation for G of about thirty-five per cent of the $1,000 over the course of nine years, or $350. However, $350 would not be the amount taxable to G under section 677(a)(2), because here again the principle of *Ruth W. Oppenheimer* comes into play: since G is taxed on the income from $4,000 because of his reversionary interest under section 673, the only additional benefit he receives by virtue of the application of his five per cent share to the declining balance of the first year's income is with respect to the income from the *remaining* corpus—$6,000. To illustrate again, if G had retained $4,000 of the original $10,000 corpus, as he is considered to have done for purposes of section 673, he would be tax-

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[138] *See* text at notes 171–84 *infra*.

[139] It is theoretically impossible for G to receive *all* the income because his share is computed on the basis of a percentage of a declining balance.

[140] For example, if in the first year of the trust G has a ten year life expectancy, the first year's income, and its declining balance, will be included in the value of the fund for the next ten years only; the income in the second year of the trust will be included for only nine years, etc.

Note, of course, that if there are other beneficiaries besides G, the amount considered accumulated for G under section 677(a)(2) will be reduced *pro tanto*.

able on (1) all the income from $4,000, plus (2) five per cent of the income from the remaining $6,000 (under section 677(a)(1)), plus (3) five per cent of the declining balance of the income from the remaining $6,000 over nine years (under section 677(a)(2)). Thus, of the first year's income of $1,000, G would be taxed as follows:

(1) on $400—the income from $4,000—under section 673;

(2) on $30—five per cent of $600, the income from the remaining $6,000 of corpus—under section 677(a)(1) and the *Oppenheimer* principle;

(3) on $210—five per cent (over nine years) of the declining balance of $600, the income from the remaining $6,000 of corpus—under section 677(a)(2) and the *Oppenheimer* principle.[141]

The total amount taxable to G in the first year under the grantor trust provisions is thus $640.

4. *The Amount Taxable to G Under Section 662(a).* The provisions of subpart E relating to grantor trusts do not exhaust G's taxability in the example under discussion. Under the scheme of the Code, as heretofore explained, income taxed to the grantor or another under subpart E (sections 671 to 678) is considered to be received directly by the grantor or such other person. Any income over and above the amount governed by subpart E, is governed by subparts A to D (sections 641 to 669).[142] That latter amount, in our hypothetical, is $360 ($1,000 less $640 taxable to G under subpart E); and the short of it is that G, assuming he is the only current beneficiary (as he is in our hypothetical), will be taxed on that amount under section 662.

Section 662 requires that a beneficiary—and the fact that G is the grantor does not make him any less a beneficiary here—include in his gross income any amounts distributed to him up to the distributable net income of the trust. The distributable net income of our hypothetical trust in the first year, disregarding items of deduction, is $360 calculated as follows: Under section 643, distributable net income is the taxable income of the trust with certain modifications, none of which, it is assumed, are applicable here. Although the trust realized $1,000 of income in the year in question, it reports as gross income only the amount in excess of the amount (here,

141 Applying our formula used with respect to the corpus under section 673, note 130 *supra*, we find that G will receive about forty per cent of $600 over ten years, or about $240, from which we subtract the $30 attributable to the first year since it is already accounted for under section 677(a)(1).

142 *See* I.R.C. § 671; Reg. Sec. 1.671-2(d) (1956).

$640) taxed to the grantor or other person under subpart E.[143] Disregarding items of deduction, the gross income of the trust, $360, is its taxable income which in turn is the distributable net income of the trust. Since distributable net income is $360, and since G has had a distribution to him of $550, G is taxed on $360 under section 662.

It may at first seem anomalous that G, who has already been taxed under subpart E on more than what was distributed to him, should be taxed on $360 more because of his distribution. The anomaly, however, is only apparent. We start with $1,000 of tax income, all of which is subject to income tax. Because G, who created the trust, retained certain interests in it, subpart E taxes $640 of the $1,000 of income to him as though he received it (even though he actually received that year only $50 of it, the other $500 of his distribution being a partial recapture of the original corpus). The remaining $360 of tax income is covered by the rules with respect to the division of taxability between the true trust and its beneficiaries in subparts A to D. One of these rules, embodied in the interplay of section 662 and section 643, is that any distribution, even if its source could be traced to original corpus or prior accumulated income, is deemed to be a distribution of current tax income to the extent that it does not exceed the distributable net income. So here, although $500 of G's distribution is in reality a distribution of original corpus, $360 of it is deemed to be a distribution of the trust's current income of $360.

Stated more briefly:

(1) $610 of the $1,000 is taxed to G, *not because of distribution of any part of the $1,000 to him*, but because of his retained future interests in the corpus and in $950 of the $1,000 of income;

(2) $30 is taxed to him because of a distribution to him of $50 of the $1,000 of income; and

(3) $360 is taxed to him because of the distribution to him of $500 of original corpus.[144]

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[143] *See* Reg. Sec. 1.671-4 (1956).

[144] Suppose that G's right was *not* to five per cent of the value of the fund, but to five per cent of the current income only. In such a case, assuming the other figures are the same, under section 677(a)(1) of subpart E, G would be taxed on $50. This would make distributable net income $950. Could it now be said that under section 662, G is taxable on an additional $50? It would seem not. In this situation, the reason for taxing G under section 677(a)(1) is the very same as that which would be used under section 662—that is, the distribution of $50 to him. To tax G on $100 would be to tax G twice for the very same reason. Clearly if the trustee had discretion to give G five per cent of the income, but did not, G would still be taxed under section 677(a)(1) on $50 but

Although our hypothetical grantor was taxed on all of the current income in our hypothetical example, this is not always the necessary result. The presence of other beneficiaries would, of course, automatically reduce the amount taxable to the grantor under sections 673 and 677(a)(2). Even where the grantor is the sole beneficiary, the amount taxable to him under section 677(a)(2) would be affected by the number of years he could share in accumulated income. Also, the interplay among various factors such as the size of his percentage share, the value of trust corpus—including the effect of appreciation and depreciation thereof—and the amount of net current trust income, can operate to reduce the size of his distribution to a point where amounts treated as distributed to him as a trust beneficiary under section 662(a) will be in excess of the trust distributable net income. This can happen, for example, where his percentage share is large in relation to net current trust income.

The Grantor-Beneficiary of a Fixed Dollar Annuity

Assume that G, with a ten year life expectancy, creates a trust from which he is to receive a life annuity of $1,000 a year, payable in any event, remainder over. The original corpus is $100,000. The taxable income of the trust in its first year is $5,000, all of which is ordinary income. How much of this amount is taxable to G?

Before examining the individual sections in detail, it is necessary to analyze the nature of the above trust. Note that it does not specify the source of the annuity payment. There are several possibilities in this regard. For example, the grantor-beneficiary may direct that the annuity be paid from original corpus, or ratably from original corpus, accumulated income,[145] and current income, or first from current income with corpus to be invaded if current income is insufficient. Or the trustee may be given discretion as to the source, explicitly (*i.e.*, by specific trust provisions) or implicitly (where the trust is silent as to source).

At first it would seem that these possible variations would raise complications with respect to the analysis of the grantor's taxability under sections 673, 677 and 662. Suppose that the trustee was vested with discretion as to the source of the annuity payment. In such a case it could be argued that the grantor has retained no

not again under section 662 since there was no distribution. The situation should be no different because the distribution is mandatory.

[145] Here, of course, income refers to tax income.

reversionary interest within section 673; the fact that the trustee *may* pay the annuity from corpus would not seem to amount to a retained *interest*. Moreover, although it is *possible* at the inception of the trust that, because of insufficient earnings, the annuity may have to be satisfied, in effect, by a recapture of original corpus, such a possibility should not be equated with a section 673 reversionary interest in corpus. This follows because, on our facts, G's interest (considering the possibility an interest) is not one which "will or may *reasonably be expected* to take effect in possession or enjoyment within 10 years." [146] On the other hand, since the trustee may select the source of the payment, it would seem that the current income "may be" distributed to the grantor and would thus be taxable to him under section 677(a)(1).

It is submitted, however, that the above results are unsound. In the case of a unitrust it would seem sufficient to note that since no distinction is drawn between corpus and income items, directions as to source of distributions are not meaningful. More fundamentally, it is submitted that where, as in our hypothetical, the fixed sum annuity is made payable in any event, directions (or lack thereof) with respect to the source of payment—indeed the source itself—should be considered irrelevant to the application of sections 673 and 677. As authority for this suggestion, reliance is placed squarely on the Supreme Court's decision in *Burnet v. Whitehouse*.[147] There the testator's will established a $5,000 life annuity payable to the taxpayer in all events. The testator died in 1918. Prior to November 14, 1920 the annuity was paid from the corpus of the estate, but after that date it was paid from income. The Commissioner took the position that the taxpayer was taxable on payments made to her during 1921. The Board of Tax Appeals and the court of appeals, however, held that these payments were exempt bequests.[148] In affirming this holding, the Supreme Court reasoned as follows:

146 Emphasis added. Even under such an argument there might be situations, however, where the possibility of insufficient income may be properly viewed as equivalent to a section 673 reversionary interest. Suppose, for example, G creates a trust whereby he is to receive a life annuity of $10,000 per year payable in any event, and the corpus of the trust is only $50,000. In this situation it is highly probable, to say the least, that G will recapture all of the $50,000 of original corpus within ten years.

147 283 U.S. 148 (1931), discussed in Del Cotto, *The Trust Annuity as Income: The Constitutional Problem of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231 (1968).

148 The particular statute involved was section 213 of the Revenue Act of 1921, which provided, pertinently, that "the term 'gross income' . . . Does not include . . . The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income) . . . ."

> The most plausible argument submitted for the Commissioner is this: An annuity given by will is payable primarily out of the income from the estate. The residuary estate of Bennett produced enough during 1921 to meet all bequeathed annuities. The payments received by Mrs. Whitehouse during that year were, in fact, made from such income. Consequently, it cannot be said that the bequest was one of corpus; and the payments were taxable under *Irwin v. Gavit,* 268 U.S. 161.
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> As held below, the bequest to Mrs. Whitehouse was not one to be paid from income but of a sum certain, payable at all events during each year so long as she should live. It would be an anomaly to tax the receipts for one year and exempt them for another simply because executors paid the first from income received and the second out of the corpus. The will directed payment without reference to the existence or absence of income.
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> *Irwin v. Gavit* is not applicable. The bequest to Gavit was to be paid out of income from a definite fund. If that yielded nothing, he got nothing. This Court concluded that the gift was of money to be derived from income and to be paid and received as income by the donee. Here the gift did not depend upon income but was a charge upon the whole estate during the life of the legatee to be satisfied like any ordinary bequest.[149]

To be sure, the precise holding of *Whitehouse* was that an annuity payable in any event, even though paid from current income, was exempt in the hands of the recipient as a bequest of property. The reasoning of that case, however, is fully applicable to our situation. It is clear from its opinion that the Supreme Court held as it did because the annuity was payable without regard to the presence of income so that the bequest was in reality a bequest of corpus, *i.e.*, a bequest of *property* of the estate not a bequest of the *income from property* of the estate. The source of the payment was properly considered irrelevant since it had nothing to do with the essence of the rights transferred to the annuitant.

Likewise, in our situation, the grantor, by making the annuity payable in any event, has in reality retained, *pro tanto,* the property formally placed in trust, regardless of any directions, or lack thereof, with respect to the source of the annuity payment. If, as in our hypothetical, a grantor places $100,000 in trust and directs that he be paid an annuity of $1,000 for life, he has retained an interest *in the property and not in the income from the property.* The grantor in such a case, in precisely the same sense as the annuitant in *Burnet v. Whitehouse,* has no interest in, and in no way benefits from, the income from the property unless and until the property is

[149] 283 U.S. at 150-51.

exhausted by the annuity payments. Any provision, or lack thereof, with respect to the source of payment in no way affects this nature of the grantor's interest.

As has been indicated previously, the result of *Burnet v. Whitehouse* has been changed *with respect to nongrantor beneficiaries* (subparts A to D) by specific legislation which has the effect of treating periodic gifts and bequests of corpus as gifts and bequests of income to the extent that the distributions to the beneficiaries do not exceed the distributable net income of a trust (or estate). However, as has also been noted previously, no such statutory rule exists in the grantor trust area (subpart E). Absent such a statutory provision, the reasoning of *Burnet v. Whitehouse* would seem to control. As will be seen, the ramifications of this analysis will be present in all the Code sections which apply to our case.

1. *The Amount Taxable to G Under Section 673.*Under the above analysis, G has retained an interest in the corpus which will take effect in possession each time an annuity payment is made to him. Thus, over the course of ten years G will in effect recapture $10,000 of original corpus. This will render him taxable, from the inception of the trust, on the income allocable to $10,000. Therefore, in the first year of the trust the amount taxable to G under section 673 will be $500.[150]

2. *The Amount Taxable to G Under Section 677(a)(1).* Recall that the effect of section 677(a)(1) is to tax the grantor on tax income which:

> is, or, in the discretion of the grantor or a nonadverse party, or both, may be . . . distributed to the grantor . . . .

This section is designed to tax a grantor who has retained an interest in (or power over) income. But under our analysis, the grantor-beneficiary of a fixed sum annuity payable in any event has not retained any interest in income, regardless of the source of payment. This means that, even if the trustee is required to, or in his discretion may, pay the annuity out of current income, the grantor will not be taxed under this section even though the statutory language literally applies. In *Burnet v. Whitehouse*, the Commissioner relied in part on section 219(a)(4) of the 1921 revenue act which taxed beneficiaries on "[i]ncome which is to be distributed to the beneficiaries periodically . . . ." The Supreme Court replied suc-

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[150] $$\frac{\$10{,}000 \text{ (reversionary interest)}}{\$100{,}000 \text{ (value of original corpus)}} \times \$5{,}000 \text{ (income)}$$

See Reg. Sec. 1.671-3(a)(3) (1956).

cinctly: "But clearly enough, we think, this section applies only to income paid as such to a beneficiary." [151] What the Court seems to be saying is that income is not "paid as such" even if it is the source of the payment, *i.e.*, even if it is "paid," where the payment does not depend upon the existence of income. This approach seems clearly to be the proper one in light of the purpose of section 677(a)(1). The purpose of that section is to tax a grantor on current income which will or may inure to his benefit. The purpose is not to tax him on income whose existence is a matter of economic indifference to him, even though he may actually receive what, when realized, is income. The existence of income in the case of a trust to pay a current beneficiary a fixed sum regardless of income, benefits not the current beneficiary, but the remaindermen, that is, those whose interest would be depleted by the annuity payment in the absence of sufficient income.

Consequently under section 677(a)(1), properly interpreted, the grantor would not be taxed on any of the current income. This should be so even when the annuity payments have exhausted original corpus because at that time, as well as at the outset of the trust, the grantor's payment does not depend on the existence of income. His payments at that time would in reality be made from accumulated income of prior years.

3. *The Amount Taxable to G Under Section 677(a)(2).* As noted previously, the effect of section 677(a)(2) is to tax a grantor upon income which:

> is, or, in the discretion of the grantor or a nonadverse party, or both, may be . . . held or accumulated for future distribution to the grantor . . . .

The question arises whether G, as a beneficiary of a fixed sum annuity, will be taxed on current undistributed income under this section on the ground that he may receive it in the future. Recall that in discussing this question in connection with the taxability of a grantor who has a *percentage share,* we saw that G was presently taxable on the current income that would or might be received by him in future years due to the application of the percentage to income accumulations. In that situation, our concern with the language in section 677(a)(2)—"may be . . . accumulated for future distribution to the grantor"—was with respect to whether its application, in the absence of a fixed term, would be limited by G's

151 283 U.S. at 151.

life expectancy or by some other standard which would establish a fixed number of years beyond which G would not be considered to share in any accumulation of current income.

Similar considerations are present in the case of a grantor-beneficiary of a *fixed sum annuity* payable in any event. On the one hand, under the analysis generated by *Burnet v. Whitehouse,* the payments made to the grantor are in reality payments of corpus (until original corpus is exhausted). Thus, the fact that a trustee may pay future annuities out of current income which has been accumulated will not render the grantor taxable under the provisions of section 677(a)(2) which tax the grantor on income which "may be . . . accumulated for future distribution to the grantor." Just as in the case of the "may be . . . distributed" language of section 677(a)(1), the fact that the payment may be made from income items is irrelevant where the payment does not depend on income. If the fact that current income items may be currently used to satisfy the annuity does not render the grantor taxable under section 677(a)(1) (since the annuity is payable regardless of the existence of income), the fact that the current income items may be accumulated and distributed to the grantor in satisfaction of future annuities should likewise not render the grantor taxable under the "may be accumulated" language of section 677(a)(2) (since the annuity is payable regardless of the existence of the income which is accumulated).

On the other hand, it may happen that the original corpus will be depleted before the termination of the grantor-beneficiary's annuity. If, for example, the grantor is, as in our hypothetical, a life beneficiary, there is the possibility that the grantor will live long enough to deplete the original corpus. That possibility, on our facts, is extremely remote, to say the least. But it is a theoretical possibility. There is also the possibility that the original corpus may suffer depreciation. Such possibilities may have the effect of requiring that future annuities be paid from accumulated income and if that happens, the grantor will have had the benefit of that income.[152] As noted in connection with the application of section 677(a)(2) to a grantor-beneficiary of a *percentage share,* the effect of such possibilities under that section will be fully discussed under a later heading.[153] It is sufficient to note at this time that it cannot be concluded with certainty that the degree of remoteness of the possibilities will be the decisive factor. It cannot therefore be con-

[152] *See, e.g.,* Samuel v. Comm'r, 306 F.2d 682, 689 (1st Cir. 1962).
[153] *See* text at notes 171–84 *infra.*

cluded here that under no circumstances will the grantor of our hypothetical be taxed under section 677(a)(2). However, for purposes of further discussion, we will assume that none of the first year's income will be taxed to G under section 677(a)(2).

4. *The Amount Taxable to G Under Section 662(a).* Thus far we have determined that of the $5,000 of income for the first year, G will be taxed on $500 under section 673 and on no amount under section 677(a)(1). We have also *assumed* that G would not be taxed on any amount under section 677(a)(2). In accordance with our prior discussion, the $500 taxable to G under section 673 is excluded from the calculation of the trust taxable income and thus from the trust distributable net income. This, however, will leave the trust with distributable net income of $4,500 (disregarding deductions). Therefore, even though the payment to G is in reality a distribution of $1,000 of original corpus, G will be taxed *on that distribution*, $1,000, under section 662, for the reasons outlined in our discussion of the grantor-beneficiary of a percentage share.

The Grantor-Beneficiary of a Combination Share

As noted heretofore, the unitrust may state the share of the beneficiary as the greater or lesser of a percentage share and a fixed amount. Such a share raises the question of the extent to which the prior analyses, employed with respect to the percentage share or fixed amount share considered singularly, will have to be varied.

1. We consider first the combination share stated as the greater of a percentage and a fixed amount, *e.g.*, five per cent but no less than $5,000, or $5,000 but no less than five per cent.

a. Section 673. As we have seen, both the percentage share and the fixed sum will result in a reversionary interest under section 673. Where the share is stated as the greater of a percentage share and a fixed sum, the reversionary interest can be calculated by determining which element will probably be affirmatively operative. Suppose that the original corpus of the trust is $100,000 and the grantor's share is stated as the greater of five per cent or $1,000. In this situation, the percentage share will ordinarily result in the greater payment to the grantor, and, accordingly, will be the factor employed to determine the reversionary interest. If, on the other hand, the share were stated as one per cent but no less than $5,000, the fixed sum would result in the greater payment and would be the factor used to calculate the reversionary interest.

Of course, the above conclusions are based on the assumption that there will be no drastic depreciation or appreciation in the value of the original corpus during the first ten years. Depreciation or appreciation may result in the operative factor (percentage or fixed sum) varying from year to year within the first ten years, especially if the percentage and the fixed sum will produce almost equivalent payments. In such cases, precise calculation is not possible and an estimate would have to suffice. In this connection, recall that section 673 speaks in terms of an interest which "may reasonably be expected to take effect in possession or enjoyment within 10 years." The estimate would be made under this general principle.

b. Section 677(a)(1). Our prior discussion indicated that section 677(a)(1) will result in taxation of part of the income where the share is only a percentage share, but not where the share is only a fixed dollar share.

Thus, where the share is stated as the greater of a percentage or a fixed sum, taxability of the grantor under section 677(a)(1) will turn on whether, and the extent to which, the percentage share is affirmatively operative. Suppose that the original corpus of the trust is $100,000 and that the grantor's share is five per cent but not less than $5,000. In year one of the trust there is ordinary income of $5,000 increasing the value of the fund to $105,000. G is thus entitled to $5,250. The percentage element has operated to give G $250 more than he would have received by virtue of the fixed sum alone. To this extent, therefore, G has been paid current income and would be taxed under section 677(a)(1).[154]

c. Section 677(a)(2). Here separate consideration must be given to the "is held" and the "may be held" language of section 677(a)(2).

(i) "is held." Where the grantor's share is stated only as a fixed sum, the "is held" language will not apply unless it can be determined that, from a consideration of the size of the fixed sum, the size of the original corpus, and the duration of the share, the annuity will, or most probably will, exhaust original corpus and will thus have to be satisfied by accumulated income. The "is held" language, however, will always have application where the share is stated only as a percentage share since the percentage is applied to all assets, including those which constitute accumulated income. Therefore, where the share is stated as the greater of a fixed sum and a percentage, the grantor will be taxed under section 677(a)(2) —"is held"—(a) to the extent that the percentage element is

[154] Note that appropriate adjustments will have to be made because of the *Oppenheimer* principle; *see* text at note 135 *supra.*

affirmatively operative, or (b) to the extent that it can be determined that the fixed sum will have to be satisfied out of accumulated income.

For example, suppose that the original corpus is $200,000, that the grantor has a life expectancy of twenty years, and that the share is stated as the greater of $5,000 or one per cent. In this situation the percentage share is not affirmatively operative and the original corpus will most likely not be exhausted during the grantor's life. Thus, no amount would be taxed to the grantor under the "is held" language of section 677(a)(2).

Suppose, however, that, in the above example, the original corpus was only $25,000. Here, of course, the fixed sum would be operative and would exhaust the corpus in five years. Moreover, assuming a normal return on the original corpus and accumulated income, it is reasonably certain that the grantor's annuity will consume all accumulated income. Therefore, under the "is held" language of section 677(a)(2), all of the income would be taxed to the grantor.

On the other hand, suppose the original corpus is $200,000, that the life expectancy of the grantor is ten years, and that his share is stated as the greater of five per cent or $5,000. Here it is reasonable to expect that the percentage element will be affirmatively operative during the grantor's life. Therefore, to the extent the percentage will operate affirmatively, the grantor would be taxed under the "is held" language of section 677(a)(2). Suppose, *e.g.*, that in the first year there is ordinary income of $10,000 increasing the value of the fund to $210,000. G's share is $10,500 of which $5,500 is due to the independent operation of the percentage element. As noted above, G has in effect been paid $500 of the current income and is taxed on that amount under section 677(a)(1), as modified by the *Oppenheimer* principle. Moreover, assuming no drastic depreciation in the value of the fund, in the future years of the trust G will receive, by the affirmative independent operation of the percentage element, five per cent of the accumulated income of $9,500 on a declining balance. Therefore, using the formula employed previously, G would be taxed on about thirty-five per cent of the income under the "is held" language of section 677(a)(2).

(ii) "may be held." The analysis here is, in part, essentially the same as that under the "is held" language. That is, the income which would be taxed to G under the "is held" language would be taxed to G under the "may be held" language even if there were no "is held" language. But the "may be held" language could result in the taxation of additional income on the ground that certain contingencies may occur which would result in more of the accumulated income being distributed to G. The kinds of contingencies which may increase the amount taxable under the "may be held" language, and the significance under the language of the degree of remoteness of the contingencies in question, will be discussed hereafter.[155]

d. The Amount Taxed to G Under Section 662(a). Finally, it must be remembered that any amounts not taxed to G under the above sections of subpart E enter distributable net income, and, under section 662(a), are taxable to G to the extent of his distribution of corpus.

2. The combination share may also be stated as the lesser of a percentage share and a fixed sum.

a. Section 673. As was the case where the share was the greater of the percentage and the fixed sum, the section 673 reversionary interest can be calculated by determining the operative factor. Here, however, since the grantor is entitled to the lesser of the percentage and the fixed sum, the operative factor will be the one which operates as the maximizing factor.

Suppose that the original corpus is $100,000, that the grantor's life expectancy is at least ten years, and that his share is stated as five per cent but no more than $1,000. In this situation the operative factor is the fixed sum, *i.e.,* the grantor will recapture during the first ten years $10,000 of original corpus, but no more. If the share were stated as five per cent, but no more than $10,000, the operative factor will be the percentage. Under the formula used for calculating reversionary interests with respect to percentage only shares, G will recapture about forty per cent of the original corpus, but no more.[156]

b. Section 677(a)(1). As we have seen, where the grantor's share is stated as a fixed sum only, none of the income should be taxed to the grantor under section 677(a)(1). Where, however, the share is a percentage share only, part of the income will be taxed to the grantor under the "is distributed" language of section 677(a)(1).

If the share is stated as a fixed sum, but no more than a percentage, the share, for the purposes of section 677(a)(1), is identical with the fixed sum only share. In such a combination, the per-

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[155] *See* text at notes 171–84 *infra.*

[156] Note that in this situation the percentage factor is the maximizing factor even though the share is stated as five per cent but *no more than $10,000.*

centage can never operate affirmatively and thus no income would be taxed to the grantor under section 677(a)(1).

The situation becomes complicated, however, if the share is stated as a percentage, but no less than a fixed amount. Where the amount distributable to the grantor is less than the fixed dollar sum, the share can properly be viewed, under the section 677(a)(1) "is distributed" language, as identical with a percentage only share. Suppose the original corpus was $10,000, that the income was $1,000, and that G's share was five per cent but no more than $1,000. G's distribution is $550 of which $50 is a distribution of current income (although not all is taxed to him under section 677(a)(1) because of the *Oppenheimer* principle). However, where the percentage results in a distribution higher than the fixed sum, a proration is necessary. Suppose that in the above hypothetical, G's share is stated as five per cent but no more than $500. In such a case, G's distribution is only $500, not $550, and it is therefore proper to say that only one-eleventh of the distribution was due to the operation of the five per cent on the income of $1,000.[157] Thus, only about $45 is within section 677(a)(1) as income which "is distributed."[158]

c. Section 677(a)(2). As under section 677(a)(1), where the combination is stated as a fixed amount, but no more than a percentage, the share should be treated as though it were a fixed sum only share since the percentage factor can never operate affirmatively. It should be noted, however, that since the percentage element may operate to reduce the grantor's distribution, this factor must be considered in determining whether to tax the grantor under section 677(a)(2) on the ground that the fixed sum will or may exhaust corpus and thus require the distribution of accumulated income.

Where the share is stated as a percentage but no more than a fixed sum, the *maximum* amount of current income which will be taxed to the grantor can be calculated by viewing the share as a percentage only share. No more will be taxed to the grantor than would be the case if the share were a percentage share only since the fixed dollar amount is a maximum and thus can never operate to require the distribution of more accumulated income than that which will be distributed to the grantor by virtue of the application of the percentage share.

157 $\frac{\$1{,}000 \text{ (income)}}{\$11{,}000 \text{ (total value of fund)}} \times \$500 \text{ (distribution)}$

158 This again is subject to the *Oppenheimer* principle.

There may, however, be a situation where the fixed dollar maximum will operate to *reduce* the distribution of accumulated income below the amount which would be distributed by virtue of the percentage share, just as under section 677(a)(1) the fixed dollar maximum may reduce the amount of current income which is currently distributed below what would be distributed by virtue of the percentage. Suppose G establishes a trust with an original corpus of $100,000 and retains an annual life interest of "five per cent but no more than $2,200." Suppose further, that in year one the trust realizes income of $10,000, increasing the fund to $110,000. The percentage share results in $5,500, so that the fixed dollar maximum is operative and G is entitled to a distribution of $2,200. Under our prior analysis (disregarding the *Oppenheimer* principle), G is taxed under section 677(a)(1) on $200 since that is the pro rata portion of the distribution which is due to the application of his percentage share to current income and is thus the amount of current income which "is . . . distributed" to him. The $2,200 distribution reduces the fund to $107,800, of which $98,000 is original corpus and $9,800 is accumulated income of year one. The question under section 677(a)(2) is how much of that $9,800 "is or may be" held for future distribution to G. We know that some of it will be distributed since we know that in succeeding years G's five per cent will be applied to it. As was the case where G had only a percentage share, we are not certain as to how many years the five per cent will be applied to it unless the instrument so provides or unless section 677(a)(2) is construed as limiting the number of years to G's life expectancy. However, even if we knew the number of years, we could not determine how much would be distributed since (1) unless and until the fund falls below $44,000, the fixed dollar maximum will operate and thus necessitate a proration, not only under section 677(a)(1) as to current income currently distributed, but also under section 677(a)(2) as to current income which "is or may be" held for future distribution, and (2) proration under section 677(a)(2) would require a knowledge, not only of the amount of (a) undistributed original corpus and (b) undistributed current income (both of which are knowable), but also (c) future income, which is not precisely ascertainable. If we knew, *e.g.*, that in year two of the trust the income would be $10,000, thus increasing the total fund to $117,800, we would know that $\frac{4900}{5890}$ of the $2,200 distributed in the second year was due to the original corpus, $\frac{500}{5890}$ of it was due to current income, and $\frac{490}{5890}$ of it was due to the accumulated income of year one.[159]

There seems to be no precise solution to the question. We know that some of the current income will be distributed later, but we cannot accurately determine how much because one of the elements necessary to the determination cannot be presently known. It would seem clearly improper to tax the grantor under section 677(a)(2) in our supposed situation as though he had a percentage share only. Such an approach could only be justified if the "may be" portion of section 677(a)(2) were construed to extend to the utterly remote possibility that, for a given number of years after the income is realized, (1) there will be no income at all, and (2) the original corpus will depreciate to the point where five per cent of the original corpus plus accumulated income was no more than $2,200.

Perhaps the most satisfactory approach would be to assume that future income will be generated at the same rate as current income and prorate accordingly. This at least would seem to be a more rational and realistic application of the "is or may be" language of section 677(a)(2).

d. The Amount Taxable to G Under Section 662(a). Finally, as in our other hypothetical examples, all income not taxable to G under subpart E is governed by subparts A to D and may be taxed to G under section 662 to the extent any distribution of corpus to him does not exceed distributable net income.

The Grantor Who Is Not a Current Beneficiary

The Short-Term Trust—Section 673(a)

Under section 673(a), the grantor is treated as the owner of any portion of a trust if, because of a retained reversionary interest, the corpus or the income therefrom "will or may reasonably be expected to" revert to the grantor's possession or enjoyment within ten years of the inception of that portion of the trust. As previously noted, when this section applies, a reversionary interest in the income alone will cause the grantor to be taxed only on the ordinary income of the trust, whereas, if the reversionary interest is in the corpus of the trust, all income, including capital gains, is

[159] Five per cent of the total fund is $5,890. Undistributed original corpus is $98,000, five per cent of which is $4,900. Undistributed income of the first year is $9,800, five per cent of which is $490. Income of the second year is $10,000, five per cent of which is $500.

taxed to the grantor.[160] Thus, if a grantor establishes a conventional trust to pay the income to A for five years, the trust then to terminate and the entire corpus to revert to the grantor, the grantor will be taxed under section 673(a), from the outset of the trust, on all the income.

Suppose, however, that a grantor establishes a five year unitrust, under which A is to receive five per cent of the value of the fund each year for five years, the trust to terminate at the end of five years and the balance of the fund to be paid to the grantor. Here the *entire* original corpus *will not* revert to the grantor at the termination of the trust since some of it will be received by A over the five year term of the trust. *Under section 673*, therefore, the grantor will not be taxed on all of the income, but only on the income attributable to the percentage of corpus which will revert to him on the termination of the trust.[161] In addition, however, a certain portion of the income from the amount of original corpus which will not revert to the grantor will be accumulated for distribution to the grantor at the termination of the trust. This additional income will be taxed to the grantor under section 677(a)(2) in accordance with the principles developed below in connection with the over ten year percentage share unitrust.[162]

If the five year unitrust were one under which the current beneficiary were entitled to a fixed dollar annuity payable in any event, instead of a percentage share, the current beneficiary, under the rationale of *Burnet v. Whitehouse*, is in effect receiving corpus distributions. Therefore, even though the beneficiary is not thereby insulated from taxation on current income (because of the statutory provisions in subparts A to D which change the *Whitehouse* rule vis-a-vis the beneficiary), the reversionary interest of the grantor should be reduced to the extent that the beneficiary will receive part of the original corpus over the five years.[163]

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160 Reg. Secs. 1.671-3(b)(1), (3) (1956).

161 The percentage which will revert to the grantor can be calculated by the use of the formula which has been discussed in connection with the amount taxable to a grantor who is a current beneficiary of a percentage share. *See* note 130 *supra*.

162 In the conventional under ten year trust, *i.e.*, where all the trust income is distributed to the current beneficiary but the entire corpus will revert to the grantor within ten years, it is unnecessary to apply section 677(a)(2) since the grantor will be taxed on all the income under section 673. Theoretically, however, section 677(a)(2) would be applicable in such a situation to any tax income (capital gains) which is not distributed to the beneficiary but added to the corpus which reverts to the grantor.

163 The application of section 677(a)(2) to the under ten year fixed dollar annuity trust will not differ from the application of that section to the over ten year fixed dollar annuity trust, as to which, see the text at note 165 *infra*.

The Long-Term Trust—Section 677(a)(2)

If the grantor has retained a reversionary interest which will take effect ten years (or more) after the inception of the trust, section 673 does not apply. However, if income is accumulated for future distribution to the grantor at the termination of the trust, he will be currently taxed on such accumulations under section 677(a)(2).[164]

In applying this latter rule to a unitrust, difficulties arise because the unitrust does not proceed on the usual dichotomy of income and corpus. Since beneficiaries are not entitled to distributions of trust income, but rather to an amount representing a percentage of all trust assets or to a fixed dollar amount payable irrespective of the sufficiency of current trust income, the grantor's reserved interest cannot be conveniently labeled as an interest in either income or corpus. Moreover, there is no provision in subpart E, such as is found for subparts A through D in section 662(a)(2), which in effect treats trust distributions as proceeding first from income.

Regulation section 1.671-3(a)(3) provides an apparent solution to the problem:

> If the portion of the trust treated as owned by a grantor . . . consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to that portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocable to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor . . . and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question.

In the case of the conventional trust, the application of this regulation is clear enough. Assume a grantor creates a trust the corpus of which will revert to him after ten years, and ten per cent of the current income of which is payable to the current beneficiary, with the balance of income to be accumulated for the grantor. Under section 677(a)(2) the grantor will take into account as his own ninety per cent of all items of ordinary income, deductions and credits,

[164] Reg. Sec. 1.671-3(b)(2) (1956). *See* Comm'r v. Wilson, 125 F.2d 307 (7th Cir. 1942) (taxing capital gains of trust to grantor who retained a reversionary interest under section 167 of the 1939 Code—the predecessor of section 677 of the 1954 Code); Graff v. Comm'r, 117 F.2d 247 (7th Cir. 1941); *but cf.* Comm'r v. Branch, 114 F.2d 985 (1st Cir. 1940).

together with all of the capital gains and losses of the trust to the extent they are not paid or payable to the current beneficiary. This seems clearly to be the proper result since ninety per cent of the annual income, and all capital gains to the extent they are not currently paid or payable, will eventually be received by the grantor. The case of the unitrust, however, is not so evident.

a. The Grantor Who Is Not a Beneficiary—A Percentage Share Unitrust. Suppose that the grantor creates a unitrust with a term of more than ten years, under which the current beneficiary is to receive annually ten per cent of all trust assets. On its face, the above regulation would seem to require substantially the same result as under the conventional trust: that the grantor be taxed under section 677(a)(2) upon ninety per cent of all items of trust income, both ordinary and capital gains. This appears to follow from the fact that the grantor has an undivided fractional interest in the amount of ninety per cent. However, except for the last year of the trust, this result would seem to be wrong because the grantor will not eventually receive ninety per cent of each year's accumulation due to the fact that the accumulation is added to the fund and will be depleted by future distributions to the current beneficiary by application of that beneficiary's annual ten per cent interest to *all* trust assets. Thus, the amount accumulated for future distribution to the grantor in any current year, except for the last year of the trust, will not be ninety per cent of income, but rather, ninety per cent reduced by future distributions to be made therefrom over the term of the trust to the current beneficiary. In the above example, the beneficiary will take ten per cent of the declining balance of any accumulation, and depending on the size of the accumulation and the length of the trust term, accumulations in the early years of the trust could be practically exhausted, leaving very little to be taxed to the grantor.

b. The Grantor Who Is Not a Beneficiary—A Fixed Dollar Share Unitrust. In the situation of a ten year unitrust where the beneficiary is to receive a fixed annuity the tax consequences to the grantor under section 677(a)(2) appear to be substantially different. In the above example, where the beneficiary was entitled only to a percentage share, the principle of regulation section 1.671–3(a)(3) seems properly to apply with the modification that the grantor's fractional share must be reduced for future distributions to the current beneficiary out of accumulations of income. This modification, however, does not deny the fact that the beneficiary of a percentage share benefits pro rata from each item of income since each such item is utilized in determining the amount which is required to be distributed to the beneficiary. Such utilization, in substance, makes one the beneficiary of the item utilized, so that the beneficiary is properly treated as receiving a pro rata portion of each item of income.[165] But consider the case where the beneficiary is entitled to an annuity in a fixed number of dollars, payable in any event, rather than a percentage of all trust assets. Then, in accordance with the rationale of *Burnet v. Whitehouse*, since the annuity does not depend on the presence of income (at least to the extent of original corpus), the annuity is a charge on corpus, and *all* income is in effect being held for future distribution to the grantor, until such time as current distributions exhaust original corpus.[166]

c. Capital Gains. In the situation under discussion (a unitrust in which the grantor has retained a reversion which will take effect more than ten years after the inception of the trust) the tax treatment of capital gains earned by the unitrust will not differ from that accorded to ordinary income. In the percentage share unitrust, if the capital gains are utilized in computing the share of, and thus paid to, the current beneficiary, the amount taxable to the grantor as capital gains would be the percentage not taxed to the current beneficiary, reduced by the amount to be distributed out of accumulations to the current beneficiary in future years of the trust. If capital gains, current and accumulated, are not to be utilized in fixing the share of the current beneficiary, then all such gains are accumulated for future distribution to the grantor and are taxed to him under section 677(a)(2).[167] Similarly, in a fixed annuity unitrust, the principles discussed above apply equally to capital gains. Since in this latter situation none of the income is really paid to the annuitants until corpus is depleted, all of the income, including capital gains, is taxed to the grantor.

There is one significant difference between the treatment of capital gains and ordinary income. As discussed before, there is still available the Dean trust device whereby the capital gains of a trust realized in a taxable year are not paid (*i.e.*, not utilized in

[165] *Cf.* Reg. Sec. 1.643(a)-3(a) (1956).

[166] Recall that although the same arguments can be made where the successor beneficiaries are third party "remaindermen" and not a grantor with a "reversion," the statutory change of *Burnet v. Whitehouse* with respect to nongrantor beneficiaries requires that the annuitant bear the tax, to the extent of distributable net income. Here, of course, that result would be changed since any income taxed to the grantor would not be included in distributable net income.

[167] *See* Reg. Sec. 1.677(a)-(1)(g) *Ex. (2)* (1956).

computing the amount payable to the unitrust beneficiary) until the succeeding taxable year.[168] In such a case it would appear that the only change as regards the amount taxable to the grantor under section 677(a)(2) would be in reducing by one the number of years that the capital gain will be accumulated in the case of a beneficiary of a percentage share.[169]

d. Combination Shares. We have already analyzed in detail the application of section 677(a)(2) to a grantor-beneficiary of a unitrust share. It can be readily seen that what we are now discussing is merely the converse of that situation. Accordingly, where, under the principles discussed in that prior section, income would be taxed to the grantor on the ground that it is held for future distribution to the grantor, such income would not be taxed under the "is held" language of section 677(a)(2) where the grantor is not the current beneficiary.

Moreover, where the "may be" language of section 677(a)(2) is involved, we have seen that the question turns on the extent to which the degree of probability of the occurrence of certain contingencies will be given significance. That subject will be discussed shortly. It is sufficient to note here that if the "may be held" language is interpreted as "may, under any possibility, be held," then any income taxable under section 677(a)(2) to a grantor-beneficiary of a combination share would be taxable under section 677 (a)(2) to a grantor who has retained a reversion after a combination share. If the language is interpreted as "may, under any non-remote possibility, be held," any amount *not taxable* to a grantor-beneficiary of a combination share would be taxable to a grantor who has retained a reversion after a combination share. However, amounts *taxable* to a grantor-beneficiary of a combination share may or may not be taxable to a grantor who has retained a reversion after a combination share.

It would appear that whether the amount to be paid the current beneficiary is a percentage share or a fixed dollar amount depends in each case on which one of the two is the operative factor. Thus,

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168 *See* text at notes 59-63 *supra*.

169 For example, assume there was an eleven year trust where the beneficiary A gets ten per cent of the fund each year—but the capital gains are not paid (utilized) until the year after they are earned and in succeeding years. If the trust in the first year had a $1,000 capital gain and $9,000 ordinary income, the amount of ordinary income *not held* for the grantor would be calculated by multiplying the percentage by the ordinary income and its declining balance eleven times. However, the amount of the *capital gain not held for the grantor* would require application of the formula only ten times since it is not until the second year of the trust that the beneficiary receives any of the gain.

in some years one may be operative and in some years the other. And it is possible, where different beneficiaries have different shares, that the operative factor will vary from beneficiary to beneficiary. This, of course, means that the determination of the amount taxable to the grantor under section 677(a)(2) becomes an impossible task because of the inability to apply a constant factor to income accumulations in determining the amount of such accumulations the current beneficiaries will receive over the term of the trust.

Reversion Taking Effect at Death of Nongrantor-Beneficiary

Subsection (c) of section 673, dealing with reversionary interest taking effect at the death of the income beneficiary, provides:

> The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.

The substance of this subsection is to exempt the grantor from tax on income, otherwise taxable under section 673(a) because of a less than ten year reversionary interest, to the extent that the income is payable to a beneficiary for life. Thus it is not necessary to the operation of this subsection that all the tax income be payable to a life beneficiary. Suppose a conventional trust provided that A (with a five year life expectancy) was to receive one-half the income for life, that income did not include capital gains (which were to be accumulated along with one-half of the ordinary income) and that on A's death corpus (with accumulations) was to be paid to the grantor. In this situation section 673(c) would exempt the grantor from tax on one-half the ordinary income.

Applying this analysis to a unitrust, it would seem that where there is a life beneficiary of a percentage share, section 673(c) would exempt the grantor from tax on so much of the income as was distributed to the beneficiary by virtue of the application of the percentage to the current income. The remaining income would be taxed to the grantor under section 673(a) if the beneficiary's life expectancy were less than ten years. If the life expectancy were more than ten years, section 673(a) would not apply regardless of section 673(c) and the analysis would be precisely the same as was applied to a unitrust with a fixed duration of more than ten years.

However, where a life beneficiary of a unitrust is a beneficiary of a fixed dollar share, section 673(c) would not seem to have any applicability. This would certainly seem to be the case where, as in a unitrust, the indenture is silent as to the source of annuity payments since it could not be said that the beneficiary is a person to whom income is payable.[170] Moreover, even if the trust directed payment wholly or partially from income, under the reasoning of *Burnet v. Whitehouse* the beneficiary whose annuity, since payable in any event, is really paid from original corpus, should not be considered a person to whom income is payable. This result would correlate with the prior analysis of section 677(a)(2) under which the grantor who has retained a reversion after a fixed sum annuity, would be taxable on all the income on the ground that it is or may be held for future distribution to him.[171]

The Effect Under Section 677(a)(2) of Contingencies Affecting the Grantor's Right to Accumulations of Income

The discussion heretofore has been concerned with the amount taxable to the grantor under section 677(a)(2) without consideration of how various contingencies affect the result. Here consideration is given to whether the amount so taxable may be affected by the possibility that the accumulation of income may be altered by the happening of certain possible events.

First, there is the possiblity that an accumulation of income otherwise taxable to the grantor might be *reduced* in order to make required payments to the current beneficiary. This will not happen where the current beneficiary is entitled only to a percentage share over a fixed number of years. As indicated above, in this situation the amount to be accumulated for the grantor can be precisely calculated as a percentage of current income reduced by the current beneficiary's interest in the accumulation over the term of the trust. However, where the beneficiary of a percentage share is entitled to annual payments for life, although it is possible to calculate precisely the accumulations for the grantor on the basis of the beneficiary's life expectancy, it is possible that the beneficiary may live longer than his expectancy and thus reduce the amounts accumulated for the grantor. Or, where the beneficiary's share is a fixed

[170] Again, of course, no problem would be present if the beneficiary had a life expectancy of more than ten years.

[171] *See* text at notes 165–66 *supra*. Subsection (b) of section 673 provides another exception from the operation of subsection (a) where the income of the trust is irrevocably payable for a period of at least two years from the inception of the trust to a qualified charitable beneficiary. Pertinent here are the same considerations discussed with respect to subsection (c), the only difference being that where the beneficiary is a charity the income must be payable for at least two years, and not for life.

sum annuity for life, it may happen that the payments will exhaust original corpus and thus have to be satisfied from accumulated income.

Second, it is possible that the amount accumulated for the grantor may be *increased* due to the happening of an event. For example, where the term of the trust (fixed sum annuity or percentage) will end upon the earlier of the expiration of the stated term or the death of the current beneficiary, the death of the current beneficiary prior to the end of the term could increase the amount of the accumulation that the grantor will receive.[172]

Should the fact that a contingency may reduce or increase the amount accumulated for future distribution to the grantor be taken into consideration in determining the applicability of section 677(a)(2)? The section taxes to the grantor income which "in the discretion of the grantor or a nonadverse party, or both may be" accumulated for future distribution to the grantor. A literal reading of the statute seems to require that the word "may" be construed as referring only to a possibility of accumulation because of the discretion of the grantor or trustee to accumulate.[173] In support of this construction it could be said that had Congress intended a broader meaning, it would have taxed the grantor when income "may be" accumulated "in the discretion of the grantor or a nonadverse party, *or otherwise.*"

Under such a construction of the statute, contingencies, other than that involved in the possibility that a grantor or trustee could exercise discretion to accumulate, could be taken into account, if at all, only in determining what income *is* accumulated for the grantor. The effect of considering such contingencies under the "is" language of section 667(a)(2) would be to construe "is" as meaning "is or probably is." Under such a construction, if there were a substantial probability that the contingency would occur, whether it would reduce or increase amounts otherwise taxable under section 677(a)(2), the amounts considered to be accumulated would be adjusted accordingly. To use our prior example, if a trust were to terminate at the end of twenty-five years unless the beneficiary died before that, and the beneficiary had a life expectancy of twenty years, the determination of the amount which is accumulated under section 677(a)(2) would be made on the basis of a twenty year trust. Conversely, if the trust were to end in twenty-five years or the death of the beneficiary, whichever was

172 *See* I.R.C. § 673(c).

173 *See* Rollins v. Helvering, 92 F.2d 390 (8th Cir. 1937).

later, and the beneficiary had a life expectancy of thirty years, the determination would be based on a thirty year trust.

The problem involved in the above analysis is not peculiar to the unitrust and has arisen many times in connection with the conventional grantor trust.[174] Under section 167 of the 1939 Code (the predecessor of section 677) the Treasury took the position that the grantor was taxable upon accumulations unless he divested himself "permanently and definitively, of every right which might, *by any possibility* enable him to have such income, at some time, distributed to him, either actually or constructively." [175] Moreover, many of the decided cases have taxed the grantor upon accumulations not only when his receipt of them depended upon the discretion of the trustee,[176] but also when his receipt of the accumulations depended upon a contingency not within his or the trustee's control.[177] In none of these cases was the issue of remoteness discussed, although the First Circuit has stated that "the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him." [178] Several cases, however, have held against taxing accumulations to the grantor when his possibility of taking was extremely remote.[179] Typical of these is *William E. Boeing,* where the corpus and any accumulated income was to revert to the grantor if his son died before the age of 30 and the grantor survived him. The Board of Tax Appeals stated that it did not think the statute "covers or was intended to cover the situation where there is no definite provision for such future distribution to the grantor, but only the bare possibility that upon certain contingencies over which the grantor has no control the corpus and

[174] *See generally* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.14 (1957); KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 6.16 (1948).

[175] Reg. 111, Sec. 29.167-1(b) (1943).

[176] Helvering v. Evans, 126 F.2d 270 (3d Cir. 1942).

[177] Estate of Wadewitz, 32 T.C. 538 (1959) (grantor would take accumulations if he survived his wife); Wenger v. Comm'r, 127 F.2d 523 (6th Cir. 1942) (grantor could call for distribution to him of accumulations in case of "any accident, sickness, calamity, misfortune, adversity, bereavement or loss, financially or otherwise"); Kent v. Rothensies, 120 F.2d 476 (3d Cir. 1941) (income to be accumulated for two years and then paid to the grantor if living and if not used to make up any deficiency of income up to an annual fixed amount payable to the current beneficiary); Altmaier v. Comm'r, 116 F.2d 162 (6th Cir. 1940); and Kaplan v. Comm'r, 66 F.2d 401 (1st Cir. 1933).

[178] Kaplan v. Comm'r, 66 F.2d 401, 402 (1933).

[179] Henry Martyn Baker, 43 B.T.A. 1029 (1941); Christoper L. Ward, 40 B.T.A. 225 (1939), *rev'd on another issue,* 119 F.2d 207 (3d Cir. 1941); William E. Boeing, 37 B.T.A. 178 (1938), *rev'd on another issue,* 106 F.2d 305 (9th Cir.), *cert. denied,* 308 U.S. 619 (1939).

accumulations may revert to him."[180] A similar rationale was expressed in *Commissioner v. Betts*,[181] where the grantor could not receive the accumulated income except by surviving his mother, wife, his children and their descendants.

Under the decided cases, therefore, apparently the rule is that the grantor will be taxable upon accumulations of income although the eventual distribution of the accumulation to him depends upon a contingency, unless there is only a remote possibility of the contingency occurring.[182] Under such a rule the fact that a grantor might take accumulations due to the death of the current beneficiary before the end of the trust term will be disregarded where such death is highly unlikely, and will be taken into account where such death is not an unlikely possibility.[183] A weighing of probabilities will be required.

The Treasury, however, apparently has not yet conceded that remoteness is a relevant factor. Regulation section 1.677(a)-1(c) provides that:

> [T]he grantor is treated as the owner of a portion of a trust if he has retained any interest which might . . . enable him to have the income from the portion, at some time, distributed to him either actually or constructively . . . . If the grantor strips himself permanently and definitively of every interest . . . he is not treated as an owner under section 677 after that divesting.

This regulation is essentially identical with the regulation under the 1939 Code with the exception of the omission of the phrase "by any possibility." This latter phrase, however, only underscored the language remaining, which requires the grantor not to have *any* interest in order to avoid tax.

It would thus appear that the question whether the word "may" as used in section 677 disregards remote possibilities that the grantor will receive accumulated income, or whether it takes them into account, is in a somewhat unsettled state.[184] There is thus no assurance that income which may be necessary to fund a fixed annuity will not be taxed to the grantor; and, more importantly, where the trust term is for the life of the current beneficiary, there is the possibility that *all* accumulations will be taxed to the grantor

180 37 B.T.A. 178, 185 (1938), *rev'd on another issue*, 106 F.2d 305 (9th Cir.), *cert. denied*, 308 U.S. 619 (1939).

181 123 F.2d 534 (7th Cir. 1941).

182 *See* MICHAELSON, INCOME TAXATION OF ESTATES AND TRUSTS 65 (1963).

183 *See* William E. Boeing, 37 B.T.A. 178 (1938), *rev'd on another issue*, 106 F.2d 305 (9th Cir.), *cert. denied*, 308 U.S. 619 (1939).

184 *See* KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 6.16 (1948).

because of the possibility, however remote, that the beneficiary will die in the first year of the trust.

Grantor's Retained Powers

Subpart E taxes a grantor of a trust where the grantor has retained an *interest in,* or a *power over,* the corpus of the trust or the tax income.[185] Retained *interests* are governed by section 673 and section 677. Retained *powers* are governed by sections 674, 675, 676 and 677.[186] As in the case of the retained interest, the retained power which renders the grantor taxable may be a power over corpus alone, tax income alone, or both.

We have already analyzed the tax consequences of grantor's retained *interests* in a unitrust under section 673 and section 677.[187] The consequences of retained powers remain to be considered.

It should first be noted that unlike retained interests in a unitrust, retained powers are not necessarily affected by the unitrust's departure from the conventional income and corpus dichotomy. Suppose that a grantor establishes a unitrust whereby A is to receive five per cent of the value of the fund for life, remainder to B. The grantor retains the power to revoke the entire trust. The consequence of this retained power of revocation is the same under section 676(a) as it would have been if the trust were a conventional trust whereby A was to receive income for life, and B was to receive the remainder. In both cases, the grantor would be taxed on all of the income. Similarly, for example, a power to borrow corpus without security will have identical effect whether the trust is a unitrust or a conventional trust.

The operation of the retained powers section of the Code *can be* affected by the no distinction between income and corpus aspect of the unitrust only where the retained power is directed to an *interest* which has this unitrust nature, as where the grantor retains the power to make himself a percentage share beneficiary. Even here, moreover, the operation of the power sections *may not* be affected by the unitrust nature of the interest subject to the retained power. For example, an "excepted" power under section 674(a)(4) to allocate among charitable beneficiaries, and the excepted power of

185 *See* Reg. Sec. 1.671-1 (1956).

186 Section 677 thus applies to both interests and powers. The interests are covered by reference to income which *is* distributed or *is* held for future distribution. Powers are involved in the provisions respecting income which *may* be distributed or *may* be held for future distribution.

187 Note that the prior analysis involved retained *powers* to the extent that the "may be" portions of section 677(a)(1) and section 677(a)(2) were considered.

an independent trustee to sprinkle income or corpus, are nontaxable powers even under a unitrust.

Second, where a grantor has retained a power over a unitrust interest, the tax consequences should be precisely the same as where he has retained the interest itself. The underlying theory and design of subpart E, with respect to grantors, is to treat a grantor as never having transferred property, for income tax purposes, where he has not surrendered, at least for a sufficient time, substantial dispositive control over the income derived from the property. No distinction in this respect is made between (1) retaining dispositive control over income by virtue of a retained *interest* in it and (2) retaining dispositive control over income by virtue of a retained *power* over it.[188] Both are properly considered equivalent since in both the beneficial enjoyment of the income is subject to the grantor's wishes. Indeed, the Code contains explicit correlations where different results otherwise would occur, depending on whether a power or an interest was involved. This is true for both *income* and *corpus* interests and powers.

For example, with respect to corpus, if G creates a five year trust, corpus to revert to him on termination, G is taxed under section 673. If instead G creates a twenty year trust, but reserves the power to revoke the trust after the fifth year, he has no section 673 reversionary *interest* but is taxed in precisely the same way as though he did, by virtue of section 676(a).[189] If, on the other hand, he reserved the power to revoke only after the twelfth year, he is not taxed from the outset under section 676 just as he would not be taxed from the outset under section 673 if his reversionary *interest* took effect in the twelfth year.[190]

[188] All of the sections which delineate the *powers or interests* which result in taxation to the grantor begin with the statement that: "The grantor shall be treated as the owner of any portion of a trust . . . ."

[189] Section 676(a) provides: "The grantor shall be treated as the owner of any portion of a trust . . . where *at any time* the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both." (Emphasis added.) *See* Helvering v. Dunning, 118 F.2d 341, 344-45 (4th Cir. 1941) (decided under section 166 of the 1939 Code).

[190] Section 676(b) of the Code provides:

> [Section 676(a)] . . . shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

Note that G would be taxed under section 676 after the twelfth year—just as he would be taxed on the income from the property which reverted to him after a twelve year trust. *See also* section 674(a)(2).

Similar correlation is found in the income area. For example, by virtue of the "is" or "may" provisions, section 677(a)(1) equates a grantor's *interest* in current income with a grantor's *power* over current income, and section 677(a)(2) similarly equates a grantor's *interest* in accumulated income with a grantor's *power* over accumulated income.

There is no apparent reason why powers and interests should not also be correlative with respect to unitrust shares. If, for example, a grantor retains the power to make himself a beneficiary of a current percentage share of the fund, the tax consequences under section 676 (and section 677) should be no different from what they would be if the grantor had, in establishing the trust, made himself such a beneficiary.[191] The same should be true, to take another example, for a retained section 674 power to add beneficiaries other than himself.[192]

Capital Gains And The Grantor-Beneficiary

Retained Interests

Where the grantor retains an *interest* in a unitrust share, such as a percentage share, fixed dollar share, or a combination share, we have seen that the applicable provisions are sections 673 and 677 of subpart E, and section 662 of subparts A to D.

a. Section 673. When a grantor retains a section 673 reversionary interest in corpus, he will be taxed on capital gains as well as ordinary income.[193] If his reversionary interest is in the entire original corpus, *all* of the capital gains as well as all of the ordinary income will be taxed to him.[194] If his reversionary interest is only in part of the original corpus, he will be taxed on a pro rata share of capital gains and ordinary income.[195] Thus if his reversionary interest is in one-half of the corpus, and the income for a certain taxable year consists of $1,000 ordinary income and a $2,000 capital gain, the grantor will be taxed on a total of $1,500, of which $500 will be taxed to him as ordinary income and $1,000 as capital gain.

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[191] In which case sections 673 and 677 would be applicable, as discussed in the text at notes 131–42 *supra*.

[192] Note that this analysis has no relevance to the taxability of a grantor under section 662, *i.e.*, under subparts A to D. If a grantor is taxable by reason of a retained power but there is no distribution to him, he will not be taxed at all under subparts A to D.

[193] Reg. Sec. 1.671–3(b)(3) (1956).

[194] Reg. Sec. 1.671–3(a)(1) (1956).

[195] Reg. Sec. 1.671–3(a)(3) (1956).

Applying these principles to the unitrust, the grantor-beneficiary of a unitrust share, whose share is such as to give rise to a section 673 reversionary interest (*e.g.*, a percentage share), will be taxed on that percentage of capital gains which corresponds to the percentage of original corpus in which he is considered to have retained a reversion.

b. Section 677(a)(1). In a conventional trust the capital gains are normally allocated to corpus and are not considered trust income. Therefore, if a grantor retains only the right to trust income, he will not receive the proceeds of capital gain transactions. In such a case, he will not be taxed on the gains under the "is . . . distributed" language of section 677(a)(1).[196] On the other hand, if a grantor retains the right to income and directs that income includes proceeds from capital gain transactions, or if he retains the right to income *and* capital gains, he will receive the gains and will be taxed on them under the "is . . . distributed" language of section 677(a)(1), since the word "income" in that section includes capital gains, as well as ordinary income.[197]

Similarly, if a conventional trust contains a provision by which income *may be* distributed to the grantor, this provision will normally not comprehend capital gains and the grantor will thus not be taxed on such gains under the "may be . . . distributed" portion of section 677(a)(1). However, if under the instrument income includes capital gains, or such gains are otherwise available for current distribution to the grantor, the gains will be taxed to the grantor.

Under our prior analyses, it was concluded that (1) the "is . . . distributed" language has no applicability with respect to a grantor-beneficiary of a fixed sum annuity, and (2) the "may be . . . distributed" language of section 677(a)(1) has no applicability with respect to a grantor-beneficiary of a percentage share or fixed sum annuity. This leaves the situation of a grantor-beneficiary of a percentage share under the "is . . . distributed" language.

Suppose the grantor is a five per cent beneficiary and that in a certain year the trust has $1,000 of ordinary income and $2,000 in capital gains. As discussed previously, since part of G's distribution is due to the application of his percentage to the tax income of $3,000, $150 of income has been distributed to him within the meaning of section 677(a)(1). Of that $150, $100 should be considered to have been received as capital gains since $100 of the $150 is due to

[196] Reg. Sec. 1.677(a)-1(g) *Ex. (1)* (1956).

[197] *Cf.* Reg. Secs. 1.671-3(b)(2), 1.671-2(b), 1.677(a)-1(a) (1956).

the application of his percentage to the $2,000 capital gains. Such a result is supported in principle, if not *in haec verba,* by the regulations.[198]

c. Section 677(a)(2). If a conventional trust contains a provision whereby income is to be accumulated for future distribution to the grantor, this provision will not normally comprehend capital gains and such gains will thus not be taxed under the "is held" language of section 677(a)(2). However, if under the instrument income includes capital gains, or such gains are otherwise to be accumulated for the grantor, he will be taxed on them under this section. Similar principles would apply with respect to the "may be . . . held" language of section 677(a)(2).

With respect to the unitrust, it is necessary to consider separately the "is . . . held" and the "may be . . . held" language with respect to both the percentage share and the fixed dollar share.

(i) Section 677(a)(2)—"is . . . held or accumulated for future distribution to the grantor"

Percentage Share. As we have seen, when the grantor retains a percentage share, he will be taxed under the "is . . . held" portion of section 677(a)(2) since in the years succeeding that in which the income is realized, part of his distribution will be the result of the application of his percentage to the current income which has been accumulated. We saw also that the amount so taxed to him could not be accurately determined unless we knew the number of years during which his percentage would be applied to such income.

For the purpose of discussing the capital gains question, however, we will assume that we know that the number of years is ten. By using the same formula employed to determine the reversionary interest under section 673, we determine that over ten years the grantor would receive about thirty-five per cent of the declining balance of current income and would thus be taxed on thirty-five per cent of current income under the "is . . . held" language of section 677(a)(2). Thus, as was the case with respect to a percentage share under the "is . . . distributed" portion of section 677(a)(1), under the "is . . . held" language of section 677(a)(2) thirty-five per cent of the capital gains should be taxed to the grantor as

[198] Reg. Sec. 1.671-3(a)(3) (1956). The above discussion, for the sake of clarity, omits the reference to the *Oppenheimer* principle. The mentioned result, however, would be modified by that principle so that under section 677(a)(1), $90 rather than $150 would be taxed to G—of which $60 (two-thirds of $90) would be taxed as capital gain and $30 (one-third of $90) would be taxed as ordinary income.

capital gains and thirty-five per cent of the ordinary income should be taxed as ordinary income.[199]

Fixed Dollar Share. Unlike the case of a percentage share, the satisfaction of a fixed dollar annuity will not normally involve a distribution out of accumulated income of prior years and the "is . . . held" language of section 677(a)(2) will thus be inapplicable.

(ii) Section 677(a)(2)—"may be . . . held"

Percentage Share. The analysis of the capital gains here is essentially the same as in the case of the percentage share under the "is . . . held" language discussed immediately above. The only significance of the "may be" language is with respect to the number of future years over which the percentage will be considered to be applied where the instrument does not specify. When that number is determined, however, the mentioned formula can be used to calculate the applicable percentage, and, as indicated with respect to the "is . . . held" language, that percentage of the capital gains should be taxed as capital gains under the "may be" language of section 677(a)(2).

Fixed Dollar Share. Recall that the amount of current income which will be taxed to the grantor-beneficiary of a fixed dollar share under the "may be . . . held" language of section 677(a)(2) will turn on the extent to which that language is held to make relevant the degree of probability that the accumulated income of prior years will be used to satisfy annuities of future years.

Of course, if the degree of probability is considered irrelevant with the result that all of the current income is taxed to the grantor under section 677(a)(2) ("may be . . . held"), so much of the current income as is capital gain will be taxed to the grantor as capital gain.

If, however, less than all of the current income is taxed to the grantor, we are presented with the question of how much, if any, of the amount of income taxed to the grantor under the "may be" portion will be taxed as capital gains.

Suppose it is determined that under the "may be . . . held" language of section 677(a)(2) $5,000 of current income is taxable to the grantor, out of a total current income of $10,000 ($5,000 of which is ordinary income and $5,000 capital gains). How much of the $5,000 will G be taxed on *as capital gains*? It would seem arbi-

[199] Again, this result must be modified by the *Oppenheimer* principle.

trary to say that the entire $5,000 should be taxed as capital gains. It seems equally arbitrary to say it should all be considered ordinary income. Nor does either of these positions find support in the statute or legislative history. The proper approach would seem to be that of proportionate allocation, *i.e.*, to tax one-half (the ratio of capital gains to total income) of the $5,000 as capital gains and one-half (the ratio of ordinary income to total income) of the $5,000 as ordinary income. Once again, the regulations can be said to support this result in principle.[200]

d. Section 662 (Subparts A to D). For the purposes of section 662 the grantor-beneficiary is treated in the same manner as a non-grantor beneficiary. As we have seen, under section 662 a beneficiary is taxed on any distribution to him to the extent that the amount distributed does not exceed the distributable net income of the trust. Under section 643 distributable net income may or may not include current capital gains. To the extent such gains are not included in distributable net income, the distributable net income amount is reduced—which may result in the beneficiary receiving part or all of his distribution without tax to him.

Current capital gains are included in distributable net income if they are allocated to income (trust income) or are "paid, credited, or required to be distributed" to the beneficiary.[201] If, however, such gains are "paid, credited, or required to be distributed" to a *grantor*-beneficiary, they will be taxed to him under section 677(a)(1) which taxes income (capital gains as well as ordinary income) which is or may be distributed to the grantor. Being taxable to the grantor under subpart E they would not be governed by subparts A to D and thus would not be included in determining the amount of distributable net income. To that extent, therefore, distributable net income would be reduced and the grantor may receive part of his distribution without tax to him.[202]

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200 Reg. Sec. 1.671-3(a)(3) (1956). The principles set forth above will be equally applicable to combination shares. *E.g.*, where the particular combination results in a section 673 reversionary interest the grantor will be taxed on that percentage of capital gains (as capital gains) which corresponds to the percentage of original corpus in which he is considered to have retained a reversion. Or where the particular combination results in taxation to the grantor under section 677(a)(1) or section 677(a)(2), the applicable principle will depend on the extent to which the percentage element or fixed dollar element is affirmatively operative.

201 I.R.C. § 643(a)(3).

202 The amount taxed to a grantor under section 662 will always be due to a corpus distribution to him since any distribution to him which in substance is an income distribution will be taxed under section 677. Moreover, since, on the above analysis, distributable net income will never include current capital gains, and since on a similar analysis distributable net income will never include current ordinary income taxable

Retained Powers

a. Grantor Trust Provisions (Subpart E). As was previously indicated:

(i) The operation of the retained powers sections of subpart E (sections 674, 675, 676 and 677) will be affected by the unitrust's departure from the income and corpus dichotomy of a conventional trust only where the retained power is directed to an interest which has this unitrust nature, *i.e.*, a unitrust share, and

(ii) Where a grantor has retained a power over a unitrust *interest*, the tax consequences should be precisely the same as where he has retained the interest itself.

It would seem to follow, therefore, that where a grantor has retained a power over a unitrust interest, he will be taxed on capital gains, as capital gains, to the same extent that he would have been if he had retained the interest itself. Suppose a grantor with a ten year life expectancy, establishes a trust with a corpus of $10,000 and reserves the right to make himself a beneficiary of an annual five per cent of the fund for life. Suppose further, that in the first year of the trust there is income of $1,000, $500 capital gains and $500 ordinary income.

G would be treated as though he had retained an annual five per cent interest which would result in G's being taxed:

(1) under section 673, on forty per cent of the capital gains as capital gains ($200), and forty per cent of the ordinary income as ordinary income ($200);

(2) under section 677(a)(1), as modified by the *Oppenheimer* principle, on five per cent of the income from $6,000 (that is, on five per cent of the $600 ($30)). Prorating the capital gains and the ordinary income to this $30, G would be taxed on $15 as capital gains and $15 as ordinary income; and

(3) under section 677(a)(2), on five per cent (over nine years) of the declining balance of $600, again modified by the *Oppenheimer* principle, *i.e.*, on $210. Prorating the capital gains and the ordinary income to this $210, G would be taxed on $105 as capital gains and $105 as ordinary income.

Thus, of the total of $640 taxed to G under subpart E, $320 would be taxed to G as capital gains and $320 as ordinary income.

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under section 677, distributable net income in any given year will consist only of that amount of current ordinary income which neither is nor may be (1) distributed to the grantor, or (2) held for future distribution to the grantor.

b. Section 662—Subparts A to D. It will be recalled that under a prior hypothetical [203] where the entire $1,000 of income was ordinary income, the remaining $360 was taxed to G under subparts A to D, *i.e.*, under section 662. Here, however, $500 of the $1,000 is capital gain. Three hundred and twenty dollars of it has been taxed to G under subpart E. The remaining $180 of capital gain will not be taxed to G under section 662 since, as explained above, that $180 will not be included in distributable net income. Distributable net income will only include the remaining $180 of ordinary income, and G will thus be taxed under section 662 only on $180 because of his corpus distribution of $500 (five per cent of original corpus of $10,000).

c. The Irish Case. In the above discussion, G's taxability was partially analyzed on the basis of section 673. That section, however, is not strictly applicable where G did not retain a *reversionary interest* in original corpus, but rather a *power* over original corpus. The applicable section, therefore, is section 676 (power to revest corpus) or section 674 (power to dispose of the beneficial enjoyment of corpus). Section 673 was used in the analysis because the Code correlates section 673 reversionary interests in corpus with section 674 and section 676 powers over corpus.

In terms of section 676 and section 674, what G had was a power to revest in himself forty per cent of the original corpus over ten years. Viewing G's interest as such, it becomes necessary to consider the case of *Irish v. Commissioner.*[204]

In that case, the grantor, in 1935, established a trust of $250,000 worth of securities. The trust indenture provided that the income of the trust should be paid to the settlor for life, with remainder over. It also provided that the grantor could withdraw "from the principal in any one year . . . a sum not exceeding $18,000, such right of withdrawal not to be cumulative."

In 1935 and 1936 the trust realized capital gains of less than $18,000. These gains were allocated to corpus and thus not distributed to the grantor. For those years the grantor reported, and paid tax on, only the ordinary income of the trust (that is, what had been distributed to him). The Commissioner assessed a deficiency for the *entire amount* of capital gains for both years. The grantor "conceded that he was taxable under Sec. 166 [the predecessor of section 676] . . . on the capital gains on that portion of the

[203] *See* text at notes 142–45 *supra.*
[204] 129 F.2d 468 (3d Cir. 1942).

trust corpus which he could revest in himself under the right to withdraw up to $18,000 of corpus in any one year."[205]

The Third Circuit, however, held that the entire amount of the capital gains was taxable to the grantor. In its opinion it stated that:

> [T]he present situation is clearly covered by Sec. 167(a)(2) [the predecessor of section 677(a)(2)] of the Revenue Acts of 1934 and 1936.[206] By the terms of the trust indenture not only was the petitioner entitled to receive for life the distributable trust income as determined by the law of Pennsylvania but also, under his right to withdraw corpus, he could obtain the capital gains derived from the sale of trust assets so long as such gains did not aggregately exceed in any one year the withdrawal limit of $18,000. To that extent it was therefore within the settlor's "unfettered command" or uncontrolled discretion to enjoy by withdrawal of corpus (not exceeding $18,000 in any one year) the equivalent of any or all capital gains from the sale of corpus assets. For the years in question the capital gains which the petitioner could thus have received were $644.20 and $2,073.67. The fact that he did not elect to enjoy such corpus gains in the years in which they accrued is wholly immaterial for the tax is assessable according to what *may* be done under the trust rather than what *is* done under it.[207]

If the reasoning of *Irish* were applied to our hypothetical grantor who retained the right to revest in himself $500 of corpus in the first year by making himself a five per cent beneficiary, he would for that reason be taxable under section 677 on $500 of the $1,000 income.[208]

The court's decision, however, seems clearly to be based on a misconception of the design and purpose of the predecessors of sec-

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205 129 F.2d at 470.

206 Sec. 167(a)(2), which is identical in the Revenue Acts of 1934 and 1936, 26 U.S.C.A. Int. Rev. Acts page 727 and page 895, provides in part here material as follows:

> § 167. *Income for Benefit of Grantor*
> (a) Where any part of the income of a trust—
> * * * * * *
> (2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor;
> * * * * * *
> then such part of the income of the trust shall be included in computing the net income of the grantor.

(Original footnote renumbered.)

207 129 F.2d at 471–72.

208 In a unitrust, the *Irish* rationale would effectuate this result whether the tax income was all ordinary income, all capital gains, or a combination since there is no principal and income dichotomy (as was present in *Irish*) which would prevent the amount of distribution from being satisfied out of one kind of item (*e.g.*, ordinary income, as in *Irish*) as opposed to another (*e.g.*, capital gains, as in *Irish*).

tion 676 and section 677. Where a grantor retains the power to revest in himself a part of the original corpus, section 676 treats him as never having transferred that part of corpus. The result is that the grantor continues to be taxed on the *income from that part.* To tax the grantor on an amount of income equal to the amount of corpus which can be revested in the grantor would be to treat the grantor as having retained more than he can revest.

If the grantor in *Irish* had retained $36,000 worth of securities, funded the trust with only $214,000 worth of securities, and retained only the right to the ordinary income, none of the capital gains attributable to $214,000 worth of securities in the trust would have been taxed to him—he would be taxed only on the gains derived from the $36,000 worth of securities he retained.

It has been suggested that the result "was perhaps justified by the literal language of section 167 of the 1939 Code, taxing the grantor on 'any part of the income . . . [which] may . . . be distributed' to him at his discretion."[209] The point of this suggestion would seem to be that the language of section 677 under the 1954 Code is more clearly indicative of the nontransfer approach which is the basis of all the grantor sections of subpart E.[210] This seems also to be the view of the Treasury, under whose regulations *Irish* would have been taxed only on a pro rata share of the capital gains.[211]

Conclusion

The reader who has come this far can only conclude that the Internal Revenue Code is at best a clumsy, and very often an unwieldy, tool for dealing with the problems of a trust annuity like the unitrust. The structure of the Code, assuming as it does that the trust observes the usual distinction between trust principal and

209 Note, *Taxation of Capital Gains Realized by Trusts,* 12 TAX L. REV. 99, 106 (1956).

210 However, even under the 1939 Code, the nontransfer approach, resulting in proportionate taxation had been followed in other cases, essentially indistinguishable from, and decided both before and after, the *Irish* case. *See, e.g.,* Barber v. United States, 251 F.2d 436 (5th Cir. 1958); Ruth W. Oppenheimer, 16 T.C. 515 (1951); Sarah A. W. Coursey, 33 B.T.A. 1068 (1936). *But cf.* Estate of Wadewitz, 32 T.C. 539 (1959) (nongrantor trust).

211 *See* Reg. Sec. 1.671-3(a)(3) (1956). This, however, does not mean that *Irish* would have fared much better under the 1954 Code. Since *Irish* could withdraw $18,000 a year from corpus, he would be taxed under section 676 on the income due to $180,000 ($18,000 for ten years). He thus would be taxed on 18/25 of the capital gains each year (in addition to all the ordinary income by virtue of his retained right to a distribution of such income).

trust income, simply cannot deal efficiently with a trust form in which this distinction is ignored. The problems begin with the very constitutionality of the statute. Fortunately for the statute the provisions in question appear to be a constitutional, albeit a questionable, exercise of congressional taxing power. The operation of the tier system in subparts A to D of subchapter J is understood only after traveling a long road of legislative history, beginning with the years prior to 1942. In the area of capital gains serious questions arise due to the notion of "utilization" of such gains in computing a beneficiary's share, a notion not generally relevant to the conventional principal and income trust. The marital deduction might be allowable for the trust annuity depending on the extent to which the *Northeastern Pennsylvania National Bank* case has done away with the "fractional share" requirement of the regulations, an unsettled question at best. Finally, gifts to a charity of interests in a unitrust invite a disallowance of the deduction by application of the "not so remote as to be negligible" rule.

Nevertheless, in spite of the difficulty of applying the Code and the regulations to the unitrust in the above areas, the problems are at least manageable and are not such as to prevent the use of this advantageous form of trust by the careful practitioner. The grantor trust area is, however, something else. It is in this area that the Code, in assuming the use of a conventional principal and income trust, creates such a maze of tax problems for the unitrust as almost to preclude understanding. It would seem that the only rational conclusion to be drawn from the discussion is that the grantor should, under no circumstances, retain an interest in or power over a unitrust. Why then, the reader may ask, was the subject labored so long and hard? The authors are frank to admit that it was only by working through the area that the massive complexity of the subject was seen. We then felt it should be recorded since a good deal of the discussion has value for trust forms besides the unitrust. Also, and most importantly, as the unitrust becomes a better understood trust form, someone may wonder about its use for grantor retained interests or powers. He will have a discussion available. If he nevertheless uses it for that purpose, the discussion may be helpful in the ensuing litigation over the proper application of subpart E of subchapter J.