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TRUSTS AND THE TAX REFORM ACT

F. William Haberman*

This paper surveys the more important changes made in trust taxation by the Tax Reform Act passed by the United States Congress in 1969. Consideration is given to charitable trusts, the new set aside rules, accumulation trusts, trusts for a spouse, and sales of term interests held in trust.

Charitable Remainder Trusts

The Tax Reform Act made many changes in the area of charitable remainder trusts. Before examining them, however, brief consideration should be given to the defects Congress found in prior law.

Prior to the Tax Reform Act, an individual could obtain a deduction for income, gift, and estate tax purposes for the present ascertainable value of a remainder interest held in trust and designated for charity. The deduction was based on actuarial life expectancy tables and the assumption that there would be a 3½% income return on trust assets.¹ Frequently, trustees were permitted to invade corpus for the benefit of income beneficiaries; the deduction was still permitted, however, if the power to invade was limited by an "ascertainable standard."²

The House Ways and Means Committee noted that the assets of such trusts could be invested "so as to maximize the income interest with the result that there was little relation between the interest assumptions used in calculating present values and the amount received by charity;" that experience indicated that the assumption that trust assets would yield only 3½% annually was unrealistic in view of current financial conditions, since for deduction purposes the assumption understated the income interest and overvalued the remainder; and that trustee investment practices and invasions of corpus for private beneficiaries left little to charity.³

To correlate more equitably the charitable contribution deduction with the amounts ultimately received by charity, Congress replaced the old charitable trust rules with a set of complicated new ones. Now, deductions for income, estate and gift tax purposes for contributions of

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¹Treas. Reg. §§ 1.170-2(d) (2) and 20.2031-7(f) (1958).
charitable remainders held in trust are permitted only for annuity trusts, unitrusts, and pooled income funds.\(^4\) Charitable contribution deductions are denied for gifts of remainder interests made in any other trust form.

**Annuity Trusts and Unitrusts**

New Section 664(d)(1)(A) defines a charitable remainder annuity trust as one from which a sum certain which is not less than 5% of the initial net fair market value of all property placed in trust, is to be paid not less often than annually to one or more persons, at least one of which is not an organization described in Section 170(c) and, in the case of individuals, only to an individual alive at the time of the creation of the trust, for a term of years (not to exceed 20 years) or for the life or lives of such individual or individuals.

A charitable remainder unitrust, on the other hand, requires a "fixed percentage", as opposed to a "sum certain", of the net fair market value of all its assets, valued annually, to be paid not less often than annually to one or more persons alive at the creation of the trust, for a term of years not in excess of 20 years or for the life or lives of such individual or individuals. For example, if a unitrust with an initial value of $100,000 must pay a "fixed percentage" of 5% per year to its income beneficiary, and at the end of the first year the trust property has appreciated $15,000 and trust income is $5,000, the unitrust will be valued at $120,000 and the income beneficiary must receive $6,000.

These definitions are more meaningful when it is realized that annuity trusts and unitrusts have many characteristics in common. Both the sum certain of the annuity trust\(^6\) and the fixed percentage of the unitrust\(^7\) may be expressed in terms of a fraction or a percentage of the assets against which they must be determined. It is inherent in both types of trusts that if current income is insufficient to satisfy the specified payout, then corpus must be applied for the benefit of income beneficiaries. Even if corpus is exhausted, the charitable deduction will still be permitted.

All of this reflects the solution Congress found to the real problem posed by charitable remainder trusts under prior law. The problem was that the income interests of private beneficiaries were often in conflict with the remainder interests designated for charity and that the income interest was enhanced at the expense of the remainder.

The solution was to abolish the differences, for investment purposes, between income and remainder interests and so end the conflict between

\(^4\) [Int. Rev. Code of 1954, §§ 170(f)(2)(A), 2055(e)(2)(A) and 2522(c)(2)(A), as amended [hereinafter all references shall be to the Internal Revenue Code of 1954, as amended, and will be cited as Code].

\(^5\) Code, § 664(d)(2)(A).


them. The annuity trust concept, for example, requires that the income beneficiary receive at least a flat 5% of the trust’s assets as valued initially regardless of any fluctuation in the value of trust assets.

The unitrust concept treats income and principal as a total fund against which the annual payout is determined. The income beneficiary and the remaindermen of a unitrust share the consequences, good or bad, of the trustee’s investment policy which will generally work to the benefit of both in an inflationary economy.

Key to both concepts, however, is that the income interest cannot be enhanced at the expense of the remainder.

The specified payout must be made at least annually, to one or more persons at least one of which is not a 170(c) organization, and payments made within 2½ months of the end of the trust’s taxable year will be regarded as payments made in the previous year. Individuals receiving income payments must be named persons, and may be members of a named class, but all such individuals must be living at the time of the creation of the trust.

A trust is not a charitable remainder annuity trust or unitrust if any person has the power to alter amounts to be paid to any named person other than a 170(c) organization, if such a power will cause that person to be treated as the owner of a trust under Sections 671-678 of the Internal Revenue Code. This merely confirms the requirement in Proposed Treas. Reg. §1.664-1(a) (3) that a charitable remainder trust is deemed created at the earliest time at which the grantor or any other person is deemed not to be the owner thereof.

No amount (other than the “sum certain” or the “fixed percentage”) may be paid to any income beneficiary other than a 170(c) organization. This prohibits invasions of corpus for the benefit of income beneficiaries other than 170(c) organizations and likewise forbids the payment of income, in excess of the specified payout, to such beneficiaries. Thus, the many cases which defined an ascertainable standard for purposes of determining when invasions of corpus could be made for the benefit of private income beneficiaries while still preserving the charitable deductions are no longer relevant.

The payment of preexisting encumbrances upon property placed in the trust is not a forbidden payment, but the creation of encumbrances after transferring property to the trust pursuant to arrangements with

9 Ibid.
10 Ibid.
persons connected with creation of the trust, might well subject such persons and the trustee to the rules against self-dealing.\textsuperscript{13}

The payout periods of life beneficiaries are limited to the life or lives of named beneficiaries or for a fixed term of years not to exceed 20 years.\textsuperscript{14} It is permissible to create successive income interests; but since all income beneficiaries must be living at the time the trust is created, the duration of the trust is inherently limited. If an individual receives an amount for life it must be for only his life and the income interests to 170(c) organizations are, similarly, limited to the lives of particular individuals.\textsuperscript{15}

The 5\% payout test must be met each year, including short taxable years, until termination of all income interests.\textsuperscript{16} The Proposed Regulations provide examples of permitted dispositions. They include: (1) a specified payment to A and B for their joint lives and then to the survivor; (2) a specified payment to A for life or for a term of years, whichever is longer (or shorter), if the length of the term of years is not longer than 20 years; (3) a specified payment to A for a term of years not to exceed 20 years, and then to B for life; (4) a specified payment to A for life, then a specified payment to B for life if the percentage given to each individual is not less than 5\%\textsuperscript{17}.

At the termination of all income interests, the entire corpus of the trust must be irrevocably transferred in whole or in part to a 170(c) organization, or must be retained in whole or in part by the trust for the use of such an organization.\textsuperscript{18} Any retention of assets by the trust for the benefit of 170(c) organizations will subject the trust to treatment as a private foundation.\textsuperscript{19}

While Sections 664(d)(1)(C) and 664(d)(2)(C) seem to require that the remainder interest is to be transferred to “an” organization described in Section 170(c), thereby implying that the entire remainder interest must be transferred to only one charity, the Proposed Regulations state that more than one charitable organization can receive a remainder interest and that such interests can be enjoyed concurrently or successively.\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{13} \textit{Code}, §§ 4947(a)(2) and 4941(d)(1)(A).
\item \textsuperscript{14} \textit{Code}, §§ 664(d)(1)(A) and (2)(A).
\item \textsuperscript{18} \textit{Code}, §§ 664(d)(1)(C); 664(d)(2)(C).
\end{itemize}
As a consequence the once common device of dividing a remainder interest among charitable and non-charitable beneficiaries is no longer permitted. It is now necessary to create two trusts with one of the trusts receiving the full charitable remainder.

If, at the end of the trust’s term, the 170(c) organization originally designated as remainderman is no longer in existence, a substitute 170(c) organization must be provided.\textsuperscript{21}

Annuity trusts and unitrusts share the problem posed by hard-to-value assets. The House Committee Report indicated that a deduction would be denied where assets lacking an objective ascertainable market value, such as real estate and shares in closely held corporations, are transferred to a unitrust, unless an independent trustee is solely responsible for making the annual determination of value.\textsuperscript{22} The Senate Report contained the more drastic suggestion that a gift of a remainder interest in really reserving a life estate simply could not be framed in the form of an annuity trust or unitrust.\textsuperscript{23}

As it turns out, neither the Code nor the Proposed Regulations prohibits transfers of hard-to-value assets to annuity trusts or unitrusts. The Proposed Regulations do provide that, if the net fair market value of trust assets is incorrectly determined, the trust shall pay to each income beneficiary, in the case of an undervaluation, or be repaid by each income recipient, in the case of an over-valuation, a pro rata share of an amount equal to the difference between the amount the trust should have paid and the amount the trust actually paid.\textsuperscript{24}

A number of differences exist between the charitable remainder annuity trust and the unitrust. These differences will determine whether a taxpayer chooses an annuity trust or unitrust to convey a charitable remainder.

A most important alternative exists in the case of the unitrust that is not permitted in the annuity trust form. A charitable remainder unitrust may provide for distributions of all annual income if such income is less than the required “fixed percentage.”\textsuperscript{25} Thus, if trust income were $3,000, and 5% of trust assets at the valuation were $5,000, only $3,000 would be distributed to the income beneficiary under the income payout alternative. The Statute indicates that any deficiency in an income distribution, that is, the difference between the “fixed percentage” otherwise payable and trust income, must be made up in subsequent years when the trust income exceeds the “fixed percentage.”\textsuperscript{26} The

\textsuperscript{21} Ibid.
\textsuperscript{22} H. R. REP. No. 91-413 (Pt. I), 91st Cong., 1st Sess. at 60 (1969).
\textsuperscript{23} S. REP. No. 91-552, 91st Cong., 1st Sess. at 87 (1969).
\textsuperscript{25} CODE, § 664(d) (3).
\textsuperscript{26} Ibid.
Proposed Regulation, on the other hand, provides that such deficiencies need not be made up.\textsuperscript{27}

The purpose of the income payout alternative is "to allow greater flexibility in the making of charitable gifts, but at the same time protect against abuse."\textsuperscript{28} Since payouts are restricted to annual income if such income is less than the "fixed percentage", it is not necessary to invade corpus or distribute capital gains to the income beneficiary. By utilizing the power to make up deficiencies when annual income exceeds the "fixed percentage" it is possible to even out annual payments which might otherwise fluctuate to a great degree because of differences in the value of trust assets from year to year.\textsuperscript{28a}

In addition, the valuation of assets serving as the basis for calculation of the specified payout for an annuity trust is calculated at a different date from that used for unitrust. The assets of an annuity trust are valued upon transfer to the trust.\textsuperscript{29} The basis upon which the "sum certain" is to be paid to income beneficiaries is thereafter fixed. Accordingly, the income beneficiary will not share the fruits of a trustee's successful investment policy. Neither, of course, will he be subject to his trustee's failures as an investor.

The assets (income plus principal) of a unitrust are valued annually.\textsuperscript{30} Accordingly, the income beneficiary and remainderman will benefit from a successful investment policy. The new rules do not insist on any particular date for valuation. Valuation can be made on any given date during the taxable year or by taking the average of valuations made on various dates during the year if the same dates are used each year.\textsuperscript{31} It is clear, incidentally, that valuation dates cannot be selected so as to avoid a distribution in the first year of a unitrust. If the valuation date selected by the trust instrument does not occur during a short first year, then the assets are valued for that year on the last day of the taxable year in which they are transferred to the trust.\textsuperscript{32}

Finally, future contributions to an annuity trust must be expressly forbidden by the trust instrument; future contributions to unitrusts are permitted, however.\textsuperscript{33} Special rules are established by the Proposed Regulations for the valuation of future contributions to unitrusts.\textsuperscript{34}

Taxpayers will prefer the unitrust to the annuity trust because of its greater flexibility. On the one hand corpus is protected by an income

\textsuperscript{28} S. REP. NO. 91-552, 91st Cong., 1st Sess. at 90 (1969).
\textsuperscript{29} CODE, § 664(d) (1) (A).
\textsuperscript{30} CODE, § 664(d) (2) (A).
payment provision; on the other hand the income beneficiary will benefit from the trustee's good investments. Neither is possible with an annuity trust.

Generally, the amount of the charitable contribution deduction for charitable remainders held by annuity or unitrusts is computed on the basis that 5%, or any larger amount designated by the trust instrument will be paid out annually to the trust beneficiary even if less than 5% is actually paid to such beneficiary, as might be the case under the unitrust income payout alternative.

Valuation of the deduction for the annuity trust is straightforward. The computation is made by subtracting the present value of the annuity from the fair market value of the property transferred to the trust. Valuation of the annuity is computed under §20.2031-10 of the Estate Tax Regulations.

Valuation of charitable remainders in a unitrust is made more complex by the many different valuation dates and payout sequences available to such trusts. Rather than subtracting the income interest from the fair market value of the property, the Proposed Regulations establish methods to determine the remainder interest independent of the income interest. A number of recently published articles also explain how such remainder interests are valued.

Taxation of Income Distributions

The Tax Reform Act establishes a new system of tiers characterizing income payments of charitable remainder trusts to beneficiaries. Each payment to a beneficiary is deemed to consist: first, of ordinary income for the current year and undistributed ordinary income for prior years; second, of long-term capital gains for prior years; third, of all other income for the current year (including tax exempt income) and accumulated other income for prior years; and fourth, of trust corpus.

This system of tiers is maintained throughout. Thus, losses for the current year may be used to reduce gains for prior years, but losses in one tier may not be used to reduce gains in another. Amounts treated as paid from one of the above tiers will be treated as consisting of the same proportion of each class of items included in only that tier.

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35 Code, § 664(e).
37 Ibid.
40 Ibid.
41 Ibid.
as the total of current and accumulated income of each class of items bears to the total of current and accumulated income from that tier.\textsuperscript{42}

Likewise, deductible expenses of the trust for the taxable year which are reasonably related to a specific class of items must be allocated to that class; other deductible expenses of the trust must be allocated among the classes of items on the basis of gross income of such classes for the taxable year reduced by expenses directly related to those items.\textsuperscript{43}

If there are two or more recipients of income distributions, each will be treated as receiving his pro rata portion from each tier.\textsuperscript{44}

The new system of tiers departs radically from previous concepts governing the taxation of distributions from charitable remainder trusts to their income beneficiaries.

Prior to the Tax Reform Act, non-charitable beneficiaries of charitable remainder trusts included in their gross income those amounts distributed to them to the extent of the charitable trust's distributable net income ("DNI") for the year.\textsuperscript{46} Consistent with the conduit principle, income received by a beneficiary had the same character in his hands as it did in the hands of the trust.\textsuperscript{46}

Under the new tier system DNI no longer measures taxability of distributions to current beneficiaries. Whether capital gains are includable in DNI is not relevant to charitable remainder trusts.

Moreover, discarding DNI as the measuring rod of taxability of distributions may mean that the new throwback rules do not apply to charitable remainder trusts, because the concept of DNI is central to the definitional sections of the new throwback rules. Thus, in very general terms, an accumulation distribution is a distribution in the current year in excess of DNI for the trust in that year.\textsuperscript{47} The accumulation distribution is thrown back to the earliest year there is undistributed net income, defined to be the amount of DNI, less taxes, not distributed in that year.\textsuperscript{48} When it is recalled that 664(a) provides that Section 664 shall apply notwithstanding any provision of subchapter J to the contrary, it appears that elimination of DNI as a measuring rod of taxability of distributions to income beneficiaries and the substitution of the new tier system in its place should render the throwback rules inapplicable to charitable remainder trusts.

The new tier system accelerates the receipt of, and tax upon, items of ordinary income and capital gain and, conversely, defers the receipt
of non-taxable items. This is quite different from the rule of prior law established by Section 662(b), that amounts distributed to a beneficiary consist of the same proportion of each class of items entering into the computation of trust DNI, as the total of each class bears to the total DNI of the trust.

Assume that in 1970 a trust received $1,000 in dividends, $1,000 in tax exempt interest and $1,000 in long term capital gains, and that the income beneficiary received a distribution of $1,500.

Under the new rules, the distribution would consist of $1,000 of ordinary income and $500 in long term capital gain all taxable to the beneficiary. The undistributed capital gain of $500 and the tax exempt interest of $1,000 would be allocated to the charitable remainder and would not be taxable. Both items would be available for future distributions, however, (and taxed as far as the capital gain item is concerned) to the income beneficiary.

Under the old rules the trust would have had DNI of $2,000 consisting of $1,000 in ordinary income and $1,000 in tax exempt interest. The beneficiary would have been deemed to receive $750 of ordinary income and $750 of tax exempt interest and no capital gain.

The taxation of charitable trusts themselves is changed. Prior to the Tax Reform Act, charitable remainder trusts, like non-charitable trusts, were treated as separate taxable entities permitted deductions for amounts distributed to non-charitable beneficiaries. There was an unlimited charitable deduction for amounts paid to or permanently set aside for charity.

Under the new rules, a charitable trust is exempt from income tax pursuant to Section 664(c) if certain rules are met. First, the charitable remainder trust must not have "any" unrelated business taxable income as defined by Section 512 of the Code. Otherwise, the "trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year." Apparently one dollar of unrelated business taxable income will subject all trust income to subtitle A.

Second, to be exempt under Section 664(c), the trust must be either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. A trust which provides for the payment each year to a non-charitable beneficiary of a sum certain or a fixed percentage of the value of trust assets, whichever amount is greater, is neither a charitable remainder annuity trust nor a unitrust.

50 CODE, § 661(a).
51 CODE, § 642(c).
because the payment for the year may be either a "fixed percentage" or a "sum certain."\(^{53}\)

A charitable remainder trust is deemed such at the earliest time the grantor or any other person is not treated as the owner of such a trust. For example, if a donor creates an inter vivos revocable trust which is to pay his wife 5% of the value of the trust assets valued annually with remainder to charity, the trust is not a charitable remainder trust until the donor dies and the trust becomes irrevocable.\(^{54}\)

For income tax purposes, the new provisions are effective, generally, with respect to any trust created after July 31, 1969. Thus, any trust created prior to August 1, 1969 is not exempt under Section 664(c), even if it otherwise satisfies the definition of a charitable remainder annuity trust or unitrust.\(^{55}\) However, the Proposed Regulations, as extended, gave taxpayers a break with respect to trusts which were not charitable remainder trusts within the new definitions at the date of their creation, if that date is subsequent to July 31, 1969 but prior to July 1, 1971. Such trusts will be treated as proper charitable remainder trusts from the dates of their creation for all purposes if at the time of their creation the governing instrument provided that a 170(c) organization was to receive an irrevocable remainder interest; and if the governing instrument of the trust is amended so that the trust meets the definitions of a charitable remainder trust before July 1, 1971 or, if later, on or before the thirtieth day after the date on which any judicial proceedings begun before July 1, 1971 and required to amend the governing instrument become final; and if adjustments are made with respect to distributions or lack of distributions to an income beneficiary so as to comply with the amounts which should have been distributed if the trust had been a proper one.\(^{56}\)

For estate tax purposes the new provisions are effective with respect to decedents dying after December 31, 1969. However, if a testator executed his will before October 10, 1969 and had no right to change the charitable remainder provisions, or if he does not republish his will before October 9, 1972 and on that date and thereafter lacks the mental capacity to do so, or if he dies before October 9, 1972 without republishing his will after October 9, 1969, the old rules will still apply.\(^{57}\)

These transitional rules give taxpayers a three year grace period to change their wills. If a testator is living on October 9, 1972, has testamentary capacity and the right to change his will, he should then


\(^{57}\) P.L. 91-172, Sec. 201(g) (4) (A) & (B) [Hereinafter, P.L. 91-172 is referred to as "TRA"].
execute a new will if he wishes to comply with the new charitable remainder trust provisions. For gift tax purposes the act is effective after July 31, 1969.\textsuperscript{58}

The transitional rules are similar for trusts. The Act applies to trusts executed after October 10, 1969 but not to trusts executed on or before October 9, 1969 if the trustor dies before October 9, 1972 without amending the instrument, or if the property transferred is an irrevocable interest to charity, or if the instrument governing the disposition was not amended before October 9, 1972 and the decedent on that date and thereafter was under mental disability.\textsuperscript{59}

**Pooled Income Funds**

A third type of trust which entitles the donor to a charitable deduction is the pooled income fund, a device commonly used by so-called 50% charitable organizations such as hospitals, churches or schools.

Typically, the 50% charity solicits funds of appreciated securities, which it lumps together in one fund. The fund then pays out the income earned by such securities to the donor or other beneficiaries named by the donor and after the death of these beneficiaries, severs the securities from the fund and retains them for its own use.

Pooled income funds are especially attractive to persons owning stock which has substantially appreciated but which pays little income. These persons can trade the appreciated stock for a higher income without a capital gains tax by donating the securities to a pooled income fund. The charity often sells the donated stock and because of an exception to the charitable set aside rules, pays no capital gains; it then re-invests in higher income stocks and pays the income from such stocks to the donor. The donor avoids the capital gains tax, increases current income, and obtains a present income tax charitable deduction for donation of the remainder interest. The donated property may be includable in the donor's estate, but he gets an estate tax deduction in the same amount. This again, produces an advantage: the adjusted gross estate is increased without increasing the estate tax, thereby increasing the available marital deduction.

Essentially all of these tax benefits are available to pooled income funds and their donors if the following requirements of new Section 642(c)(5) are met:

Each donor to the fund must contribute an irrevocable remainder interest in the property to the use of a public charity, an organization or organizations defined by clauses (i) to (vi) of Section 170(b)(1)(A).\textsuperscript{60} By defining a public charity to be "an organization or organiza-

\textsuperscript{58} TRA Sec. 201(g)(4)(D).
\textsuperscript{59} TRA Sec. 201(g)(4)(C).
tions," it may make it possible to contribute a remainder interest to more than one public charity.

Each donor must retain for himself a life income interest in the property or create similar interests for one or more named beneficiaries each of whom must be living at the time the donor transfers the property to the pooled income fund; the income beneficiaries may include a public charity and all may enjoy their income interests concurrently or consecutively. A donor is not required to retain a life interest in all the income from the transferred property, provided the balance of such income is contributed to the organization which maintains the pooled income fund.

Apparently, it is not possible to create an interest for a fixed term of years in the donor's ratable portion of the income of a pooled income fund, and it also appears that it is impossible to sprinkle the income among various beneficiaries, because the Proposed Regulations require the governing instrument to specify at the time of the transfer the particular person or persons to whom the income is payable and the share of income distributable to each such person.

The property transferred to the fund must be commingled with and invested with other property transferred to the fund by donors satisfying the requirements of Section 642(c)(5). An organization managing the fund may maintain more than one pooled income fund and may commingle assets in any pooled income fund with other assets of the organization, for example, its general endowment fund. When such a commingling occurs, detailed accounting records must be maintained specifically identifying the assets included in the pooled income fund and the income attributable to such assets.

The pooled income fund may not hold tax exempt securities or accept tax exempt securities from a donor. This prohibition, among others, puts an end to the so-called Pomona College Plan in which individuals traded appreciated securities for tax exempt life interests in pooled income funds of universities without payment of a capital gains tax.

The pooled income fund must be maintained by the same organization to or for the use of which the irrevocable remainder interest is contributed. The requirement is met when the organization exercises control, directly or indirectly, over the fund, and it is satisfied if the organization has the power to remove the trustee or trustees of the fund

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62 Ibid.
63 Ibid.
65 Ibid.
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and designate a new trustee or trustees. It is also possible for a national organization which carries out its purposes through local organizations to maintain a pooled income fund, remainders from which are designated for the local organization.

The fund may not have, and the governing instrument must prohibit the fund from having, any donor or income beneficiary of the fund as the trustee. However, such a donor or beneficiary may be a trustee, officer, director or other official of the charity to or for the use of which the remainder interest is contributed.

Each income beneficiary entitled to income in any taxable year of the fund must receive income determined by the rate of return earned by the fund for that year determined by rules established in the Proposed Regulations. Beneficiaries are entitled to income payments at least once in each taxable year, but payments may be made more frequently. A payment is considered as made on the last day of a taxable year of the fund if the payment is made within 2½ months after the close of the taxable year, and "income" is determined by the instrument and by state law.

Upon the termination of the income interest of the designated beneficiary, the organization to receive the remainder interest must sever from the pooled income fund an amount equal to the value of the property upon which the income interest is based.

Once all the above mentioned requirements are met, no gain or loss will be recognized to the donor of a transfer of property to a pooled income fund to the extent the donor retains a life interest in the property transferred, and the fund will not be treated as an association within the meaning of Section 7701(a)(3). The fund and its beneficiaries will be taxed under part I, subchapter J of the Code except that subpart E relating to grantors and others treated as substantial owners will not apply.

The charitable contribution deduction allowed the donor is determined by valuing the income interest on the assumption that the rate of return of property transferred will be the highest rate of income earned by the particular pooled income fund in any of the three taxable years preceding the transfer. If a fund has not been in existence for the

68 Ibid.
70 Ibid.
72 Ibid.
73 Ibid.
three year period, the rate will be 6% unless a different rate is prescribed.79 The rules for determining the value of the remainder interest are set out in some detail in the Regulations.80

To maximize the charitable deduction the taxpayer should select a pooled income fund with a low rate of return in the three years immediately preceding the transfer of property. Note, however, that the Proposed Regulations indicate that a 6% return will be used in those cases in which the highest yearly rate of return has been manipulated to obtain a excessive charitable contribution deduction.81

A fund created after December 31, 1970 will not be treated as a pooled income fund unless it meets the foregoing requirements.82 However, a fund created before July 1, 1971 will be treated as a valid pooled income fund, if on July 31, 1969 or on each date of transfer of property to the fund occurring after July 31, 1969, the fund possesses certain characteristics described in the Proposed Regulations, and if it is amended in accordance with the Proposed Regulations.83

**Trusts With All Interests To Charity**

A fourth type of trust that entitles the donor to a charitable contribution deduction is one in which all interests are devoted to charity.84 These trusts will be treated as private foundations in all respects.85 Since the rules governing taxation of private foundations are complicated and onerous, they will discourage all but the most generous of taxpayers from establishing such trusts.

**Charitable Income Trusts**

Congress acted on donations of income interests held in trust as well as remainders. Again, brief consideration should first be given to prior law and its alleged defects. Prior to the Tax Reform Act, an individual could, for example, establish a trust with income to a specified charity for a designated period, remainder to his children (or anyone other than the grantor) and deduct the present value of the right to receive income from the property for the period of the income interest.86 If the charitable term of the trust was at least ten years, the grantor was not taxable on trust income.87

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79 **Ibid.**


83 Proposed Treas. Reg. § 1.642 (c) -7 as extended by TIR No. 1059 (December 17, 1970).

84 **CODE,** § 170(f) (2) (D).

85 **CODE,** § 4947(a) (1).

86 See, for example, Rev. Rul. 1953-194, 1953-2 CB 128.

87 **CODE,** § 673(a). The trust term could be only two years if the income interest was contributed to an appropriate Sec. 170(b) (1) (A) organization. **CODE,** § 673 (b).
Combining an income tax deduction with an exclusion of trust income from the grantor's gross income produced a substantial tax benefit, an example of which is given in the Tax Reform Studies and Proposals of the Treasury Department. If, for example, a taxpayer in the 70% bucket retained property worth $100,000 yielding $5,000 per year for a two year period, the after tax income on the total of $10,000 would be $3,000 for the two years. If, instead, the property were transferred in trust to pay the income to the appropriate "30%" (now "50%") charity for two years with the remainder to the grantor's son, the grantor would be entitled to a charitable deduction of $6,648.00 and an exclusion of trust income from his gross income, generating a total after tax savings of $4,654.00 for the two years.\(^8^8\)

This loophole was enough to justify tax reform. But Congress was also concerned that, because the charitable deduction was computed on the assumption that the trust property would yield a $3\frac{1}{2}%$ return and because the trustees could invest trust property in a manner designed to yield little or no income, the trust property could be held for the benefit of a donor's family while the charitable beneficiary would receive little or no income, or at least substantially less than that assumed for purposes of computing the charitable contribution deduction.\(^8^9\)

The so called "gambling trust" provided a third justification for reform. By establishing a trust which provided a fixed annual amount to charity with the remainder to his family, a grantor could limit his contribution to the trust to the amount necessary to fund the annuity only. Since the actuarial value of the remainder interest would be zero, the grantor could deduct the entire amount transferred to the trust. If the trust property were then invested in highly speculative securities and the speculation was successful, the grantor's family would be the sole beneficiary. On the other hand, if the investment policy failed, only the charity would lose.\(^9^0\)

The Tax Reform Act more than amply deals with these evils noted by Congress; in fact, the new provisions produce tax pitfalls not known to charitable income trusts under prior law.

New Section 170(f)(2)(B) permits deductions for income interests transferred in trust only when the interest is in the form of a guaranteed annuity or when the trust instrument specifies that the interest will be a fixed percentage distributed yearly of the fair market value of the trust property to be determined yearly, and the grantor is treated as the owner of such interest for purposes of applying Section 671.


\(^9^0\) Treasury Dept. "Tax Reform Studies and Proposals" at 185.
Requiring the income interest to be in the form of a guaranteed annuity or a fixed percentage means that the charitable income trust must be in the form of an annuity trust or unitrust, although there is no 5% floor required as in the charitable remainder trust area. The annuity trust or unitrust will tend to prevent wild speculation on the part of the trustees, because if the trust does not produce income, the corpus must be invaded to satisfy the required payout. There is nothing in Section 170(f)(2)(B) similar to the unitrust income payout alternative, permitting only payouts of all trust income if income is less than the guaranteed amount.

The second prerequisite found in Section 170(f)(2)(B) is that the grantor must be treated as the owner of the charitable interest for purposes of 671. This condition is designed to deny the double tax benefit permitted under law where the grantor obtained a present deduction and also removed the trust income from his own gross income. The deduction is now allowed only to the extent the grantor is taxable on the income. (It is not necessary that the grantor be taxed for gift and estate tax deduction purposes, however).91

How the grantor becomes taxable on the income of a charitable income trust is not specified in the Statute. If a grantor retains an interest in, or power over, trust property as defined in Sections 673-677 of the Code, the use of a charitable income trust will produce tax disasters. Thus, if a grantor retains a reversionary interest in trust property that will vest within ten years of the date of transfer, he would certainly be treated as the owner of the entire trust and all of its income, even that in excess of the payout to charity and payable (possibly) to persons other than the grantor. Moreover, retention of a reversionary interest in the property would include it in his estate for estate tax purposes. The same results are possible with respect to retention of the other rights and powers defined in Sections 671-677.

To insure grantor taxability, Section 170(f)(2)(B) provides that if a grantor ceases to be taxed on trust income he shall, in effect, recapture a portion of the charitable contribution deduction previously taken by taking into income an amount equal to that portion of the charitable contribution deduction he received reduced by the discounted value of all amounts of income earned by the trust and taxed to him before recapture occurs. Unlike any other recapture provision in the Internal Revenue Code, Sec. 170(f)(2)(B) imposes a tax in the absence of receipt of any economic benefit in the year of recapture.

The charitable deduction will equal the present value of the donated annuity for a charitable income trust in the annuity trust form and will

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91 TRA Sec. 201(d) establishes that to be deductible for estate and gift tax purposes a charitable income interest must be in the annuity trust or unitrust form.
probably be valued as charitable remainder annuity trusts are valued, based upon §20.2031-10 of the Estate Tax Regulations.

The Proposed Regulations for charitable remainder unitrusts indicate that the remainder will be independently valued and the discount employed will be 6%. It is probable that the same mechanisms will be employed to value the income interests contributed in the unitrust form.

In any event the grantor is entitled to an immediate deduction for the present value of the income interest contributed even though he will be taxed on income as it is received by the trust and distributed to charity in subsequent years. Thus the one tax benefit that might still remain inures to a grantor in a high tax bracket in the year the income interest is contributed, if in the later years when he is taxed on trust income he is in a low tax bracket. Otherwise, the options available to taxpayers who cannot be deterred from donating income interests to charity are as follows:

1. Retain the income producing property and donate the income therefrom. The annual deduction would offset the annual income so long as the grantor is taxable on the income.

2. Donate the income interest, receive a large immediate deduction, but report income as received by the trust without an offsetting deduction in the years of receipt.

3. Create a trust for more than ten years with all of the income payable to charity. No charitable deduction will be allowed if the grantor is not taxed on the income, but he will have effectively removed the income from his own gross income.

Repeal of Two Year Charitable Trust

Consistent with the above mentioned changes is the repeal of the two year charitable trust. Prior to the Tax Reform Act, a taxpayer could avoid his personal deduction ceiling on charitable gifts by transferring income producing property to a trust that would pay its income to a qualified charity for at least two years after which the property would revert to the donor. The grantor could not take a charitable contribution deduction, but he could remove the trust income from his own gross income for the term of the trust, if the charity selected were one described in Section 170(b) (1) (A) (i), (ii), or (iii). A donor was thereby enabled to shift to charity as much of his otherwise taxable income as he chose, regardless of his own personal charitable contribution deduction limit.

The Tax Reform Act totally repeals this tax benefit. The income

[93] TRA Sec. 201(c).
[94] Code, § 170(b) (1) (D), before amendment.
[95] Code, § 673(b), before amendment.
from a two year charitable trust is taxable to the grantor for transfers in trust after April 22, 1969.96

Property transferred before April 22, 1969, will be governed by the previous rules exempting the grantor from tax on income from that property even though the income from the property is paid to charity after April 22, 1969.97 In the future, to avoid taxation on trust income ultimately paid to charity the grantor must create a trust with a ten-year or longer term.

SET ASIDE RULES

Prior to the Tax Reform Act, income paid to, or permanently set aside for, a charity by an estate or trust pursuant to the terms of a will or trust was deductible against trust income.98 Congress amended Section 642(c) to permit charitable set asides for estates only. Subject to a number of exceptions, trusts are permitted full deductions against trust income only when amounts are actually paid to charity. If a trust is required by the terms of its governing instrument to set aside amounts for charity and was created on or before October 9, 1969, and either conveys an irrevocable remainder interest to a 170(c) organization, or has a grantor who is at all times after October 9, 1969 under a mental disability to change the terms of the trust, the old set-aside rules apply.98a

Similarly, the old rules apply to wills executed on or before October 9, 1969, if the testator dies before October 9, 1972 without having republished the will after October 9, 1969, or if the testator after October 9, 1969 had no right to change the portions of the Will which pertain to the trust or if the will is not published before October 9, 1972, and the testator on October 9, 1972 and at all times thereafter lacks mental capacity to republish his will.99 Note, however, that property transferred after October 9, 1969 to any of these specifically excepted trusts will be subject to the new rules.100

A third exception is created by Section 642(c)(3) with respect to long-term capital gains realized by pooled income funds.

The definition of an allowable donee remains the same. The deduction for a permitted set-aside is not limited to the present value of the amount set aside and, as a general rule, the trust retains an unlimited deduction for amounts actually paid to charity. The latter statement must be qualified. New §642(c)(6) provides that taxable private foundations and trusts treated as taxable private foundations are subject to the charitable deduction limitations that apply to other taxpayers.

96 TRA Sec. 201(g) (3).
97 Ibid.
98 CODE, § 642(c), before amendment.
98a CODE, § 642(c) (2) (A).
99 CODE, § 642(c) (2) (B).
100 CODE, § 642(c) (2).
Mention must also be made of the election available under new §642(c)(1). A trustee or administrator (the omission of "executor" may be inadvertent) may elect to treat charitable income payments made during any year by a trust as made in that year or in the prior year. This permits the trustee to make contributions to charity at a time when he knows precisely the amount of income for the year against which the contribution will be deducted.

**Trusts Treated as Private Foundations**

Charitable trusts will be treated as private foundations in many respects. A charitable trust, all of the unexpired interests of which are devoted to purposes described in §170(c)(2)(B) and which is not exempt from taxation by virtue of §501(a) and for which a deduction was allowed for income, estate or gift tax purposes, will be treated as a private foundation in all respects except for the notice requirements found in §508(a), (b), and (c).\(^1\)

This means that such trusts will have to pay the excise taxes on net investment income, self-dealing, undistributed income, etc.

So called "split interest trusts" will also be subject to many of the private foundation rules. A split interest trust is one not exempt from tax by virtue of §501(a), at least some of the unexpired interests of which are not devoted to purposes described in §170(c)(2)(B), and which has amounts in trust for which a deduction was allowed for income, estate or gift tax purposes.\(^2\) All charitable remainder trusts and charitable income trusts are split-interest trusts. Accordingly, they will be subject to the following rules governing private foundations:

**Governing Instruments**

Section 508(e) requires every split interest trust instrument to prohibit its trustee from engaging in any activity which would incur tax under §§4941(d), 4943(c), 4944 and 4945(d). Failure to make such provision in a trust instrument precludes deductions for income, estate and gift tax purposes for charitable remainder interests held by split interest trusts.\(^3\) An example of language required by §508(e) can be found in Rev. Rul. 70-270, IRB 1970-22, 8.

**Self Dealing**

Split-interest trusts are subject to the exercise tax on self-dealing found in §4941. While amounts payable under the terms of a trust to its income beneficiaries, including, presumably, the grantor, are not instances of self-dealing,\(^4\) transactions between a trust and its grantor must be carefully watched. A sale to the trust, for example, of a

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\(^{101}\) Code, § 4947(a) (1).

\(^{102}\) Code, § 4947(a) (2).

\(^{103}\) Code, § 508(d) (2).

\(^{104}\) Code, § 4947(a) (2) (A).
grantor's assets even on an arms-length basis would subject the trustee and the grantor to the tax.

**Excess Business Holdings; Investments Which Jeopardize Charitable Purpose**

The exercise taxes on excess business holdings and investments which jeopardize a charitable purpose do not apply to split-interest trusts if either (1) all of the income interest and none of the remainder interest is devoted to charitable purposes, and all amounts in trust for which a deduction was allowed for income, estate or gift tax purposes have an aggregate value of 60% or less of the aggregate fair-market value of all amounts in the trust, or (2) a pure split-interest trust is created in which all of the remainder is designated for charity, and all the income interests are dedicated to private purposes.\(^{105}\) The excise taxes on excess business holdings and investments which jeopardize charitable purpose will not have impact on split-interest trusts as long as the trust operates for the benefit of private beneficiaries. During that period, for example, a trustee need not divest the trust of excess business holdings. But upon termination of the income interests, the trust will no longer be a split-interest trust. It will, instead, be a 4947(a)(1) trust with all interests devoted to charity subject to all of the private foundation rules. Diversification of investments and divestment of excess business holdings would then be necessary.\(^{105a}\)

**Taxable Expenditures**

Split-interest trusts are subject to the excise tax on taxable expenditures found in §4945. This section deals basically with lobbying and political activities and should not affect most trusts.

**Termination of Status**

Read literally, §507 of the Code requires a tax upon termination of a split-interest trust just as it does upon termination of private foundations. Sec. 507(b) provides that a trust will be terminated if it transfers all of its assets to one or more organizations described in §170(b)(1)(A) other than a private foundation or those described in §509(a)(2) or (3). The tax imposed by §507(a) deals with the voluntary termination of a private foundation or involuntary termination because of willful and flagrant acts giving rise to liability under Chapter 42. Since most split-interest trusts will terminate and distribute assets to organizations described in §170(b)(1)(A) in accord with §507(b), §507(a) should not trigger tax upon termination. But even if it does, the Commissioner

\(^{105}\) **Code**, § 4947(b)(3).

should abate the tax under §507(g); otherwise a deduction taken upon
the creation of even the most ordinary split interest trust will be the
basis for a deficiency upon the trust's termination—an astonishing result
that should not be permitted.

None of the private foundation rules apply to amounts transferred
in trust before May 27, 1969, or amounts other than for which a
charitable deduction was allowed if such other amounts were segre-
gated. A trust with such segregated amounts must separately
account for the various income, deduction and other items properly
attributable to the segregated amounts.

VI. ACCUMULATION TRUSTS

Without question the most complex of the new rules dealing with
trusts concern accumulation trusts. The computations required by these
new provisions are lengthy and frustrating. At the end of long hours of
mathematical manipulation, it will be discovered in most cases that little
or no tax is to be paid.

Background

The background of the new rules is familiar. Under the 1939 Code,
income retained by a trust was taxed to the trust and no tax was im-
posed on the subsequent distribution of that income to the beneficiary.
A graphic example of the tax benefits available under the old law is
found in the legislative history of the Tax Reform Act. If “X”
creates a trust and contributes $200,000 to it and under the terms of the
trust the income is to be distributed annually to “X’s” son, “Y”, and the
annual income is $14,000 with an annual expense of $400 per year, “Y”
will receive $13,600 per year. If “Y’s” other taxable income is $40,000,
his additional tax because of the $13,600 distributed by the trust will be
$8,152.

If, instead, the $13,600 is accumulated and distributed to “Y” at a
later time, the tax would be paid by the trust. In this case, in addition
to a deduction for the $400 of expenses, the trust would receive also a
personal exemption of $100. The tax due from the trust on the $13,500
would be $3,370, or $4,782 less than the tax due if the income had been
distributed currently to “Y”.

Multiple trusts increase the tax benefits. If “X” created ten separate
trusts and contributed $20,000 to each, the net income in each trust per
year would be $1,360. Omitting trust expenses but including the personal
exemption of $100 for each trust, the tax due from each trust would be
$186.60, or a total of $1,866 for the ten trusts. This is $1,504 less than
the tax imposed on a single accumulation trust and $6,286 less than the

106 Code, § 4947(b)(2).
107 Code, § 4947(a)(3).
tax due if the income were distributed currently to "Y". If each trust keeps carefully segregated books, has a termination date different from the others, etc., the courts will accept it as a viable entity.

In 1954, Congress attempted to tax accumulation distribution by enacting a five year throwback rule. The five year throwback rule failed in its purpose because, in part, it was limited to distributions of income accumulated within only five years of the distribution and because it was subject to some very substantial exceptions. It did not apply to:

1. A distribution of income accumulated prior to a beneficiary’s birth or attaining the age of twenty-one;
2. A distribution of accumulated income to a beneficiary to meet his emergency needs;
3. A distribution of accumulated income as a final distribution made more than nine years after the last transfer to the trust;
4. A distribution of accumulated income not in excess of $2,000;
5. A distribution from certain trusts created prior to 1954; and,
6. A distribution of accumulated capital gains.

New Throwback Rule

Believing that beneficiaries of accumulation trusts should be taxed in substantially the same manner they would be taxed if the income had been distributed to the beneficiaries as it was earned by the trust, Congress:

1. Eliminated the five year limitation, and substituted an unlimited throwback with no exceptions to it.
2. Treated amounts distributed to beneficiaries as if they had been distributed in the first year of an accumulation, to the extent of that accumulation, then distributed successive accumulations on a first-in first-out basis.
3. Imposed an unlimited throwback on capital gain distributions.
4. Established an alternative ‘exact’ or ‘short-cut’ method to compute the tax on the beneficiary.
5. Allowed a credit, and in some cases a refund, for taxes paid by the trust.

The new rules do not attack multiple trusts directly. Rather, they destroy the efficacy of multiple trusts by disallowing the tax benefits inhering in any accumulation trust. Moreover, the new Act does not tax the beneficiary on amounts earned by the trust until those amounts are

109 Ibid.
110 Code, §§ 665-669, before amendment.
111 Code, § 665 (b), before amendment.
113 Code, §§ 665-669.
actually distributed to the beneficiary. Thus, beneficiaries of accumulation trusts still enjoy a deferral of tax as they did under the old law.

Definitions

Certain terminology must be understood before the computations involved under the new law can make sense. Generally, the throwback rules apply when there is an "accumulation distribution." The "accumulation distribution" is carried back to the earliest year in which there is "undistributed net income" to the extent of that "undistributed net income" and then carried forward to the next succeeding years of accumulation. The recipient of an "accumulation distribution" computes his tax as the lesser of an amount due under the "exact" or "short-cut" method. All of these terms are defined and explained below.

Accumulation distribution. To trigger the throwback rule, there must first be an accumulation distribution. The definition of an accumulation distribution depends on the tier system established by section 661 of the 1954 Code. It will be recalled that a first tier distribution consists of income currently required to be distributed.\(^{114}\) A second tier distribution consists of all other amounts distributed.\(^{115}\) An "accumulation distribution" is that amount by which a second tier distribution exceeds distributable net income ("DNI") for the year reduced (but not below zero) by first tier distributions.\(^{116}\)

For example, if a trust has DNI of $15,000, distributes $10,000 currently, and also distributes $10,000 of other amounts from the second tier, the accumulation distribution of $5,000 is calculated as follows:\(^{117}\)

\[
\begin{align*}
(1) \quad \text{DNI} & \quad 15,000 \\
& \quad \text{Less: 1st tier distribution} \\
& \quad 10,000 \\
& \quad \hline \\
& \quad 5,000 \\
(2) \quad \text{Other amounts (2d tier)} & \quad 10,000 \\
& \quad \text{Less: DNI from Step 1} \\
& \quad 5,000 \\
& \quad \hline \\
& \quad \text{Accumulation Distribution} \quad 5,000
\end{align*}
\]

The definition of an "accumulation distribution" is broad and embraces the following cases:

a. Pour-Over Trusts. A distribution of accumulated income from one trust to another will be an accumulation distribution. For example,

\(^{114}\) [Footnote: CODE, § 661(a) (1).]

\(^{115}\) [Footnote: CODE, § 661(a) (2).]

\(^{116}\) [Footnote: CODE, § 665(b).]

upon the death of a widow, a testamentary trust for her benefit terminates and "pours-over" to three trusts, one for the benefit of each of her children. There is an accumulation distribution to each of the three trusts.\textsuperscript{118}

b. Trust for Minor. A distribution upon termination of a trust for a minor of income accumulated for his benefit will be an accumulation distribution.\textsuperscript{119}

c. Power of Withdrawal. Any beneficiary who may withdraw corpus of a trust established for his benefit, whether such a power is exercised or not, receives an accumulation distribution to the extent the beneficiary is taxed under §678(a)(1). For example, a widow will be deemed to have received an accumulation distribution in the amount of $5,000 in a year she can require the trustee to pay her $5,000 from corpus, even if she does not exercise the power that year.\textsuperscript{120}

d. Amounts Paid for Support. An accumulation distribution is made when amounts are paid out of corpus or out of principal other than income and used to discharge an obligation to support within the meaning of sections 677(b) and 678(c) or Regulation 1.662(a)-4.\textsuperscript{121} For example, a distribution in excess of current income from a trust established by a grandfather to pay for the necessities of his grandson is an accumulation distribution, taxable to the parent to the extent amounts other than current income are used for that purpose (and to the extent Reg. 1.662(a)-4 is valid).\textsuperscript{122}

e. Power of Appointment. Exercise of a power of appointment over accumulated income or corpus should produce an accumulation distribution.

f. Separate Shares. Section 663(c) of the Code establishes the mandatory rule that substantially separate and independent shares of different beneficiaries in a trust shall be treated as separate trusts. The Treasury will compute "undistributed net income" and "accumulation distribution" separately for each share.\textsuperscript{123}

Thus, a distribution to a beneficiary in excess of his current share of income will be an accumulation distribution even if the balance of overall trust income is accumulated.

Similarly, there will be an accumulation distribution upon termination of a separate share, except that there is not an accumulation distribution to the extent that such share is held for a successive interest or

\textsuperscript{122} Arguments that Treas. Reg. § 1.662(a)(4) is invalid can be found at Mannheimer, Sprinkling Trusts, 95 TRUSTS AND ESTATES 919 (1956).
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is added to the share of another beneficiary but not distributed by the trust.\(^{124}\)

There are, however, at least three important exceptions to the definition of an accumulation distribution:

First, an amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money, or out of specific property which is paid or credited in a lump sum or in not more than three installments is not an accumulation distribution\(^{125}\) because section 663(a)(1) specifically excludes such amounts from section 661(a). An accumulation distribution is not made, for example, when a trust accumulates income until a beneficiary reaches a certain age, then pays to the beneficiary a specific sum of money as defined by section 663(a)(1).

Secondly, a first tier distribution within the meaning of section 661(a)(1) which exceeds DNI is not an accumulation distribution. When an amount charged to corpus, either under the instrument or by state law, is deductible in full for federal income tax purposes, the trust accounting income required to be distributed by the trust instrument will exceed DNI. For example, pursuant to Wisconsin's version of the Uniform Principal and Income Act, and no trust provisions to the contrary, trustees' commissions are charged 75\% to income and 25\% to principal.\(^{126}\) For tax purposes, such commissions are often deductible in full against trust income. If trustees' commissions for the year are $1,000 and fully deductible and there are no other expenses for the year, trust accounting income for the year would exceed DNI by at least $250. A first tier distribution of all trust accounting income for the year will exceed DNI, by at least $250, but there will be no accumulation distribution because an accumulation distribution is only that amount by which second tier distributions exceed DNI.\(^{127}\)

Thirdly, an amount paid or set aside for charitable purposes is not an accumulation distribution even though no charitable deduction is allowed with respect to such payment.\(^{128}\)

Undistributed Net Income. If the trust has made an accumulation distribution, the throwback rule applies, and it is necessary to throwback the accumulation distribution to the first year the trust had undistributed net income ("UNI") to the extent of the UNI for that year, any balance of the accumulation distribution to be brought forward and


\(^{126}\) Wis. STAT. § 231.40(8)(c) (1969).

\(^{127}\) The relationship between trust accounting income, as determined by the instrument and state law and trust distributable net income, has importance in the capital gain distribution context considered later. For discussion of these differences, see Hinners, Tax Accounting Problems of Trustees, 47 MARQ. L. REV. 147 (1963).

applied against the UNI for the next succeeding years.\textsuperscript{129} This first-in, first-out method is contrary to the last-in, first-out method employed by the prior five year throwback rule which required an accumulation distribution to be thrown back in inverse order to the years the trust earned and retained income.\textsuperscript{130}

UNI for any year is the DNI for that year less the sum of first and second tier distributions for that year and the taxes imposed on the undistributed DNI for that year.\textsuperscript{131} The simplest of cases is one in which a trust accumulates all of its DNI. The UNI for that year is DNI less the taxes paid by the trust. If DNI is $10,000 and the taxes paid upon it are $2,000, the UNI for that year is $8,000.

If DNI is $10,000, current distributions $2,000, other (second tier) amounts distributed $2,000, and the tax on retained amounts $1,000, the UNI is calculated as follows:

<table>
<thead>
<tr>
<th>(1)</th>
<th>DNI</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st tier distribution</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>2nd tier distribution</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Remaining DNI</td>
<td>$ 6,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(2)</th>
<th>DNI</th>
<th>$ 6,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less tax on retained DNI</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>UNI</td>
<td>$ 5,000</td>
<td></td>
</tr>
</tbody>
</table>

Undistributed income for any year to which an accumulation distribution for a later year may be thrown back will be reduced by accumulation distributions in intervening years which are required to be thrown back to such year.\textsuperscript{132} For example, if a trust has UNI for 1975, and an accumulation distribution is made in 1980, the UNI for 1975 must be appropriately reduced by any accumulation distributions made in 1976 and 1977 thrown back to 1975.

As noted above, an accumulation distribution is normally carried back to the first year in which the trust had UNI. There are two major exceptions to this rule. First, if adequate records are not available to determine trust income, an accumulation distribution is “deemed” to consist of UNI earned during the earliest preceding taxable year of the trust in which it can be established that the trust existed after the effective date of the Tax Reform Act.\textsuperscript{133} This produces the maximum pos-

\textsuperscript{129} \textit{Code}, § 666 (a).
\textsuperscript{130} \textit{Code}, § 666 (a), before amendment.
\textsuperscript{131} \textit{Code}, § 665 (a).
\textsuperscript{133} \textit{Code}, § 665 (d).
sible tax. Assume that a trust established in 1970 does not accumulate income until 1957 and then accumulates income from 1975 through 1980 and distributes all of its accumulated income in 1981. The entire accumulation distribution made in 1981 will be thrown back in one lump sum to 1970, even though there was no accumulation in that year, unless the trustee has kept records that will permit the proper application of the throwback rules.

The Proposed Regulations vary this principle in a case where adequate records are available for some years and not for others. If the trustee can establish that the failure to produce adequate records is due to circumstances beyond his control or that of one of his predecessors, the accumulation distribution is allocated first to the year in which there are adequate records, and then to each subsequent year there are adequate records, with the balance allocated to the first year of the trust’s existence after the effective date of the Tax Reform Act and for which there are no adequate records. 134

Adequate records consist of the trust’s tax return, records required by section 6001 and all information affecting such years, such as adjustments resulting from audits. 135

The second major exception concerns the transitional rules providing for the change from the old throwback rules to the new unlimited throwback. The new rules are not fully effective until January 1, 1974. Distributions prior to January 1, 1974 of income accumulated prior to January 1, 1969 are subject to a five year throwback (except for 1969, on a first-in, first-out basis, however) and will not be taxed if they fall within any of the exceptions to the old throwback rules other than the 2,000 de minimis exception. 136 Amounts subject to the exclusions will reduce UNI for those years but the tax allocated to that portion of UNI will not be deemed distributed to the beneficiary. 137

Assume a trust on the calendar year basis established January 1, 1965 accumulates income for a minor and distributes all such income when the beneficiary attains the age of 21 on January 2, 1973. Because distributions prior to January 1, 1974 are subject to the old five year limitation, amounts deemed distributed to the minor from accumulations made in 1965 through 1967 are free from tax. The amount allocated to 1968 is within the old exception concerning distributions to a minor; it, too, is free from tax. The balance allocated to 1969, 1970, 1971, and 1972 is subject to the new throwback rule. 138 Thus, only the UNI of

trusts in existence for calendar year 1969 and thereafter will feel the impact of the new rules.

*Taxes Deemed Distributed.* A recipient of an accumulation distribution is also deemed to receive an additional amount equal to the taxes paid by the trust attributable to the undistributed net income for that year. If all the UNI for a particular year is deemed distributed, then the entire tax on the UNI for that year is deemed distributed.\(^{139}\)

For example, assume a trust has UNI of $8,000 in 1974 and taxes imposed on the trust attributable to the UNI are $3,000. During 1977 an accumulation distribution of $8,000 is made which is deemed to consist of income accumulated in 1974. The beneficiary is deemed to have received $11,000 distributed in 1974.

If the amount of the accumulation distribution thrown back to a preceding year is less than the undistributed net income for that year, the additional amount of taxes deemed distributed is a pro rata portion of the trust's income tax for that year. Thus, if one-third of the undistributed net income is deemed distributed, one-third of the tax on the undistributed net income for that year is deemed distributed. This is the result of an imposing statutory formula that requires the tax for the year in question to be multiplied by a fraction, the numerator of which is the accumulation distribution allocated to that year, and the denominator of which is the undistributed net income of the trust for the same year.\(^{140}\)

**Computation of Tax**

Once it is determined that a trust has made an accumulation distribution and once the accumulation distribution has been thrown back and applied against undistributed net income for the appropriate year, it is necessary to compute the tax payable by the beneficiary. Under prior law, the beneficiary computed his tax on the total amount distributed to him as the lesser of the tax due on the amount distributed as if it were income earned in that taxable year, or the tax that would have been due if the amount distributed to him had been distributed in the years to which they were actually thrown back.\(^{141}\) In effect, a beneficiary could elect to add the distribution to his other income in the year of receipt of the distribution if it was to his benefit—as it would be if the year of receipt was a low income year.

Beneficiaries of accumulation trusts no longer enjoy this option. Under the new rules, a beneficiary must compute his tax on the accumulation distribution as the lesser of an amount due under the "exact method" or the "short-cut method." In addition to this tax, the bene-

\(^{139}\) Code, § 666(b).

\(^{140}\) Code, § 666(c).

\(^{141}\) Code, § 668(A), before amendment.

\(^{142}\) Code, § 668(b)(1)(A).
ficiary must also pay the tax due on other income earned by him in the year of receipt of an accumulation distribution and any tax imposed by the capital gains throwback rule.

**Exact Method.** Under the exact method the tax on amounts of accumulated income (plus taxes deemed distributed) is the aggregate tax that would have been payable if the distribution (accumulated income plus tax) had actually been made on the last day of each preceding taxable year that the distribution is thrown back. For example, if a trust accumulates income in 1971 and distributes it in 1972, the beneficiary, pursuant to the exact method, must recompute his tax for 1971 by adding the accumulation distribution (plus taxes deemed distributed to him) to his other income in that year and calculate the tax that would have been due if he had received the accumulation distribution in 1971. This additional tax (after deduction for trust taxes paid in 1971) is entered on the beneficiary's 1972 tax return.

Important qualifications on the use of the exact method must be considered. The exact method is not available to, and the short-cut method must be used by, any taxpayer who cannot supply such information as the Regulations prescribe with respect to his income for each taxable year to which an accumulation distribution is thrown back.

With his return for the year of receipt of an accumulation distribution a beneficiary must file a statement showing gross income, adjustments, deductions, credits and taxes paid and any subsequent adjustments required by an audit, etc., for the year to which an accumulation distribution is thrown back.

In support of this statement the beneficiary must retain certain records. The statement is not subject to question if an income tax return (plus proof of later adjustments, if any) is filed for a year beyond the period of limitations on assessment established by section 6501. If the period of limitations has not expired, then the records required by section 6001 must be retained as proof of the items contained in the statement.

Finally, a trust beneficiary must prepare and keep a memorandum tax return beginning with the first year he has income, even though a return was not required to be filed.

**Short-cut Method.** The short-cut method is an income averaging device. In general, the taxpayer averages the tax attributable to a pro rata amount of accumulated income and taxes deemed distributed to him as if he had received those pro rata amounts in the three taxable years

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143 Code, § 668(b) (5) (A) and Proposed Treas. Reg. § 1.668(b)–4A(a) (2), 36 Fed. Reg. 2623 (1971).
146 Ibid.
preceding the distribution. He then determines the average additional tax for the three years and multiplies that sum by the years of the accumulation to determine the tax. The full computation involves three steps.

(a) Computation of the average annual income. The accumulation distribution is divided by the number of preceding years of the trust from which the distribution was deemed to have been made.\textsuperscript{148} Thus, if an accumulation of $10,000 is deemed accumulated over a ten year period, the average annual income is $1,000. A year is disregarded if the undistributed net income deemed distributed in any year is less than 25\% of the accumulation distribution divided by the total number of years to which it is allocated.\textsuperscript{149} In the example, if an amount less than $250 (25\% of $10,000 divided by 10) is attributed to one of the accumulation years, the computation is made on the basis of 9 years rather than 10. The purpose of this provision is to prevent accumulations of small amounts of income in anticipation of distribution of a large amount in the hope of averaging the distribution over a large number of accumulation years. This average amount consists of pro rata portions of each class of income making up the accumulation distribution.\textsuperscript{150}

(b) Computation of the average annual tax increase. Add the average annual income computed in Step 1 ($1,000 in the example) to the income of the beneficiary in each of the three years immediately preceding the year of the distribution, compute the additional tax payable in each such year, and divide by 3 to obtain the average annual tax increase.\textsuperscript{150a}

(c) Computation of the Tax. The average annual tax increase as computed in step 2 is then multiplied by the number of preceding taxable years of the trust from which the distribution was deemed to have been made (10 in the example). If in the computation of average annual income pursuant to Step 1, a year was disregarded because of a small accumulation that year, the average annual tax increase computed in Step 2 is multiplied by the reduced number of preceding years.\textsuperscript{151}

The short-cut method may not be used, and the exact method is required if any part of an accumulation distribution is deemed to have been distributed in a prior year in which any part of prior accumulation distributions by two or more other trusts have also been deemed distributed.\textsuperscript{152} This limitation is designed to prevent staggered

\textsuperscript{148} Code, \$ 668(b) (1) (B).
\textsuperscript{149} Code, \$ 668(b) (2) (C).
\textsuperscript{150} Proposed Treas. Reg. \$ 1.668(b)-1A(c) (1) (ii), 36 Fed. Reg. 2621 (1971).
\textsuperscript{150a} Proposed Treas. Reg. \$\$ 1.668(b)-1A(c) (1) (iii) and (iv), 36 Fed. Reg. 2621 (1971).
\textsuperscript{151} Code, \$ 668(b) (2) (C).
\textsuperscript{152} Code, \$ 668(b) (2) (B).
distributions every three years by multiple trusts so as to take unfair advantage of the short-cut rule.\textsuperscript{153}

It would not be proper, for example, to employ the short-cut method in the following situation. Assume that three trusts for the same beneficiary accumulate in 1975. Assume that in 1979 one of the trusts distributes the income accumulated in 1975 to its beneficiary. Assume that in 1982 and 1985 the other two trusts make accumulation distributions of income accumulated in 1970. It would be permissible for the beneficiary to use the short-cut method for the distributions made in 1979 and 1982. It would not be permissible to use the short-cut method for the distribution made in 1985. The beneficiary must instead use the exact method in 1985 so that at least some portion of the income accumulated for his benefit in 1975 will be taxed at 1975 rates.\textsuperscript{154}

A beneficiary may, however, use the short-cut method for accumulation distributions from only two trusts that are thrown back to the same year. In fact, he could use the exact method for distributions from one of the trusts and the short-cut method for the other, and he may choose in what order he is deemed to have received the accumulation distributions if they are made in the same year.\textsuperscript{155}

\textit{Rules Applicable to Both Exact and Short-Cut Methods}

A number of rules apply to both the exact and short-cut methods. In computing the partial tax on an accumulation distribution for any particular year, the beneficiary using either method of computation must include in his income, for of the each years involved, the income or capital gains previously deemed distributed in such years from prior accumulation distributions or capital gain distributions, whether from the same trust or not.\textsuperscript{156} For example, if a taxpayer received an accumulation distribution of $10,000 in 1975 of income deemed accumulated in 1972 and then in 1976 received an additional accumulation distribution of $5,000 from income deemed accumulated in 1972, he must include the $10,000 of the prior accumulation distribution in his income for that year if he chooses to use the exact method for the distribution made in 1976. Similarly, if the taxpayer employs the short-cut method to determine the partial tax on the accumulation distribution made in 1976, he must include in his income for each of the three years immediately preceding the distribution, the amount deemed distributed

\textsuperscript{154} See also Proposed Treas. Reg. \textsection 1.668(b)-1A(d), 36 Fed. Reg. 2622 (1971).
\textsuperscript{155} \textit{Code}, \textsection 668(b) (4).
\textsuperscript{156} \textit{Code}, \textsection 668(b) (3) (A) and Proposed Treas. Reg. \textsection 1.668(b)-2A (b), 36 Fed. Reg. 2622 (1971). Note that the beneficiary's income does not include capital gain distributions from the same trust for the same year. \textsection 668(b) (3) (B).
in such years from any prior accumulation distribution, whether from the same trust or not.\textsuperscript{157}

For beneficiaries not in existence on the last day of a trust year in which an amount is deemed accumulated (for example, a year in which income is accumulated for after born beneficiaries), it is assumed that the beneficiary is single, has no dependents, is entitled to the personal exemption, is on the calendar year, has no gross income other than that from other throw backs from other trusts to the same year, and has no deductions other than the standard deduction.\textsuperscript{158} The same assumptions apply to trusts and estates except that they get no standard deduction and are limited to the personal exemption provided by Section 642(b).\textsuperscript{158a}

A problem concerning errors in closed years and carry-overs and carry-backs in years involving computations for throwback years has been resolved by the Proposed Regulations. Assume that a beneficiary receives an accumulation distribution in 1980 deemed to consist of income accumulated in 1970, a year in which the beneficiary incorrectly computed his income. Will the throwback be computed on the basis of the beneficiary's return as filed, or on the basis of a corrected return for what will then be a closed year? The Regulations state that if the return "shows a mathematical error on its face," the computation will be based on the corrected return.\textsuperscript{159}

In addition, the income thrown back will increase the gross income basis used to calculate medical deductions and charitable contributions\textsuperscript{160} and will absorb more of the net operating loss carry-over or carry-back, charitable contribution carry-over or carry-back, and capital loss carry-over or carry-back than otherwise might have been used in that year.\textsuperscript{161}

If the short-cut method is not available because part of an accumulation distribution is deemed distributed to a beneficiary in a prior year in which prior accumulation distributions by two or more other trusts have been deemed distributed to him and the exact method is likewise not available because the beneficiary has not kept adequate records, the beneficiary's income will be determined by the Secretary "on the basis of information available to him."\textsuperscript{162}

\textbf{Credit for Trust Tax Paid.} The final computation required to determine a beneficiary's tax is that of the credit he receives for taxes paid

\textsuperscript{158a} Ibid.
\textsuperscript{162} \textit{Code}, § 668(b) (5) (B).
by the trust for the years in which the accumulation is deemed distributed. The credit is first allocated against the tax upon the accumulation distribution itself, then to the beneficiary's other tax liability for the year of receipt of the accumulation distribution, with any excess credit allowed as a refund. A credit is not allowed at all, however, with respect to taxes paid by a trust in years in which the beneficiary of the accumulation distribution was not in being.

Consequences of Throwbacks of Ordinary Income

**Tax problems.** The new rules are taxing in more ways than one. They are complex and demand great study.

The computations required by the rules will be arduous and expensive. The record keeping requirements will be burdensome, and questions will arise about trustee responsibility in this area. In fact, some trust companies are now retaining copies of all beneficiaries' tax returns and records substantiating itemized deductions.

**Simple Trusts.** There are additional problems created by the new act of a more substantive nature. Simple trusts will at some point be subject to the throwback rules. It is well known that a simple trust becomes a complex trust upon its termination, since at that point it distributes amounts in excess of income earned in the last year of its existence. Under the new throwback rules, when amounts in a simple trust are distributed in excess of DNI, there is an accumulation distribution and a throwback. Of course, the throwback rules have tax impact only when the simple trust has previous undistributed net income. This will occur when the trust receives taxable income allocated to corpus by the instrument or by local law.

For example, many trusts are funded from probate estates. Assets used to fund such trusts will often include estate DNI in the year of funding. The estate pays no tax on this estate DNI distributed, but the simple trust does. Thus, when the simple trust terminates, amounts distributed in excess of the final year's DNI will be thrown back to the first year of the trust's existence to the extent of the estate DNI used to fund it.

Ordinary income in respect of a decedent may be received by a simple trust and allocated by its terms to principal. Nothing in the Code excludes such income from DNI; therefore, the simple trust has undistributed net income for that year ultimately subject to a throwback.

Lump sum distributions from qualified plans attributable to employer contributions are often made payable to trusts so as to avoid estate tax pursuant to Sec. 2039(c). Prior to the Tax Reform Act, lump sum distributions...
distributions were treated as capital gain items and excluded from DNI to the extent that they were allocated to corpus.\textsuperscript{168} After the Tax Reform Act, a lump sum distribution attributable to employer contributions made in the calendar year 1970 and thereafter will be treated as ordinary income,\textsuperscript{169} and if that portion of a lump sum distribution is allocated to the principal of a simple trust, it will constitute undistributed net income ultimately subject to a throwback.

Receipts such as royalties from wasting assets are fully taxable as ordinary income.\textsuperscript{169a} However, the Wisconsin version of the Principal and Income Act does not specifically deal with receipts from wasting assets.

If this means that in the absence of trust provisions dealing with the question Wisconsin common law governs the issue, receipts from wasting receipts should generally be allocated to principal.\textsuperscript{170}

If either the trust instrument or Wisconsin decisions require royalties to be allocated to principal, the royalties will constitute undistributed net income ultimately subject to a throwback.

While extraordinary dividends and taxable stock dividends received by a simple trust and allocated to corpus in good faith by the trustee are excluded from DNI\textsuperscript{171} and are not treated as "income" within the meaning of Sec. 643(b),\textsuperscript{172} they suddenly become undistributed net income subject to a throwback in the year they are distributed.\textsuperscript{173}

Pour-Over Trusts. A number of problems vitally concern pour-over trusts. For example, if Trust A accumulates $100,000 over 10 years and distributes it to Trust B and Trust B distributes the $100,000 in the year following receipt, will the beneficiary of Trust B be forced to throwback the income to only the previous year, the year Trust B received it, or will be allowed to spread the income over the 10 years that it was actually accumulated by Trust A?

Proposed Treas. Reg. § 1.665(b)-1A(b)(1) states that if:

"... (i) A distribution is made from one trust to a second trust, and by the second trust to the ultimate beneficiary,

(ii) The second trust is serving as a conduit for distribution to the ultimate beneficiary, and

(iii) The purpose of such distribution is (a) to avoid the capital gain distribution provisions or (b) to avoid or mitigate the progressive rates of tax or the minimum tax by bunching income accumulated in several taxable years of the first trust into one taxable year of the second trust, the distribution shall be

\textsuperscript{168} \textsc{Code}, §§ 402(a)(2) and 643(a)(3).
\textsuperscript{169} \textsc{Code}, § 402(a)(5). The tax on the ordinary income portion is computed on a special averaging basis. See, § 72(n)(4).
\textsuperscript{169a} \textsc{Code}, § 61(a)(6) and Treas. Reg. § 1.61-(8)(a) (1957).
\textsuperscript{170} Estate of Walls 156 Wis. 294, 144 N.W. 174 (1913).
\textsuperscript{171} \textsc{Code}, § 643(a)(4).
deemed to be an accumulation distribution by the first trust to the ultimate beneficiary."

That the distribution from the second trust must be made to the ultimate beneficiary in the year of receipt by the second trust to meet the terms of the Proposed Regulation is supported by the idea embodied in the Proposed Regulation that the second trust’s distribution must have as a purpose the avoidance of either the capital gains “taint” or the higher rate of tax incident upon a bunching of income in one year. By delaying distribution for a year, the second trust will pay a tax on the bunched income in the year it received it; the distribution will not have avoided the capital gains “taint” or the progressive rates. Any unavoidable bunching is mitigated somewhat if the second trust has been in existence as long as the first trust and could then make use of the exact method to reduce significantly the tax payable by it or to obtain a refund.

A related problem confronting pour-over trusts concerns the credit for trust taxes paid available to the ultimate beneficiary. Assume that Trust B receives $100,000 from Trust A in 1980. If Trust B was funded with nominal amounts during the period Trust A accumulated income, or even if Trust B first came into existence in 1980, employment by Trust B of the exact or short-cut method might result in no taxes being paid by Trust B, and in some cases a refund. In either event, “no tax is imposed” on Trust B.

New Section 667(b) authorizes a credit to a trust beneficiary against his tax liability but only “in an amount equal to the amount of the taxes deemed distributed to such beneficiary by the trust . . .” Read literally, new Sec. 667(b) would deny the beneficiary of Trust B a credit based on taxes paid by Trust A. However, Proposed Treas. Reg. §1.665(b)-1A(b)(1), previously referred to, treats certain distributions from pour-over trusts as accumulation distributions to the ultimate beneficiary and should entitle any “ultimate beneficiary” within its terms to the credit for taxes paid by the first trust. Other beneficiaries may not receive the credit.

Separate Share Rule. The definition of accumulation distribution when combined with a failure to meet the tests of the separate share rule may inadvertently favor one beneficiary at the expense of another where a trust has more than one beneficiary. Thus, a trust that distributes portions of its assets chronologically as beneficiaries reach a certain age, for example, 21, will find that the first beneficiary attaining the age of 21 will receive an accumulation distribution which will either require him to pay a tax or entitle him to a refund, thereby treating him differently than the other beneficiaries.\(^\text{174}\)

**Tax Benefits.** The mere power to accumulate income does not trigger the imposition of a tax. An accumulation still defers without interest the additional amounts of tax otherwise payable by a beneficiary on a current distribution. Thus, the new rules should not deter a taxpayer from creating accumulation trusts for all the non-tax reasons that have always made them valuable devices.

**Low Bracket Beneficiary.** Trusts for low bracket taxpayers may be even more attractive now than they were previously. For example, assume that in 1969 a trust for a minor earned $10,000 of ordinary income and had no expenses. After the $100 exemption, the trust had $9,900 of taxable income. The tax, including surcharge, in 1969 on this income is $2,378. If, upon receipt of the trust assets when he attains the age of 21, the beneficiary uses the exact method to compute his tax and had no other income in 1969, he will receive taxable income of $8,400 ($10,000 less $1,000 standard deduction and $600 exemption). The tax on this amount is $1,916. But, in 1969 the trust paid $2,378. The beneficiary is entitled to a refund of $462 for that year. Potential refunds will increase as the new low income allowance and the new larger personal exemption available to individuals but not available to trusts, become fully effective.

Existence of the exact method of computing a beneficiary's tax encourages dispositions that will delay distributions of income to low-bracket taxpayers. Clearly, more tax benefits are available with respect to distributions to afterborn minors than to their high bracket parents.

**Choice of Exact and Short-Cut Method.** Existence of the exact and short-cut methods of computing a beneficiary's tax allows a taxpayer to choose years for a throwback computation that put him in the lowest bracket. The short-cut method is desirable when the 3 years immediately preceding the accumulation distribution are low bracket years. A retired individual may find the short-cut method advantageous. The exact method is desirable if the three years immediately preceding the accumulation distribution are high bracket years relative to the years the income was actually accumulated. An adult for whom income was accumulated while a minor may find the exact method advantageous.

**Distributions in Kind.** The basis of trust property in the hands of a trust beneficiary is its fair market value at the time it is distributed, to the extent such value is included in the gross income of the beneficiary. Thus, distributions in kind to trust beneficiaries should receive a step up in basis to the extent the property carries out accumulated ordinary income subject to the throwback rules. If such a distri-

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bution in kind is made to an appropriate beneficiary, a step-up in basis could be achieved along with a refund.

The tax consequences to the trust upon a distribution of appreciated property are somewhat undetermined. The Regulations provide that no gain or loss is realized by a trust or estate by reason of a distribution in kind unless the distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed.\textsuperscript{177}

The Commissioner may attempt to fit distributions in kind from accumulation trusts into the "specific dollar" mold. In the past, the Commissioner has successfully contended that satisfaction of a legacy or annuity by trust distributions of appreciated property created capital gains taxable to the trust.\textsuperscript{177a}

Or the Commissioner may employ the satisfaction of an obligation theory as he did in Rev. Rul. 67-74, 1967-1 CB 194, involving a trust requiring current distributions of income. In one year, although there was sufficient cash to fund the required distribution, the trustee and the beneficiary agreed that the required distribution should be made instead in stock that had appreciated in the hands of the trustee.

Without citing the Regulations, the Commissioner treated the transaction as if cash had first been distributed to the beneficiary, who in turn purchased the stock from the trustee. Accordingly, the trust received a deduction for the distribution and realized capital gain upon the fictional sale of the stock "equal to the difference between the basis of the stock and the amount of the obligation satisfied by the transfer." The beneficiary received ordinary income and a stepped up basis for the assets received.

Neither of the Commissioner's theories should apply to discretionary distributions in kind from accumulation trusts. The trustee of a truly discretionary trust is under no obligation to transfer any amount of income to a trust beneficiary; accordingly, no obligation is satisfied by distributions in kind from a discretionary trust. Furthermore, a discretionary distribution does not involve a specific dollar amount that can be determined by an established formula within the holdings of Eaton and Kenan.\textsuperscript{177b}

\textbf{Capital Gains Throwback Rule}

The Tax Reform Act introduced a new throwback rule in the case of capital gains. Since the capital gains throwback rules operate in a manner similar to those for ordinary income, the mechanics of those rules will be considered here only in a general way. A capital gain dis-

\textsuperscript{177} Treas. Reg. § 1.661-(a)-2(f) (1) (1956).
\textsuperscript{177a} Suisman v. Eaton, 15 F. Supp. 113, \textit{aff'd per curiam} 83 F.2d 1019 (2d Cir. 1936), \textit{cert. den.} 299 U.S. 573 (1936); W. R. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).
\textsuperscript{177b} Id.
tribution is that amount, to the extent of undistributed capital gain for such taxable year, that the portion of an accumulation distribution exceeds undistributed net income of the trust for all preceding taxable years.\footnote{178}{\texttt{CODE, \S\ 665(g).}}

Once it is determined that a capital gain distribution has been made it must be thrown back to the earliest year that there was undistributed capital gain.\footnote{179}{\texttt{CODE, \S\ 669(a).}} Undistributed capital gain is that amount for any taxable year of a trust beginning after December 31, 1968, that gains in excess of losses from the sale or exchange of capital assets (to the extent such gains are allocated to corpus and are not paid, credited, or required to be distributed to any beneficiary during such taxable year or paid, permanently set aside, or used for charitable purposes) exceed the amount of taxes imposed on the trust attributable to such gains.\footnote{180}{\texttt{CODE, \S\ 665(f).}}

The recipient of a capital gain distribution is also deemed to receive an additional amount equal to the taxes imposed on the trust and attributable to the undistributed capital gain.\footnote{181}{\texttt{CODE, \S\ 669(d).}} If, for example, the capital gain distribution thrown back to a preceding year is less than the undistributed capital gain for that year, a pro-rata portion of capital gains taxes is deemed distributed as an additional amount.\footnote{182}{\texttt{CODE, \S\ 669(b).}}

The character of the capital gain is the same in the hands of the beneficiary as it is in the hands of the trust.\footnote{183}{\texttt{CODE, \S\ 666(e).}}

Capital gains are taken into account separately in determining the additional tax payable by the beneficiary. The beneficiary may elect to compute his tax under either an exact method or a short-cut method similar to that for accumulations of ordinary income.\footnote{184}{\texttt{Proposed Treas. Regs. \S\ 1.669(b)-1A et. seq., 36 Fed. Reg. 2624 (1971).}} The Proposed Regulations also provide rules similar to those for accumulation distributions of ordinary income relative to situations in which the beneficiary was not in being in a prior year, relative to prior distributions to the same year from 2 or more other trusts, to minimum distributions in a prior year, to multiple distribution in the same year and to record keeping requirements, etc.\footnote{185}{\texttt{CODE, \S\ 669(a).}}

\textit{Trusts subject to the Rule.} The capital gains throwback rules do not apply to any trust so long as it distributes all of its income currently.\footnote{186}{\texttt{CODE, \S\ 668(a).}} Neither do they apply to a complex trust so long as the trust has always distributed all of its income currently.\footnote{187}{\texttt{CODE, \S\ 668(a).}}
Regardless of the date of its creation, any trust accumulating income after January 1, 1969 will attract the capital gains "taint". Because it is not always possible to determine how much accumulated income there is at the end of a taxable year, a trustee may elect to treat distributions or any portion of a distribution made within 65 days of the end of the trust's taxable year as distributions of accumulated ordinary income for the previous year.\textsuperscript{188} Thus trusts on the calendar year should have been examined by March 6, 1970, and again on March 6, 1971, to ascertain whether all accumulated income of those trusts should have been distributed to avoid attraction of the capital gains taint. A temporary regulation sets forth the rules and procedures for making an election under the 65 day rule.\textsuperscript{188} Note that an election must be made each year.

**Distributions Subject to the Rule.** The Tax Reform Act is not clear in all cases concerning how the capital gains throwback rule will be applied. For example, will the capital gains throwback rule apply to capital gains accumulated in years when the trust distributed all of its ordinary income but distributed after the trust began to accumulate ordinary income? Assume a trust created in 1970 distributes all of its ordinary income in the years 1970 through 1974 but accumulates capital gains in those years. Assume also that the trust accumulates ordinary income in the years 1976 and 1977 and distributes all of the previously accumulated capital gain in 1977. Will the capital gains throwback rule apply to capital gains deemed distributed in years 1970-1974? The Proposed Regulations concede the issue to the taxpayer by making it clear that a trust which accumulates trust income will be subject to the capital gains throwback rule beginning with the first year of accumulation, but not for any prior years.\textsuperscript{189}

The converse problem is presented by a trust which accumulates ordinary income for a period, ceases to accumulate ordinary income at a time it accumulates capital gains, and then distributes the accumulated capital gain. Will the throwback rule apply to capital gains realized and accumulated during periods in which ordinary income has not been accumulated?

Proposed Regulation 1.665(g)-1A states that "undistributed capital gain includes the total undistributed capital gain for all years of the trust beginning with the first taxable year beginning after December 31, 1968 in which income is accumulated . . ."

That the Regulation must be read literally so as to taint capital gains accumulated even after a trust ceases to accumulate income is supported

\textsuperscript{188} Code, § 663(b).
by the accompanying example in which a hypothetical trust made the following accumulations:

<table>
<thead>
<tr>
<th>Year</th>
<th>UNI</th>
<th>Undistributed Cap. Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>0</td>
<td>10,000</td>
</tr>
<tr>
<td>1970</td>
<td>1,000</td>
<td>3,000</td>
</tr>
<tr>
<td>1971</td>
<td>0</td>
<td>4,000</td>
</tr>
</tbody>
</table>

On December 31, 1972, the trustee distributes to the beneficiary $10,000 consisting, in part, of a capital gain distribution of $7,000. None of the $7,000 is allocated to 1969 (the trust had not yet begun to accumulate income), but $4,000 is allocated to 1971, a year in which no ordinary income was accumulated.

Because of an apparent drafting error, the capital gain throwback rules may be severely limited. Section 665(a) of the Code provides that the term "capital gain distribution" means the amount there described "to the extent of undistributed capital gain for such taxable year." The phrase "for such taxable year" refers to the year in which the capital gain distribution is made. A literal reading of this clause renders the capital gain throwback virtually meaningless. For example, assume a trust makes a capital gains distribution of $100,000 in 1975, a year in which the trust accumulates $50 of capital gain income. If the capital gain distribution is truly limited "to the extent of undistributed capital gain" for the year the capital gain distribution is made, the throwback rule will be limited to $50. In Proposed Regulation 1.665(g)-1A the Treasury seeks to "amend" the statute by defining undistributed capital gain for "such taxable year" (the distribution year) to include undistributed capital gains for all prior years in which (or following which) the trust accumulated income. The Treasury's position is supported by legislative history.191

The throwback rule applies only to capital gain distributions in the calendar year 1970 and thereafter.192 However, because of transitional rules, the new capital gain throwback rules do not apply to distributions made before January 1, 1972, to a beneficiary of a trust in existence on December 31, 1969 and in addition, for the same beneficiary, to distributions made prior to January 1, 1972, from a marital deduction trust.193 If a beneficiary receives distributions from more than one non-marital deduction trust before January 1, 1972, he may select the trust to which the transitional rule will apply.194

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192 CODE, § 665(e) (1) (C).
193 TRA Sec. 331 (d) (2) (C).
194 Ibid.
Consequences of Capital Gain Rules

The new capital gain throwback rules do not create any tax benefits. Imposition of a new tax where none existed previously can only create problems for trustees and beneficiaries.

Every year a trustee must decide, for example, whether he should distribute all accumulated ordinary income so as to avoid the capital gains taint. The "income" to be distributed is defined by the instrument and by state law.\(^{195}\) Trustees must realize that distributing net income each year may not be sufficient to avoid the capital gains taint because trust accounting income may, in many cases, exceed distributable net income for the year.

For example, it was noted previously that, no trust provision to the contrary, commissions under the Wisconsin version of the Uniform Principal and Income Act must be charged 75% to trust income and 25% to corpus; whereas it is often the case that 100% of the trustees' commissions may be deducted from trust income for tax purposes. The 25% of trustee commissions not charged to trust accounting income must be distributed currently to income beneficiaries if the capital gains taint is to be avoided.

The trustee will have similar problems characterizing items of income for trust accounting and tax purposes. For example, no trust provisions to the contrary, all dividends are allocated to income under the Wisconsin version of the Uniform Principal and Income Act.\(^{196}\) However, for tax purposes, dividends are taxable only if they are paid from a corporation's earnings and profits.\(^{197}\) If dividends are not out of earnings and profits, trust accounting income will exceed DNI. All dividends, therefore, must be distributed to income beneficiaries if the capital gains taint is to be avoided.

Pursuant to the Wisconsin version of the Uniform Principal and Income Act, the trustee must, with respect to bonds (such as Series E Bonds) issued at a discount and subject to a definite appreciation in value on a fixed schedule, allocate each increment of appreciation to income on each date the increment occurs.\(^{198}\) For tax purposes, a trustee may treat the increments of appreciation on a Series E Bond as income received in the year of redemption or maturity, or he may elect to report each increment of appreciation as income in the year it occurs.\(^{199}\) Whether or not the trustee makes the election for tax purposes, the trust must distribute the annual increment which is deemed income for trust accounting purposes if the capital gains taint is to be avoided.

\(^{195}\) **Code**, § 643(b).

\(^{196}\) **Wis. Stat.** § 231.40(3) (a) (1969).

\(^{197}\) **Code**, § 316(a).


\(^{199}\) **Code**, § 454.
At times a trustee will be unable to determine with certainty whether items of income or expense should be allocated to principal or income. Theoretically, an expense that should have been allocated to corpus by a trustee, but was in fact erroneously charged to trust accounting income would reduce the income that should have been distributed so as to avoid capital gains taint. There are indications that the IRS will apply a "good faith rule", thereby permitting the avoidance of taint if a reasonable effort is made to distribute all income currently even though, for example, an expense is subsequently capitalized. The Proposed Regulations, as issued, omitted such a provision however.

In many cases, trustees are given discretion by the trust instrument to allocate items of expense or income to principal or income as they see fit. Section 2 of the Wisconsin Uniform Principal and Income Act specifically permits such discretionary provisions. The provisions in the Uniform Act allocating items of income and expense apply only in the absence of trust provisions to the contrary. Nevertheless, the Wisconsin Supreme Court in Will of Clarenbach apparently gutted this section of the Uniform Act when it held that, despite the discretion conferred by a trust instrument, the trustees, who were also income beneficiaries, could not allocate a capital gain item to income.

Hopefully, the case will be interpreted in the future as one of abuse of discretion by trustees. However, there are unfortunate statements in the opinion that the discretion conferred by the trust instrument there involved meant only that the trustee could determine in good faith whether any particular receipt of a trust is income or principal from an accounting standpoint.

In view of Clarenbach, a trustee's discretion to allocate items to income or principal may be illusory. To be sure of safely avoiding the capital gains taint, trustees may decide to distribute all trust income "from an accounting standpoint."

When the Tax Reform Act became law, no one ever considered that what was not "income" under local law could ever be accumulated so as to "taint" capital gains. Nevertheless, the Treasury envisions this possibility. Proposed Regulation §1.668(a)-1A(c) provides that since for purposes of Section 668(a)(3):

"... certain items may be included in distributable net income but are not under applicable local law 'income' ..., a trust which has undistributed net income from such sources might still...

200a 23 Wis. 2d 71, 126 N.W. 2d 614 (1964).
201 Id. at 74 and see, Discretion of Trustees to Allocate Receipts as Income or Principal, 1965 Wis. L. Rev. 391, 393 (1965).
qualify as a trust which has not accumulated income." (Emphasis supplied).

In Wisconsin, royalties from wasting assets could be such an item. The inference that an item that must by law be allocated to corpus could taint capital gains improperly mixes up the concept of "income" as it is used in Section 643(b) of the Code with the tax concept of DNI.

Trustees may avoid tax on tainted gains by making distributions of capital gain accumulations prior to January 1, 1972, the end of the transitional rules, and may avoid the taint altogether either by: always distributing trust income annually; realizing capital gains early in the trust's existence and before income is accumulated so that a distribution of the capital gain item can be made subsequently, even after accumulations of ordinary income; or retaining capital assets until termination of the trust. In view of the alternative tax applicable to long term capital gains, the tax impact of the capital gain throwback will be relatively minimal in many cases.

VII. TRUSTS FOR SPOUSE

Prior to the Tax Reform Act, trusts for a spouse were valuable income splitting devices. While a husband could not escape tax on income paid or accumulated for his benefit from a trust created by himself, he could accomplish much the same thing by creating a trust for his wife lasting for more than 10 years, accumulating the income, and distributing the accumulation at the trust's termination. The trust paid the taxes on the income earned during the 10 years and the accumulation was distributed without further tax to the wife in accordance with the termination exception to the old five-year throwback rule.

The new rules treat husband and wife as an economic unit. The word 'grantor' in Section 677 has been amended to read "grantor or grantor's spouse," and the grantor of a trust accumulating income for his wife's benefit is taxed on the trust income as earned, even though it is unavailable to him to pay the tax.

A grantor is not taxed on the income of a trust which is taxable to his spouse under any other provision of the Code; for example, see §71 relating to alimony and separate maintenance payments or §682 relating to income of an estate or trust in case of divorce.

The scope of new Section 677 is wide. The grantor will be taxed on trust income that may be paid to any one of a group of beneficiaries, including the grantor's spouse, and he will be taxed on corpus income,

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202 CODE, § 677.
204 CODE, § 677.
such as capital gains, ultimately intended for his spouse, even though someone else receives current trust income.\textsuperscript{206}

The new rules apply to trusts created for a spouse after October 9, 1969, and to all transfers of property into existing trusts for a spouse after October 9, 1969.\textsuperscript{207}

Trusts for a spouse in existence on October 9, 1969 required to accumulate income will be subject to the new accumulation rules. When the accumulation is distributed to the spouse upon termination of such a trust, the distribution will be subject to a throwback except to the extent that the final distribution is made prior to January 1, 1974, and the transitional rules apply.

\textbf{VIII. SALES OF TERM INTERESTS}

Prior to the Tax Reform Act, an individual owning an income interest in a trust received by gift, bequest, or inheritance could not amortize his basis over the term of his interest.\textsuperscript{208} However, by selling his income interest, the trust beneficiary could reduce his gain by the basis he had in the interest and treat the proceeds as capital gain.\textsuperscript{209} The purchaser of the interest could amortize the purchase price over the remaining term of the interest.

Newly added Section 1001(e) is designed to deny this double tax benefit by providing that the sale of an income interest in a trust (or any term interest) may not be reduced by the adjusted basis of such an interest determined pursuant to Section 1014 or 1015.

New Section 1001(e) may have produced a case of disappearing basis. It is not clear what happens to the basis of the seller of a trust income interest that cannot be used to reduce his gain. One commentator suggests that it will be picked up by the remainderman.\textsuperscript{210}

Section 1001(e) does not affect the sale by a remainderman of his interest, a resale by the purchaser from the seller of the income interest, nor a sale where both the owner of the income interest and the remainderman simultaneously sell their interests to the same person or persons.

\begin{footnotesize}
\begin{enumerate}
\item TRA Sec. 332 (b).
\item Code, § 273.
\item McAllister v. Comm. 157 F.2d (2d Cir. 1946) \textit{cert. den.}, 330 U.S. 826 (1947).
\end{enumerate}
\end{footnotesize}