

Taxation: Amendments to the Clifford Regulations

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TAXATION—AMENDMENTS TO THE CLIFFORD REGULATIONS

Trusts have been in existence as a device for the disposition of property long before the impact of federal taxes, and although they do lend themselves to tax avoidance, there is nothing inherently suspect in the trust. Some realization of the bona fides of the many trust dispositions is slowly finding recognition and is apparent in the new Clifford Regulations.

Early legislative efforts to handle the tax avoidance problems of trust income were based on the theory that if the grantor had the right to get back the income or corpus, he was the owner of the income and properly taxable thereon.¹ This limited concept has been greatly broadened in recent years. Since the *Horst* case² the concept of income ownership has been defined as the power to dispose, the theory being that it may be more important to a wealthy grantor to be able to designate who shall receive the income than to have the power to collect himself. Such a concept naturally affects many normal trust powers, such as powers of accumulation, apportionment, and encroachment. The *Clifford* case³ further broadened the concept of income ownership by including the factors of retained administrative control and temporary short term disposition. This broadening of the legislative concepts of I.R.C. Sections 166 and 167 was achieved by judicial interpretation of I.R.C. Section 22(a) which actually says little or nothing on the subject.

In the *Clifford* case the grantor irrevocably transferred certain property to himself as trustee for five years, with income payable to his wife. The trust corpus was to revert to the grantor on termination of the trust. During the trust term the grantor had broad administrative powers and could pay out the income to his wife or accumulate the income for her benefit. Under these facts the grantor was held to be the owner of the trust income. In determining this ownership, the Supreme Court applied a combination of the three following factors: short duration of the trust, allocation of the income within an intimate family group and substantial administrative controls in the grantor. Mr. Justice Douglas emphasized this combination of factors approach by stating in his decision, "Our point here is that no one factor is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership . . ." ⁴

After many decisions in which the courts attempted to apply the Clifford doctrine, the Commissioner entered the picture and did some

¹ Sec. 166 and 167, Internal Revenue Code of 1939, as amended.

² *Helvering v. Horst*, 311 U.S. 112, 85 L.Ed. 75, 61 S.Ct. 144, (1941).

³ *Helvering v. Clifford*, 309 U.S. 331, 84 L.Ed. 788, 60 S.Ct. 139, (1940).

⁴ *Ibid.*, 309 U.S. at p. 336.

legislating of his own in the form of the Clifford Regulations.⁵ In attempting to set up more definite standards, the Commissioner at first blush appears not to have considered the fact that the Clifford decision was based upon a combination of factors. The Regulations gave independent significance to three grounds, any one of which would suffice to tax the grantor on the trust income. Only two of these, short duration of the trust and administrative powers in the grantor, were derived from the *Clifford* case. The third ground, power to control enjoyment of the trust income, is traceable directly to the *Horst* case.⁶ The element of the "intimate family group";⁷ one of the prime factors used by the Supreme Court, was disregarded in the Regulations.

No definite theory of taxation seems to have been followed by the Commissioner in the Regulations. When it is remembered that the essential problem is one of ownership, the approach of the Commissioner seems almost undirected by basic theory and presents a multitude of conditions, circumstances and factual situations under which the grantor is held to be the owner of the trust income. Out of the intricate maze of the original Regulations one truth clearly appeared: the Regulations did not allow sufficient flexibility for normal trust operation. Grantors contemplating a trust found it necessary to weigh the tax avoidance possibilities against those things which, though essential to a trust, would result in taxation under the Regulations.

This situation has been remedied somewhat by the recent amendments to the Clifford Regulations.⁸ It is impossible to discuss these new Regulations by accurate generalities and any attempt to discuss them in detail requires almost a reprint of the actual changes themselves. Only general observations are attempted here. All of the changes made by the Commissioner would seem to benefit the taxpayer, by allowing for broader administrative powers and greater flexibility in the management of family trusts.

⁵ Regulations 111, Sec. 29.22(a)-21, as added by Treasury Decision 5488, (Dec. 29, 1945). Prentice-Hall Federal Tax Service, Par. 15, 312. Commerce Clearing House Tax Service, Par. 86A. Mertens, Law of Federal Income Taxation, Vol. 6, Sec. 37.17. 1947 Cumulative Supplement. Guterman, "The New Clifford Regulations." 1 Tax L.R. 379, (1946). Smith, "How the New Regulations Affect the Clifford Case," 24 Tax Mag. 624, (1946).

⁶ See supra, note 2.

⁷ "We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not affect any substantial change in his economic position." *Helvering v. Clifford*, 309 U.S. 331, p. 335.

⁸ Reg. 111, Sec. 29.22(a)-21, as amended by T.D. 5567, (June 30, 1947); P-H Par. 15, 312; CCH Par. 86A.

REVERSIONARY INTEREST AFTER A SHORT TERM

Under the original Regulations the income of a trust with a duration of ten years or less was automatically taxable to the grantor and the income of trusts with a duration from ten to fifteen years was taxable to the grantor if he or his spouse held designated administrative powers.⁹ In determining the duration of the trust the Regulations provided that if the corpus of a trust was to return to the grantor on the death of a person whose life expectancy was less than ten years (or fifteen as the case might be) then it was within the taxable range.¹⁰

The new amendments provide that a trust created to last for the life of an income beneficiary is not taxable, regardless of life expectancy. This change seems beneficial to the taxpayer and may foster the creation of "grandmother trusts", provided always that she is an income beneficiary in some amount. The amended regulations also allow the spouse of the grantor, if she has a substantial adverse interest, to hold the designated administrative powers in a ten to fifteen year trust, which if held by the grantor would render him taxable. Apparently if the grantor held such powers conjunctively¹¹ with his spouse having a substantial adverse interest he would nonetheless be taxable.

POWERS TO CONTROL BENEFICIAL ENJOYMENT OF INCOME OR CORPUS

The original Regulations subjected the independent trustee to the same restrictions as a grantor-trustee regarding the powers to accumulate income and encroach upon the corpus.¹² The only concession made to the independent trustee was the power to apportion income subject to some reasonably definite external standard susceptible of enforcement by a court of equity.

⁹ "A power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property, whether or not of an equivalent value." Reg. 111, 29.22(a)-21 (c) (2).

¹⁰ The original Regulations included the following example: "For example, a grantor is taxable on the income of a trust if the corpus is to return to him or his estate on the death of a person whose life expectancy is six years at the date of the transfer in trust." Reg. 111, 29.22(a)-21 (c).

¹¹ "if one or more of the following powers of administration . . . are exercisable solely by the grantor, or spouse . . . not having a substantial adverse interest . . . or both . . ." Reg. 111, 29.22(a)-21(c). Compare with "Where the power to revert in the grantor . . . is vested in the grantor, either alone or in conjunction with any person not having a substantial adverse interest . . ." I.R.C. Sec. 166(1).

¹² The original Regulations did not tax a power to accumulate for a current income beneficiary, provided the income was ultimately payable to such beneficiary. A power to pay out corpus was not taxable if the power was subject to an external standard or if the amount paid was chargeable against the beneficiary's share of the corpus. Sec. 29.22(a)-21(d) (3), (4).

Under the amended Regulations, the independent trustee is free to exercise unlimited powers to accumulate, encroach and apportion.¹³ This appears to be an important concession to our trust companies, adding the advantage of tax insulation to their other trust services. Other trustees,¹⁴ including the grantor, may enjoy the power to accumulate if the accumulated income is ultimately payable to the beneficiary, or his appointees under an unrestricted power of appointment. This power of appointment would seem to be limited to a power such as would be taxable under I.R.C. 811(f) of the estate tax. Other trustees may enjoy the power to pay out corpus to the current income beneficiary if it is ultimately chargeable against his share of the trust, or if such power is limited by a reasonably definite external standard.¹⁵ Corpus may now be paid out to remaindermen if limited by an external standard. Income may be apportioned among a class of beneficiaries by a trustee other than the grantor or his spouse, if the power is limited by an external standard.¹⁶ Requirements for an external standard have been eased and the standard need not be susceptible of enforcement by a court of equity as was required in the old Regulations.

ADMINISTRATIVE CONTROL

One of the major factors making for taxability under the *Clifford* case was the broad administrative powers held by the grantor as trustee. The original Regulations provided for certain broad administrative powers which could be held by any person (including the grantor) in a fiduciary capacity.¹⁷ The holding of such powers as a trustee was presumed to be fiduciary. A further concession is now made by the new Regulations by eliminating the presumption that such powers held by any person other than a trustee are held in a non-fiduciary capacity. This places upon the Commissioner the burden of showing more than the mere possession of administrative powers by a non-trustee.

Borrowing from the trust corpus or income by the grantor is now possible, if security and interest are adequate,¹⁸ but it will still be

¹³ The amended Regulations define an independent trustee as: "a trustee or trustees, none of whom is the grantor, spouse living with the grantor, or a related or subordinate trustee . . ." Sec. 29.22(a)-21(d)(3), as amended by T.D. 5567, (June 30, 1947).

¹⁴ The amendments go into detail describing the various classes of persons who may hold these powers, but after analysis it would seem that the list is unrestricted and includes everyone except the independent trustee. Sec. 29.22(a)-21(d)(4), as amended by T.D. 5567, (June 30, 1947).

¹⁵ Sec. 29.22(a)-21(d)(4)(aa), (bb), as amended by T.D. 5567.

¹⁶ *Ibid.*, (d)(4)(ec).

¹⁷ See *supra*, note 9.

¹⁸ The original Regulations provided that a grantor could not borrow from the trust income or corpus, "whether with or without adequate security or interest." Sec. 29.22(a)-21(e)(2).

necessary to repay the loan within the tax year as was previously provided. An exception in the amended Regulations¹⁹ allows an independent trustee to loan to the grantor without adequate security, if he is authorized under a general lending power to make loans generally to other persons as well, upon the same terms.

In general the amendments to the Clifford Regulations offer relief to the taxpayer and remove some of the more bothersome restrictions which have hampered the creation of trusts and trust operation.

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¹⁹ *Ibid.*