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REGULATION OF MULTIPLE TRUSTS — THE NEED FOR NEW TAX LEGISLATION

by Arthur W. Zeitler

Since the enactment of a sharply progressive surtax, multiple trusts have been a principal method of reducing income taxes due to two tax advantages in the creation of such trusts. The first is the multiplication of the personal exemption for trusts. Since the reduction of the personal exemption available for accumulative trusts to \$100,¹ this aspect of tax avoidance has become relatively unimportant. Much more important is the opportunity to accumulate income at reduced rates by the use of a number of trusts. The Treasury Department seems to have no objection to income accumulations in separate trusts for separate beneficiaries in situations where, aside from tax considerations, separate shares in a single trust would serve as well.² On the other hand, the splitting of income by means of creating a number of accumulation trusts for the same beneficiary has concerned the Treasury Department for a number of years.³ In addition to the tax advantages there are many valid nontax reasons for the use of multiple trusts.⁴ Because such trusts are highly valuable estate planning devices, Congress has been hesitant to prohibit them altogether despite the frequently occurring tax avoidance abuses. The difficulty has been in drafting legislation that would be broad enough to control such abuses without encroaching on the legitimate uses of multiple trusts.

Although the Internal Revenue Service has attempted, in the absence of adequate legislation, to establish a judicial standard to correct the often occurring abuses in the field of multiple trusts,⁵ efforts in this direction have been substantially hindered by the recent tax court decision in *Estelle Morris Trusts*.⁶ In this decision, the tax court refused to adopt any of the

¹ INT. REV. CODE OF 1954, § 642(b).

² Treas. Reg. § 1.6012-3(a)(4) (1961). See generally INT. REV. CODE OF 1954, §§ 665-68.

³ The Treasury Department has proposed corrective legislation. See ADVISORY GROUP ON SUBCHAPTER J, 85TH CONG., 2D SESS., FINAL REPORT ON ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS 9 (Comm. Print 1958). The Treasury has also litigated the issue in several instances. See *Boyce v. United States*, 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961); *Sence v. United States*, 394 F.2d 842 (Ct. Cl. 1968); *Estelle Morris Trusts*, 51 T.C. 20 (1968); *James S. Reid Trust*, 6 T.C. 438 (1946); *Charles S. Davis*, 37 B.T.A. 587 (1938).

The use of multiple trusts can reduce the actual tax paid by a substantial percentage. For instance, a single taxpayer with no dependents receiving \$100,000 per year from personal services and \$100,000 ordinary income from investments pays approximately \$156,000 in taxes at present rates. If all of the investment property were transferred and taxed to a single trust, the saving would be approximately \$22,000 per year. The use of ten trusts, however, would save an additional \$41,000. See INT. REV. CODE OF 1954, § 642(b).

⁴ One nontax reason for use of separate trusts is that the settlor may wish to select different trustees to manage certain types of assets or investments. A second reason is that the grantor may wish to establish one trust for maintenance and another for education with each having separate fiduciaries. Furthermore, the settlor may also want A to be remainderman in one trust and B remainderman in a second trust, even though the principal beneficiary may be identical in both instances.

⁵ Most of the "loopholes" in the multiple trust area have not been litigated. See generally H. HARRIS, FAMILY ESTATE PLANNING GUIDE 110 (1957); 2 J. LASSER, ESTATE TAX TECHNIQUES 1562 (1961); Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402 (1956).

⁶ 51 T.C. 20 (1968).

regulative judicial standards used in other areas of tax law,⁷ and stated that Congress and not the courts should fashion the rules needed to regulate multiple trusts. The decision in *Morris* clearly indicates the need for new and effective tax legislation in the field of multiple trusts.

The purpose of this Comment is to trace the historical development of multiple trust regulation, including the important decision in *Estelle Morris Trusts*, and to analyze what type of multiple trust tax legislation would best solve the complex problems involved.

I. JUDICIAL MULTIPLE TRUST STANDARDS

In response to the failure of Congress to enact adequate legislation,⁸ several tests have been used by the courts to determine whether multiple trusts would be ignored for income tax purposes. Until recently, the "four corners-intent" test was the only test effectively applied against multiple trusts; however, the "close scrutiny" test is now being used by several courts. In addition, a "principal purpose" test has been proposed by the Treasury Department but has never been adopted by the courts.

The Four Corners-Intent Test. Nearly all tax cases in the multiple trust field have concerned, to a greater or lesser degree, the problem of intent. This issue is ordinarily resolved by a determination of the grantor's intent as evidenced by the writing contained within the four corners of the trust instrument.⁹ If it appears from the trust instrument that the grantor actually intended to create multiple trusts, then the intent is upheld by the court. This "four corners-intent" approach occupied the attention of the taxpayer, the Internal Revenue Service, and the courts for almost thirty years.¹⁰

The application of this test by the courts has been ambiguous and at times inconsistent. The settlor generally must have intended to set up multiple trusts and in fact must have done so with the forms prescribed by local property law.¹¹ The intent to create multiple trusts can be proven even though there is only a single instrument and the physical assets placed

⁷ *Id.* at 43.

⁸ Congress has failed to pass a statute dealing with the problems of multiple trusts because of a great diversity of opinion as to what measures, if any, should be taken to correct the situation. See *Hearings on H.R. 9662 Before the Senate Finance Committee*, 86th Cong., 2d Sess. 116, 120, 143-44, 147-48, 151-52, 165-69, 175-77, 194-98, 208 (1960).

⁹ Evidence as to the number of trusts intended to be created is usually admitted by the courts in the following order: (1) the one or several trust instruments; (2) where the instruments are ambiguous, the trustee can testify as to how the trusts are administered; (3) testimony of the grantor. If the instrument clearly provides for a single trust, the grantor will not be permitted to change by testimony what he has otherwise created. See *William T. Belcher*, 6 CCH TAX CT. REP. 967 (1947).

¹⁰ See *United States Trust Co. v. Commissioner*, 296 U.S. 481 (1936); *Commissioner v. McIlvaine*, 78 F.2d 787 (7th Cir. 1935), *aff'd*, 296 U.S. 488 (1936); *Wynne v. Commissioner*, 77 F.2d 473 (5th Cir. 1935); *Lynchburg Trust & Sav. Bank v. Commissioner*, 68 F.2d 356 (4th Cir.), *cert. denied*, 292 U.S. 640 (1934); *State Sav. Loan & Trust Co. v. Commissioner*, 63 F.2d 482 (7th Cir. 1933); *Kohtz Family Trust*, 5 T.C. 554 (1945); *Balter, Major Tax Savings for Family in Use of Family Partnership Plus Multiple Trusts*, 5 J. TAXATION 212, 216 (1950). *But see* *Fred W. Smith*, 25 T.C. 143 (1955). See generally 1 A. SCOTT, TRUSTS §§ 23-26 (2d ed. 1956).

¹¹ *United States Trust Co. v. Commissioner*, 296 U.S. 481 (1936); *McHarg v. Fitzpatrick*, 210 F.2d 792 (2d Cir. 1954); *Commissioner v. McIlvaine*, 78 F.2d 787 (7th Cir. 1935), *aff'd*, 296 U.S. 488 (1936); *State Sav. Loan & Trust Co. v. Commissioner*, 63 F.2d 482 (7th Cir. 1933).

in trust are not segregated.¹² In addition, multiple trusts can exist where there is an undivided interest in a common fund.¹³ Although the use of separate instruments tends to clarify the trustor's intent, it does not guarantee multiple trust treatment. The use of single or plural words may have a significant bearing on the court's construction of the trustor's intent. In *MacManus v. Commissioner*¹⁴ the Sixth Circuit held that even though there was only one capital account, the settlor did not necessarily intend only one trust. The court emphasized that the grantor, in instructing his trustee regarding the management of the corpus and the income, had referred to the word "trusts" twenty times and the word "trust" only once.

However, the use of singular or plural words is only one factor utilized by the courts in determining the intent of the grantor. In *Kobtz Family Trust*¹⁵ the tax court held that although the word "trust" was used more often than the plural "trusts," there were numerous other indications that the grantor intended to create multiple trusts. One factor which has often been held to be important is the presence or absence in the trust instrument of directions by the grantor to the trustee to keep a separate fund for each beneficiary.¹⁶ Provisions in the instrument requiring the trustees to keep separate and independent accounts and file separate and independent income tax returns have also been held to indicate an intent to create multiple trusts.¹⁷

Close Scrutiny Test. In the 1961 case of *Boyce v. United States*,¹⁸ the right of a taxpayer to receive tax benefits from the creation of separate but identical trusts was first placed before a court. In *Boyce* ninety trust indentures of identical language were created. The settlor gave the trustee ninety checks payable to the trustee in the total sum of \$17,740. On the same day, the trustee gave to the settlor ninety checks drawn on his account as trustee in the same amounts as those given by the settlor to the trustee. The next day, in consideration for the \$17,740 given him by the trustee, the settlor conveyed title to certain land and buildings to the trustee for the benefit of the ninety trusts. One of the buildings was then leased back to the settlor. The settlor's son was to be the single, ultimate beneficiary of all ninety of the trusts. In the ensuing litigation the taxpayer stated that the sole purpose in attempting to create the ninety trusts was to avoid income taxes by dividing the income from the trust properties.¹⁹ The Court of Appeals for the Fifth Circuit affirmed the trial

¹² *McGinley v. Commissioner*, 80 F.2d 692 (9th Cir. 1935); *James S. Reid Trust*, 6 T.C. 438 (1946).

¹³ *United States Trust Co. v. Commissioner*, 296 U.S. 481 (1936).

¹⁴ 131 F.2d 670 (6th Cir. 1942).

¹⁵ 5 T.C. 554 (1945). See also *Lynchburg Trust & Sav. Bank v. Commissioner*, 68 F.2d 356 (4th Cir.), cert. denied, 292 U.S. 640 (1934).

¹⁶ See, e.g., *Charles S. Davis*, 37 B.T.A. 587 (1938).

¹⁷ *Fiduciary Trust Co. v. United States*, 36 F. Supp. 653 (S.D.N.Y. 1940); *Helms Bakeries*, 46 B.T.A. 308 (1942). For a more thorough discussion of the "intent test" see Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402 (1956).

¹⁸ 190 F. Supp. 950 (W.D. La.), aff'd per curiam, 296 F.2d 731 (5th Cir. 1961).

¹⁹ *Id.* at 952.

court's holding that, on the basis of the facts, only one trust was created.²⁰

There was no evidence in *Boyce* that the settlor had failed to comply with the requirements of the "four corners-intent" test.²¹ However, the court pointed out that the application of the "intent test" was limited to cases involving separate beneficiaries of separate trusts or a single beneficiary of only two trusts.²² The court then stated that where the "intent test" is inapplicable, "close scrutiny"²³ must be given transactions involving multiple trusts. Under "close scrutiny," if the transactions are found to be a mockery of the tax laws, the form will be ignored for income tax purposes.²⁴ The court in *Boyce*, however, enunciated no criterion for determining what constitutes a mockery of the tax laws. For example, it was not clear from *Boyce* whether a series of trusts with the same beneficiary, *carefully administered as separate entities*, would be consolidated for income tax purposes.²⁵

The trial court emphasized two well established criteria for determining when it would examine the creation and administration of trusts with "close scrutiny" to decide whether or not separate trusts were in fact created. The first of these indicators involves the situation in which a taxpayer boldly proclaims that his intent in creating a trust is tax evasion. The courts will examine the forms used for the accomplishment of such a purpose with care. If the taxpayer's ingenuity fails, the courts will not aid him by resolving doubts in his favor.²⁶ The second indicator leading to "close scrutiny" by the courts is any transaction involving close family relationships.²⁷

Principal Purpose Test. In *Sence v. United States*²⁸ the court of claims further confused the question of the proper test for determining the existence of multiple trusts. In 1953, nineteen declarations of trust were executed by Sence and his wife with their grandson as the primary income beneficiary of each trust. In their important aspects all the trusts were sub-

²⁰ *Id.* at 958. The taxpayer loses not only future tax savings, but also can not recoup his initial expenses incurred in creating such trusts, keeping separate accounts, or filing separate tax returns.

²¹ The trustee insisted that the existence of separate trusts was to be determined solely on the basis of the "intent test" and that, therefore, the actions of the trustee and the tax avoidance motive of the settlor should be ignored. The trustee argued that recent decisions had held that where separate trusts are created by one settlor for a single beneficiary they must be taxed as separate entities. He further argued that Congress had considered these decisions and attempted to pass legislation to close the tax loophole, but had failed to do so; thus, the loophole remained and plaintiff had taken advantage of it. The Government answered that the ninety trusts were a sham and that tax liability should be determined on the basis of what was actually done in substance regardless of the form which was employed to avoid the tax. *Id.* at 952-53.

²² *Id.*

²³ The rule of "close scrutiny" had been previously applied to family transactions where tax avoidance was the sole motive. See, e.g., *Yiannias v. Commissioner*, 180 F.2d 115 (8th Cir. 1950); *Morsman v. Commissioner*, 90 F.2d 18, 22 (8th Cir. 1937).

²⁴ 190 F. Supp. at 957. The sham theory applies the principle that form must yield to substance. See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Yiannias v. Commissioner*, 180 F.2d 115 (8th Cir. 1950); *Belcher v. Commissioner*, 162 F.2d 974 (5th Cir. 1947); *Doll v. Commissioner*, 149 F.2d 239 (8th Cir.), *cert. denied*, 326 U.S. 725 (1945).

²⁵ Alkire, *Tax Shadows of the Sixties—Highlights of Estate and Trust Income Tax Proposals*, 100 TRUSTS AND ESTATES 696 (1961).

²⁶ *Morsman v. Commissioner*, 90 F.2d 18, 22 (8th Cir. 1937).

²⁷ *Doll v. Commissioner*, 149 F.2d 239 (8th Cir.), *cert. denied*, 326 U.S. 725 (1945).

²⁸ 394 F.2d 842 (Ct. Cl. 1968).

stantially alike. All of the trusts had the same trustee and each imposed almost identical duties upon the trustee. The only variations consisted of the date of the distribution of the income to the principal beneficiary, the designation of a minor income beneficiary, and the powers of the trustee with respect to investments.

The report of the trial commissioner to the court of claims set forth the rule that if "the principal purpose" for the creation of multiple trusts was tax avoidance, the trusts will, for tax purposes, be consolidated as one.²⁹ The plaintiffs denied that income splitting was the motivation for the creation of the multiple trusts. The court rejected the alleged nontax basis for the creation of the multiple trusts as implausible and found that multiple trusts had not been created. However, the court of claims appears to have reached this result on the basis of a test analogous to the "close scrutiny" test rather than adopting the trial commissioner's "principal purpose" test. The court stated that a taxpayer with tax avoidance motivation must affirmatively show that he created and maintained truly separate trusts before he can claim that the trusts should be taxed individually and not as one. Here the court found that the nineteen trusts were in fact administered as one. As the court noted: "If it is permissible to create separate trusts solely for tax avoidance reasons, . . . then it is appropriate to require a taxpayer to turn square corners—to dot his i's and cross his t's . . . —in order to take advantage of the rule."³⁰

The finding of the trial commissioner that multiple trusts must be consolidated for tax purposes if a principal purpose for the creation of the trusts was tax avoidance cannot easily be reconciled with prior case law.³¹ It is probably for this reason that the court of claims avoided the issue raised by the trial commissioner and decided *Sence* on other grounds. Thus the "principal purpose" test has never actually been adopted by any court. However, irrespective of the historical and theoretical doubts as to the proper applicability of the test, many authors felt that it would eventually be adopted.³² Nevertheless, the test was clearly rejected by the tax court in the case of *Estelle Morris Trusts*.³³

II. ESTELLE MORRIS TRUSTS:

REJECTION OF THE PRINCIPAL PURPOSE—SHAM DOCTRINE

*Estelle Morris Trusts*³⁴ involved ten irrevocable trusts for two primary beneficiaries. Ten written instruments were executed, each designated "Declaration of Trust." Each declaration of trust was identical in form

²⁹ *Id.* at 850-51.

³⁰ *Id.* at 851-52.

³¹ See *Boyce v. United States*, 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961), where the court felt it necessary to decide the case on the basis of the close scrutiny test even though the court had found a tax avoidance motive. The court stated: "[I]t has been held that even though the sole purpose of creating separate trusts was to achieve a reduction in the tax upon the income of trust property, this would not transgress any right of the Government." *Id.* at 952.

³² See ABA SECTION ON TAXATION, REPORT ON COMMITTEE ON INCOME OF TRUSTS AND ESTATES 85 (1956).

³³ 51 T.C. 20, 43 (1968).

³⁴ 51 T.C. 20 (1968).

except as to the period of accumulation of income and the date the trust was to terminate. The declarations gave the trustee power to accumulate the income from the trust estate for the life of the two primary beneficiaries. However, the trustee was required to distribute income and principal to the primary beneficiary of each trust upon written request and a showing by such beneficiary that he was unable to maintain his accustomed standard of living. In addition, in case of emergency the trustee was given the discretionary power to distribute current or accumulated income and principle to any beneficiary or issue of any beneficiary.

The grantors made initial cash gifts to the trusts at the time of their creation. These gifts were made by ten separate checks, each of which was drawn on the personal bank account of the grantors and made payable to the trustee for Trusts 401 through 410 respectively. Ten separate bank accounts were opened in the name of the trustee and the gifts were deposited therein. Ten sets of printed checks were prepared, one for each account, and each had the name of the trustee and the individual number of the respective trust printed thereon. At all times separate books of accounts and records were kept. In addition, each trust filed separate tax returns and issued annual financial statements. While the principal activities of the Morris Trusts were investments in real property, at no time did the trusts become involved in any business transaction with the grantors nor did the grantors receive any money from the trusts. Furthermore, the trusts did not make loans to each other or otherwise commingle their assets and funds.

The Commissioner of Internal Revenue maintained that the grantors had created multiple trusts for tax avoidance reasons and therefore ruled that the trusts should be combined into one. The government characterized the trusts as shams which lacked business purpose and substance apart from the anticipated tax benefit. The argument was similar to the one offered by the government in *Sence*.³⁵ The petitioners countered by arguing that each declaration of trust was sufficient to create separate trusts and that even if tax avoidance was the motive for the creation of the trusts, consideration of such a motive was irrelevant to the taxation of trusts.³⁶

The tax court held that the grantors had created ten trusts, rather than one, principally for tax avoidance reasons but that such a motive did not invalidate the trusts.³⁷ The multiple trusts were thus accorded independent significance. The court pointed out that Congress had carefully delineated certain areas of tax law where the tax avoidance motive is the touchstone of tax liability.³⁸ However, the court concluded that Congress had taken

³⁵ 394 F.2d 842 (Ct. Cl. 1968).

³⁶ 51 T.C. 20, 35 (1968).

³⁷ *Id.* at 44.

³⁸ *Id.* at 39 n.10. See also INT. REV. CODE of 1954, § 306(B)(4), which allows capital gain treatment on disposition of "section 306" stock only if the plan for such disposition does not have tax avoidance as one of its principal purposes. Section 532 conditions the applicability of the accumulated earnings tax on a determination that the corporation was formed for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation. See also INT. REV. CODE of 1954, §§ 302(c)(2), 355(a)(1), 357(b).

no action to restrict the use of multiple trusts on the basis of tax avoidance.³⁹ Quoting from an earlier case,⁴⁰ the tax court said: "We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications The validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated"⁴¹

The tax court in *Morris* did not completely overrule all court regulation of multiple trusts in the absence of legislation, but it stated that it was "required to limit those judicially developed doctrines to the situations which they were intended to cover."⁴² The court thus ruled out any use of the doctrines of business and economic sham. It noted that business purpose is often absent in donative dispositions of property and that the continuing economic and legal viability of the individual *Morris* Trusts prevented any application of the economic sham doctrine.⁴³ The tax court did, however, seem willing to apply a test analogous to the "close scrutiny" test. The court found that the *Morris* Trust Declaration was in proper legal form to create ten separate trusts for each beneficiary.⁴⁴ Furthermore, the trusts were in all respects treated as separate by both the grantor and the trustee.

The court distinguished the cases of *Boyce v. United States*⁴⁵ and *Sence v. United States*⁴⁶ by noting that neither case stood for the proposition that a finding of tax avoidance would invalidate multiple trusts.⁴⁷ The tax court felt that the decision in *Boyce* was based on the ground that the ninety trusts were shams "because they were in fact administered as one trust."⁴⁸ Similarly, in *Sence*, the court of claims expressly reserved the tax avoidance question since it found that the nineteen trusts were in fact administered as one. The tax court surmised "that the courts in *Boyce* and *Sence*, faced with multiple trusts created for tax-avoidance reasons, examined the forms used and the actions taken to see if the several trusts were in reality what they purported to be in form."⁴⁹ The tax court concluded, on the basis of past multiple trust cases and legislative enactments, that each *Morris* Trust was a "trust" "within the meaning of that term."⁵⁰ Thus the *Morris* Trusts seemed to have passed the clear scrutiny test while those in *Boyce* and *Sence* did not.

In view of the decision in *Estelle Morris Trusts*, it now appears that the Internal Revenue Service will have very limited success in challenging multiple trusts created for the purpose of tax avoidance. The "four

³⁹ 51 T.C. 20, 43 (1968).

⁴⁰ *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961).

⁴¹ 51 T.C. at 42, citing 367 U.S. at 697.

⁴² 51 T.C. 20, 43 (1968).

⁴³ *Id.* at 43.

⁴⁴ *Id.* at 40-45.

⁴⁵ 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961).

⁴⁶ 394 F.2d 84 (Ct. Cl. 1968).

⁴⁷ 51 T.C. 20, 44 (1968).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 45.

corner-intent" test⁵¹ and the "close scrutiny" test⁵² are still available to attack multiple trusts which fail to meet the standards of each individual test. Such tests, however, will provide little hinderance for the sophisticated taxpayer. The solution to the problem now lies with Congress.

III. NEW LEGISLATIVE PROPOSALS

Congress is now faced with the difficult but necessary task of drafting satisfactory multiple trust legislation. Such legislation could be of two types: explicative or directional. In either case, multiple trusts which fail to meet the prescribed statutory standards would be consolidated for income tax purposes. Related legislative changes are also necessary in order to provide thorough protection against tax avoidance. These changes should include modification of the Internal Revenue Code throwback rules and the Treasury Department's trust reporting procedure. If an explicative or directional statute proves to be unacceptable, other legislative approaches are worthy of consideration.

A. *Explicative or Directional Legislation*

Explicative. Explicative statutes provide set rules for various factual situations.⁵³ In the area of multiple trusts, such legislation would establish specific rules for determining whether multiple trusts are to be taxed separately or on a consolidated basis. With an explicative statute, the problem would be to attempt to insure that this regulation would not render the selection of multiple trusts prohibitively expensive from a tax viewpoint in those situations where the settlor has a valid nontax avoidance motive. However, the possibility that some trusts, which are not established for tax avoidance reasons, may be subjected to the proposed treatment as multiple trusts would have to be balanced against the possible difficulties involved in applying subjective standards of identification.

In addition to the problem noted above, an explicative statute would have two other major disadvantages. First, the draftsmen would probably have no experience with the many methods of utilizing multiple trusts for tax avoidance purposes or with the difficulties of attacking multiple trusts.⁵⁴ Second, closely defined limits on taxability invite the tax-conscious grantor to forego sound property planning in order to focus on achieving the maximum tax advantage. On the other hand, the certainty with respect to taxation which would be achieved through the explicative statute is of tremendous importance to proper business and property planning.

Directional. A directional statute would provide a general statutory standard to be applied by the courts rather than arbitrary technical require-

⁵¹ See notes 9-17 *supra*, and accompanying text.

⁵² See notes 18-27 *supra*, and accompanying text.

⁵³ Typical of the explicative statutes are the Clifford Trust provisions. See INT. REV. CODE OF 1954, §§ 671-78.

⁵⁴ The necessity of such experience possibly explains why the Clifford Trust statutory provisions were not enacted until fourteen years after *Helvering v. Clifford*, 309 U.S. 331 (1940).

ments to be met without court interpretation. The directional statute would have two main advantages. First, family property planning would not be affected when the taxpayer could demonstrate that his use of trusts was motivated by sound nontax considerations. Second, the tax conscious grantor would be restrained from using multiple trusts solely to minimize taxation due to uncertainty as to how far the courts would go in applying the statute.

Two statutory sections which are directional in nature have already been enacted to deal with various problems in the similar field of multiple corporations. Section 269 disallows deductions, credits, or allowances in certain corporate acquisitions where "the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax."⁵⁵ It has, however, been unsuccessful in dealing with split-ups and other multiplications of corporate entities because of its use of the definite article "the."⁵⁶ "The" principal purpose has been interpreted by the courts to mean that avoidance of taxation must be more important than any other purpose.⁵⁷ Thus, taxpayers are often able to demonstrate an important nontax purpose for each entity and avoid application of the statute.⁵⁸ Consequently, when section 1551⁵⁹ was enacted to disallow the \$25,000 surtax exemption and the \$25,000 minimum excess profits tax credit to multiple corporations, the indefinite article "a" was used.

B. *The Directional Consolidation Approach*

Trusts which are created on a multiple basis could be consolidated and the income taxed as if it were a single trust if they fail to meet a statutory standard. Of the statutory standards applied in the related multiple corporation area, such as sections 269 and 1551, the "a" principal purpose directional statute appears to be the most effective. Thus, under a similar statute multiple trusts could be consolidated for tax purposes if "a" principal purpose for their creation is tax avoidance. This would give the Commissioner power to tax the separate trust as one by the consolidation of tax returns.

Beneficiary-Probability-of-Receipt Standard. If the consolidation approach is to be used it will be necessary to identify the trusts to be grouped. For example, multiple trusts could be consolidated in any case where a common beneficiary has a probability of receipt of accumulated income from several trusts. Such a beneficiary-probability-of-receipt test may give rise to uncertainty in the determination of the likely beneficiary. However, a similar prediction of the probable recipient is required in other tax areas.⁶⁰

⁵⁵ INT. REV. CODE of 1954, § 269.

⁵⁶ *Id.* See generally S. REP. No. 627, 78th Cong., 1st Sess. 58 (1943).

⁵⁷ *Commodores Point Terminal Corp.*, 11 T.C. 411, 418 (1948).

⁵⁸ *Chelsea Prod., Inc. v. Commissioner*, 16 T.C. 840 (1951), *aff'd*, 197 F.2d 620 (3d Cir. 1952); *Dilworth Co. v. Henslee*, 98 F. Supp. 957 (M.D. Tenn. 1951); *Berland's Inc. v. Commissioner*, 16 T.C. 182 (1951).

⁵⁹ INT. REV. CODE of 1954, § 1551.

⁶⁰ See *William H. Robertson*, 26 T.C. 246 (1956). See also *Hearings on Technical Amendments to the Int. Rev. Code of 1954 Before the Subcomm. of the Comm. on Ways and Means*, 84th Cong., 2d Sess. 441 (1957).

Under this test, multiple trusts would be defined as trusts created by the same settlor or testator with a tax avoidance intent, the accumulated income of which will probably be passed on to the same beneficiary.

Several problems remain by using the beneficiary-probability-of-receipt identification standard. There are two situations in which the identity of the beneficiary cannot possibly be determined with reasonable certainty. The first occurs if the accumulations are to be paid to a class of which no potential member is in being at the close of the taxable year. The second instance arises when the payment of the accumulation lies entirely within the unhampered discretion of the trustee. In such a case there may be substantial uncertainty as to which beneficiary will receive the year's accumulation. A Congressional Advisory Group Report⁶¹ adopted the view that if there is substantial similarity of identity among the potential beneficiaries, the consolidation provision will apply. In this instance, the probability-of-receipt test would not be a precondition to the inclusion of the trust in a multiple trust group.

Common Settlor Standard. As an alternative to grouping trusts according to possible beneficiaries, the set of trusts subjected to treatment as multiple trusts could be identified by a common settlor. Such an approach, however, would involve several problems. A could set up a trust for X, give other property to B, who could also set up a trust for X to escape multiple trust consideration. In dealing with such a situation, it would be necessary to determine intent by the use of complicated treasury regulations. Furthermore, it must be determined whether trusts created by will should, after the settlor's death, be considered as having a settlor in common with those created by the settlor before his death. To answer in the affirmative would render most family dispositive arrangements subject to treatment as multiple trusts even though the probability of tax avoidance is slight.

Common Class of Beneficiaries Standard. An alternative identification standard is the common class of beneficiaries test. Using this test, those common beneficiaries who have income being accumulated by two or more trusts created by a common settlor or testator would have the income of such trusts combined and taxed as a single trust. But if the beneficiaries have differing interests in the trusts, arbitrary and unfair results could easily occur. Thus, the beneficiary with a small financial interest would

⁶¹ ADVISORY GROUP ON SUBCHAPTER J, 85TH CONG., 2D SESS., FINAL REPORT ON ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS 9 (Comm. Print 1958). The bill suggested by the Advisory Group was embodied in the Senate Finance Committee version of H.R. Rep. No. 9662. Essentially this was an attempt to tax offending multiple trusts together as a single trust whether or not the income was ultimately distributed. With respect to *inter vivos* trusts, the Advisory Group recommended the use of the identification standard: "substantially the same primary beneficiary." The proposed statute exempted from its standard as many as three trusts if created at five-year intervals. In addition, any trust having currently accumulated income or total taxable income allocated to corpus under \$2,000 would also escape consolidation. For a discussion of the other legislative approach considered during the 85th Congress see note 62 *infra*. See H.R. REP. NO. 3041, 86th Cong., 1st Sess. § 641(c) (1959). For the complete discussion of H.R. Rep. No. 3041, see Fillman & Barnett, *Recent Proposals on the Taxation of Estates and Trusts*, 41 B.U.L. REV. 35, 37-38 (1961).

possibly have his income taxed in a higher tax bracket if the income of the trusts are combined.

C. Modification of the Throwback Rules

The use of a consolidation approach does not of itself provide protection against all of the uses of multiple trusts. Consideration must be given to changing the Internal Revenue Code throwback rules.⁶² The throwback rules, adopted in 1954, provide that distributions by a trust in excess of that trust's distributable net income are stripped of their tax-free character if income equal to the distribution was accumulated by the trust in the five prior years.⁶³ To prevent double taxation of these amounts, the beneficiary may credit the taxes previously paid by the trust as though it had made down payments of tax on his behalf.⁶⁴ Certain distributions are exempted from the throwback rule with the result that they cannot be taxed beyond the amount of the trust's distributable net income.⁶⁵ These exceptions are principally for income accumulated during a beneficiary's minority,⁶⁶ distributions to meet a beneficiary's "emergency needs,"⁶⁷ and distributions upon the termination of a trust if made more than nine years after the last transfer to the trust.⁶⁸

The consolidation approach does not provide adequate protection against many present multiple trust abuses if trusts are fashioned to accumulate and distribute in a manner designed to take advantage of these various limitations on the throwback rules.⁶⁹ For this reason it is necessary to modify the present throwback rules. Elimination of the nine-year throwback rule⁷⁰ may be necessary to prevent tax evasion by those trusts which are established to accumulate income at reduced rates for a comparatively short period of time and then distribute it to the beneficiary as corpus sub-

⁶² INT. REV. CODE of 1954, §§ 665-68. One legislative approach considered by the 85th Congress was adopted by the House Ways and Means Committee. This was an attempt to prevent multiple trust abuse by subjecting them to the throwback rules. In effect, this approach would result in additional taxes on beneficiaries when they receive multiple trust distributions. A new section 669 was proposed under which the distributions of accumulations of certain multiple trusts would be subject to throwback rules of sections 666 and 668. See H.R. REP. No. 9662, 86th Cong., 2d Sess. § 669 (1960). There was to be no escape for final distributions, distributions at twenty-one, at specified ages or for emergency needs. Multiple trusts were not to be defined as such. Section 669 would begin to operate whenever a grantor creates more than one trust, and one of such trusts makes a distribution of accumulated income to a beneficiary in a year after another of the trusts has made such a distribution to the same beneficiary. For example, if A has created three trusts, all of which accumulate income to beneficiary B, section 669 would not be operative. But, if in 1962 Trust #2 distributes accumulated income to B, section 669 would come into play. Subsequent distributions of accumulated income from Trust #1 to B would not be thrown back under section 669, but such distributions to B from Trusts #2 and #3 would be. See Fillman & Barnett, *supra* note 61, at 37-39.

⁶³ INT. REV. CODE of 1954, § 666(a).

⁶⁴ B. BITTKER, FEDERAL INCOME ESTATE AND GIFT TAXATION 364 (3d ed. 1964); see INT. REV. CODE of 1954, § 666(b).

⁶⁵ INT. REV. CODE of 1954, § 665(b).

⁶⁶ *Id.* § 665(b)(1).

⁶⁷ *Id.* § 665(b)(2).

⁶⁸ *Id.* § 665(b)(4).

⁶⁹ For example, S establishes two or more trusts to accumulate income for S's son X for ten years and one day. Upon termination the accumulated income and corpus are to be paid to X. Assume X is in a high tax bracket. Even if consolidation occurs, the differential will not be corrected since the throwback rule does not apply.

⁷⁰ INT. REV. CODE of 1954, § 665(b)(4).

ject to gift exemption. Although this device for the accumulation of income at favorable rates is not dependent on the existence of more than one trust beneficiary, complete treatment of the problem may require this modification.⁷¹

D. *Modification of the Reporting System for Trusts*

A final area in which legislation adopting the consolidation approach must deal is reporting. It is apparent that the Treasury must be informed of the existence of all trusts potentially classifiable as multiple trusts in order to evaluate the facts involved. Accordingly, after one trust is created the settlor should be required to inform the Treasury of his creation of additional trusts. The obligation must be placed on the settlor rather than upon the trustee, since, in cases where a single settlor has created several trusts employing different trustees, it is possible that one or more of the trustees involved may not be aware of the existence of the other trustees.⁷²

Consolidation will raise certain mechanical difficulties if the consolidated trusts are managed by different trustees or established in different states. For example, it must be determined which trustee will file the consolidated return, which will pay the taxes, how the taxes will be apportioned among the several trusts, and what credits will be given for tax payments or savings which reflect the earnings or losses of another trust. However, such problems are not insurmountable and have been resolved in the analogous area of ancillary and domiciliary administration of decedent's estates.⁷³

E. *Other Approaches to the Statutory Solution*

Penalty Tax. Instead of consolidating the income annually, other possible legislative solutions include a special penalty tax like those on personal holding companies or on corporations which improperly accumulate surplus.⁷⁴ Such a penalty tax, however, produces equally harsh results whether or not tax avoidance was intended.

⁷¹ See *Hearings*, *supra* note 60, at 440.

⁷² For a general discussion of the filing requirements of trustees, see Hinners, *Tax Accounting Problems of Trustees*, 47 MARQ. L. REV. 147-49 (1963). Under the 1958 Advisory Committee approach, the additional tax burden imposed on an offending multiple trust would fall on the trustees themselves. To alleviate the hardship, the proposed statute provided that where the trustee did not know that the tax should be computed at the higher rate, as a result of multiple trusts being taxed as one trust, he would be relieved of personal liability. H.R. REP. No. 3041, 86th Cong., 1st Sess. § 641(c)(4) (1959). The House version of the bill provided for a more complete reporting system. Proposed section 669(d) would authorize the Commissioner to require such information "as may be necessary to carry out the purposes" of the section from (1) any person who has contributed property to two or more trusts, (2) the trustee of any trust, and (3) any beneficiary of any trust. A proposed amendment would have added a new section 6047 to the Code that would require every trust that makes a "section 669 distribution" to any beneficiary, to file a return, "with respect to such beneficiary," setting forth the grantor's name, the name and address of the beneficiary, the amount of the distribution, and such other information that the Commissioner might require. See Fillman & Barnet, *supra* note 61, at 38-40.

⁷³ See Treas. Reg. § 1.6012-3(a)(3) (1961).

⁷⁴ INT. REV. CODE of 1954, §§ 531, 541.

A Corporate or Capital Gains Type Tax. Another alternative⁷⁵ would be to tax the income from multiple trusts on a consolidated basis at corporate or other established rates and the accumulation distribution at capital gains rates. This, however, would add to the complexity of the present tax law and would produce a need for an examination of the theory of trust entities.

IV. CONCLUSION

Due to the difficulty of drafting adequate legislation, it would seem more desirable for the courts, rather than the legislature, to close the multiple trust tax avoidance loophole.⁷⁶ Prior to *Estelle Morris Trusts* the courts were tightening their position against such tax avoidance. With *Morris*, however, the tax court reversed this trend. It seems clear, therefore, that a sufficient and effective court standard for correcting the abuses in the multiple trust field cannot be devised without new and revised legislation.

It appears desirable that a statute should be adopted giving the Commissioner power to consolidate the returns of multiple trusts where tax avoidance has been "a" principal purpose for their creation.⁷⁷ The "a" principal purpose test allows the flexibility which is desirable in trust law, and the probability-of-receipt standard seems to serve adequately in determining which trusts should be grouped together for purposes of applying the consolidation-principal purpose test.

If Congress adopts a statute based on the consolidation approach with a probability-of-receipt standard and with modification of the present throwback rules, most situations of tax abuse will be reached without defeating the valid and justifiable uses of the trust form. However, the future may demonstrate that there can be no adequate solution without re-examination of a more fundamental concept—recognition of the trust as a separate entity.

⁷⁵ Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402, 432 (1956).

⁷⁶ HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 2D SESS., TAX REVISION COMPENDIUM 1755 (Comm. Print 1960).

⁷⁷ A similar statute, INT. REV. CODE of 1954, § 1551, has been successful in the field of multiple corporations.