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Multiple Trusts and Income Tax Avoidance

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I. INTRODUCTION

Since the Revenue Act of 1916,[1] the trust has been deemed a separate entity for income taxation purposes. Congress has thus sanctioned the use of the trust as a tax savings device. Under present law, a grantor may place cash or other income producing property in trust, thereby excluding the resulting income from his own tax liability. If the income is currently distributed to the beneficiary, the trust is treated as a conduit, and the beneficiary is taxed in the year of distribution.[2] But where the income is accumulatcd, the tax is payable by the trust.[3] When this "accumulation trust" is combined with a multiple trust plan, an approved tax savings instrument may become an improper income-splitting device.[4] This combination and the resulting income tax consequences provide the subject matter of this note.

Because each trust is considered a separate taxable entity, the appeal of the "accumulation trust" increases in direct proportion to the number of such trusts created by the grantor for the same beneficiary. Consider the following example: A grantor wishes to place in trust 200,000 dollars, which generates an annual net income of 12,000 dollars. If one "accumulation trust" is created, the annual tax is 2,830 dollars.[5] If ten trusts of 20,000 dollars each are created, the tax on each is 163 dollars, or a total of 1,630 dollars.[6] This is a tax saving

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1. Ch. 463, § 2(b), 39 Stat. 756. For the present comparable Code section, see INT. REV. CODE of 1954, § 641.

2. INT. REV. CODE of 1954, §§ 651 & 652.

3. INT. REV. CODE of 1954, §§ 661 & 662.

4. Where such a scheme is employed in order to avoid the income tax, the throwback rules must be avoided if income is to be eventually distributed only at the trust level. INT. REV. CODE of 1954, §§ 665-69. The throwback rules, a concept new with the 1954 Code, attempt to curtail the appeal of accumulation trusts as a means of income tax avoidance. Generally speaking, the rules tax the beneficiary on accumulation distributions at the rate he would have been taxed had the income been distributed in the most recent of the five preceding years in which undistributed net income existed. The rules are subject to certain limitations which, when combined with a multiple trust plan, render them relatively ineffective. *See, e.g.*, Ervin, *Multiple Accumulative Trusts and Related Problems under the Income Tax*, 29 S. CAL. L. REV. 402, 405-07 (1956).

5. INT. REV. CODE of 1954, § 1(b). This computation allows for the $100 deduction permitted by § 642(b); however, the 10% surtax has not been applied.

6. *Id.* Here, since each trust receives a $100 deduction, there would theoretically be no tax due if 121 trusts were created.

of 1,200 dollars. If the trust income were greater, the savings would be even more dramatic.[7]

This illustration presents a long-enduring problem which the efforts of the Treasury, Congress, and the courts have had little success in resolving. It is the purpose of this paper to place the problem in proper perspective through a discussion of the relevant legislative and judicial activity, to consider and analyze previously proposed solutions, and to recommend a workable and effective approach toward solving the problem.

II. LEGISLATIVE ACTIVITY

The use of multiple trusts as a means of tax avoidance has been under the scrutiny of Congress for over 30 years. Although there were prior rumblings,[8] the first concerted attack on the practice occurred in 1937 when the Joint Committee on Tax Evasion and Avoidance was established by Congress at the urging of President Roosevelt.[9] This committee held extensive hearings at which the Treasury Department called for legislative action and cited several flagrant abuses by taxpayers as evidence of the need for reform.[10] Strangely enough, Congress reacted only by reducing the exemption for trusts from 1,000 dollars to 100 dollars.[11] This change was unresponsive to the principal problem involved, that of avoiding the progressive rate structure through the use of multiple entities, and by itself was not of much concern to one bent on tax avoidance through the use of multiple trusts. With the exemption one-tenth of what it had been, all the grantor had to do was to establish ten times as many trusts as before the change. The change not only failed to deter the wealthy taxpayer who was shown to be the principal user of multiple trusts for tax avoidance,[12] but it served to penalize the less wealthy grantor who found no great advantage in the use of multiple trusts. Congress did, however, indicate that further consideration and study would be given to the problem.[13]

7. Assuming income of $100,000, the tax on one accumulation trust would be $55,421. If 10 trusts were created the total tax would be $21,620, a savings of $33,801.

8. *Hearings Before the Joint Comm. on Tax Evasion and Avoidance*, 75th Cong., 1st Sess., pt.2, at 270 (1937) [hereinafter cited as *1937 Hearings*].

9. H.R. Doc. No. 260, 75th Cong., 1st Sess. 4 (1937).

10. *1937 Hearings, supra* note 8, at 262-87. For example, one thrifty taxpayer created 64 trusts for the benefit of 4 family members resulting in a tax savings of $464,000 in one year.

11. Revenue Act of 1938, ch. 289, § 163(a), 52 Stat. 447.

12. Note 8 *supra*, at 262-87.

13. H.R. REP. No. 1546, 75th Cong., 1st Sess. 32 (1937).

It was 1956 before further inquiry into the multiple trust problem, as such, was made by Congress.[14] In November of that year, a subcommittee of the House Ways and Means Committee conducted hearings on a list of "substantive unintended benefits and hardships" which had been prepared by the Joint Committee on Internal Revenue Taxation and the Treasury Department.[15] Included in that list was the problem of the use of multiple trusts for the purpose of income tax avoidance. The matter was referred to an advisory group chaired by Professor A. James Casner. The group made its recommendations to the Ways and Means Committee, which in turn rejected the proposal and substituted its own approach in the tax package reported out of the Committee and later passed by the House. The Senate Finance Committee virtually reinstated the advisory group's proposals regarding multiple trusts, but this revised bill was twice passed over in the Senate and never brought to a vote.[16]

III. COURT DECISIONS

Against this background of legislative activity only three cases involving the attempted use of multiple trusts have arisen.[17] Of these, only one meets the question squarely and attempts an analytical resolution of the problem. Nonetheless, the others are important for what they do say, and an understanding of them contributes toward a full appreciation of the problem.

In *Boyce v. United States*,[18] the settlor executed 90 trust indentures with the same trustee and same benficiary in each. All of the indentures were identical in language and were consecutively numbered. Each was funded with a separate check, and the first

14. The adoption of the five year throwback rule in the 1954 Code was an attempt to curb the use of accumulation trusts generally. For the view that the exceptions to the throwback rules actually invite the use of multiple trusts see Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 COLUM. L. REV. 1237, 1250 n.41 (1954).

15. *Hearings on Technical Amendments to the Internal Revenue Code Before a Subcomm. of the House Ways & Means Comm.*, 84th Cong., 2d Sess. (1956).

16. For a detailed discussion of these conflicting approaches and their relative merits and shortcomings see notes 42-72 *infra* and accompanying text. The congressional failure to enact this tax package was due largely to disagreement over the proper solution to the multiple trust problem. *See* Somer, *First Case on Multiple Trusts Suggests that Code Revision may not be Needed*, 14 TRUSTS & ES. 363 (1961).

17. 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). In stating that these are the only cases involving multiple trusts, reference is made only to multiple accumulation trusts for the same beneficiary created by the same grantor. The term is used throughout this paper in that limited sense unless otherwise stated.

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

income payment was made by 90 separate checks drawn on the same account. Thereafter, income payments were made by one check representing the total income of all the trusts. The trustee did not file income tax returns since no trust earned in excess of 100 dollars per year.[19] The Commissioner, contending the trusts should be taxed as one, assessed deficiencies. The trustee sued for a refund.

It was stipulated by the parties that the sole purpose for attempting to create 90 separate trusts was to avoid income taxes by dividing the income from the trust into 90 parts, so that each part would be exempt from liability by reason of the 100 dollar exemption allotted each trust.[20] The plaintiff boldly argued that congressional failure to close the existing loophole demanded a "hands-off" approach by the courts until Congress prescribed a remedy, and further, that the settlor legally had taken advantage of the loophole.[21]

The Commissioner advanced two principal arguments. First, it was urged that form must yield to substance, so that if the taxpayer had not in fact done what he purported to do, he must be taxed on what he actually did. Second, the Commissioner argued that the "business purpose" doctrine[22] should be applied, and if the taxpayer could show no substantial purpose other than tax avoidance, the trusts should be taxed as one.[23] The court avoided the question of the applicability of the "business purpose" doctrine to multiple trusts by relying on the government's theory that in substance only one trust existed. In so doing, the court applied the "close scrutiny" test[24] and found that the taxpayer's failure to show compliance with the

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19. INT. REV. CODE of 1939, § 142(a)(3), in effect at that time, required the filing of a return only if net income exceeded $100.

20. 190 F. Supp. at 951.

21. *Id.* at 952.

22. Gregory v. Helvering, 293 U.S. 465 (1935).

23. 190 F. Supp. at 954. This represented a change in position by the Government—perhaps as a result of impatience with the failure of Congress to take positive action against multiple trusts. Until this time the Government had never indicated a change from its early view that where multiple trusts in fact existed, there was no ground on which to attempt to treat them as one. *See* the statement of Paul B. Bruton, an attorney in the Office of the Chief Counsel, Internal Revenue Service, in *1937 Hearings, supra* note 8, at 266. Furthermore, although Gregory v. Helvering, 293 U.S. 465 (1935) had been decided two years prior to this assertion, that doctrine was not invoked.

24. "When a taxpayer . . . boldly proclaims that his intent, at least in part, in attempting to create a trust is to evade taxes, the court should examine the forms used by him . . . and if his ingenuity fails at any point, the court should not lend him its aid by resolving doubts in his favor." Morsman v. Commissioner, 90 F.2d 18, 22 (8th Cir. 1937). Such "close scrutiny" is also applied where family transactions are involved. *See* Doll v. Commissioner, 140 F.2d 239 (8th Cir.), *cert. denied,* 326 U.S. 725 (1945).

indentures' requirements that separate records be maintained resulted in the existence of but one trust for tax purposes.[25]

Despite the court's finding that multiple trusts did not exist, *Boyce* is of importance to the multiple trust problem in three respects. First, the case demonstrates the new-found intention of the government to challenge in the courts multiple trusts for the same beneficiary. Second, the case shows an attempted application of the "business purpose" test to the problem. Third, the case indicates the close scrutiny which multiple trusts can be expected to receive.

In *Sence v. United States*,[26] the settlor arbitrarily subdivided some 1,300 acres of land and placed several of these tracts in nearly identical trusts for the same primary beneficiary. The taxpayer contended that tax avoidance was not the motive in executing the nineteen separate trust indentures.[27] Rejecting this contention, and relying on the "close scrutiny" test, the Court of Claims held the taxpayer's failure to show that the trusts were in fact maintained and administered separately required a determination that, for federal tax purposes, but one trust existed.

The importance of the *Sence* case is found in the conflicting views of the Court of Claims and the trial commissioner who initially decided the case. The trial commissioner had construed *Boyce* to hold that "where the principal purpose of the multiple trust plan is tax avoidance, the trusts will, for tax purposes, be consolidated and taxed as one."[28] This was an unduly expansive reading of the *Boyce* case, for that court relied on the taxpayer's motive solely for the purpose of determining whether to apply the "close scrutiny" test, which, in turn, led the court to the conclusion that but one trust existed for federal tax purposes.

Although the trial commissioner brushed aside without challenge the taxpayer's contention that the trusts were in fact maintained and administered separately, the Court of Claims considered this question decisive. It was thus unnecessary to apply the broad rule invoked by the trial commissioner that such trusts be taxed as one where the principal purpose of the settlor was tax avoidance.[29]

Boyce, having declined to base its decision on the "business purpose" doctrine, and *Sence*, in declining to apply the "principal

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25. 190 F. Supp. at 957.
26. 394 F.2d 842 (Ct. Cl. 1968).
27. *Id.* at 848.
28. 7 CCH 1967 STAND. FED. TAX REP. ¶ 8176, at 72,625.
29. This has come to be known as the "principal purpose" doctrine.

purpose" test, set the stage for the Tax Court's recent opinion in *Estelle Morris Trusts v. Commissioner*.[30] In this case the settlor executed ten separate trust indentures, each purporting to create one trust for each of two primary beneficiaries. The indentures varied only in the periods of accumulation and dates of distribution and termination. Although the trust property was pooled for administrative convenience, each trust declaration was administered separately and acquired separate investments. Furthermore, each trust filed its own tax return.

The Government, asserting that the twenty purported trusts constituted a single trust for federal income tax purposes, assessed deficiencies.[31] The Tax Court, however, held that each indenture was intended to, and did in fact, create two separate trusts.[32] The court next concluded that tax avoidance was a principal motivation in the creation of ten trusts, rather than one, for each beneficiary.[33] This finding required the court to determine whether multiple trusts for the same beneficiary created by a settlor who was principally motivated by tax avoidance reasons should be treated as separate entities for income tax purposes. The court answered in the affirmative.

Recounting the long history of congressional concern, but inaction,[34] the court noted express provisions in other areas of the tax law disallowing tax benefits where tax avoidance is the motivation.[35] It was pointed out that the great difference of opinion as to what measures should be taken to close the loophole militated toward invoking the doctrine of judicial restraint.[36] The court then stated:

> We do not intend to imply that we believe congressional inaction here means complete sanction of tax avoidance through multiple accumulation trusts. Rather, we believe the lesson to be learned is that courts should be wary of broad-scale incorporation of the doctrine of 'tax avoidance,' or 'business purpose,' or 'sham' in an area so fraught with its own particular problems and nuances. At the very least, we are required to limit those judicially-developed doctrines to the situations which they were intended to cover.[37]

30. 51 T.C. 20 (1968).

31. *Id.* at 35.

32. *Id.* at 36. The court relied on United States Trust Co. v. Commissioner, 296 U.S. 481 (1936) which held that one indenture may create more than one trust provided the intent to do so is clear. This case was decided three years after the Court's decision in Gregory v. Helvering, 293 U.S. 465 (1934), yet again that doctrine was not invoked.

33. 51 T.C. at 38.

34. *See* notes 8-16 *supra* and accompanying text.

35. INT. REV. CODE of 1954, §§ 269, 306(b)(4), 532, 1551.

36. 51 T.C. at 42-43.

37. *Id.* at 43.

Thus the court found the "business purpose" test inapplicable to donative transactions such as the Morris trusts.[38] It further stated that even if a "trust-business purpose" test were applied, the Morris trusts would meet that test since each was intended to, and did, carry on substantial "business functions."[39] All that remained for the court to consider was the application of the "close scrutiny" test as used in *Boyce,* since tax avoidance had already been found to constitute a principal motivation of the instant settlor. In doing so, the court found ample evidence that the Morris trusts had been carefully maintained and administered as separate entities and were therefore not subject to consolidation.[40]

In *Estelle Morris Trusts* the court recognized the myriad problems involved in seeking an adequate solution for this difficult area. In view of the congressional indecision, the court quite properly declined to assume that it should be the one to fashion a remedy.

IV. Proposed Solutions

Proceeding under the assumption that the courts should properly leave to Congress the closing of the multiple trust loophole, we shall now consider the principal solutions offered by the Treasury, the Congress, and certain commentators. Some conclusions will be made as to the most advisable approach.

A. *The Consolidation Approach*[41]

This approach was embodied in H.R. 3041,[42] which adopted the

38. *Id.* The court relied on Alden B. Oakes, 44 T.C. 524 (1965), which involved a leaseback by the settlor from the trust. That court said: "Ordinarily, any taxpayer may arrange his affairs so as to minimize his tax liabilities by means which the law permits. . . . [W]here . . . a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary for us to inquire as to whether there was a business reason for making the gift. Admittedly there was none." *Id.* at 532.

39. 51 T.C. at 43 n.30.

40. *Id.* at 45.

41. For an excellent discussion of this technique, see Gordon, *Multiple Trusts: The Consolidation Approach,* 4 Wayne L. Rev. 25 (1937).

42. H.R. 3041, 86th Cong., 1st Sess. (1959). This bill was never reported out of the House Ways and Means Committee. Instead, the committee adopted a measure which attacked multiple trusts through revision of the throwback rules. *See* H.R. Rep. No. 1231, 86th Cong., 1st Sess. 64 (1960). The latter approach was incorporated into H.R. 9662, a lengthy tax revision bill passed by the House. However, the Senate Finance Committee version of H.R. 9662 substantially reinstated the Advisory Group's consolidation approach. *See* S. Rep. No. 1616, 86th Cong., 2d Sess. 2-3, 7-10, 33-39 (1960). It has been suggested that the Senate's subsequent failure to act on this bill was due largely to the differences of opinion as to how to solve the multiple trust problem. *See* Somer, *supra* note 16, at 363.

suggestions of the Casner Advisory Group.[43] By imposing the tax at the trust level, the technique is consistent with the existing concept of recognizing the trust as a separate entity. Where multiple accumulation trusts were created by the same grantor for substantially the same primary beneficiary, the trusts would be consolidated and taxed as one. Thus, under the proposal, offending trusts would not be allowed to accumulate income at the lower tax bracket each individual trust would otherwise enjoy. The rule would not be applicable if the combined trust income were less than 2,000 dollars,[44] or if the tax resulting from consolidation were less than the sum of the taxes computed separately,[45] or if the number of such trusts did not exceed three, no one of which was created within five years of another.[46]

The proposal has been severely criticized by legislators and commentators.[47] Probably the most frequently recurring objections charge that the proposal is both complex and vague. As to the latter, it has been stressed that the suggested rule lacks in definitional standards.[48] For example, no definitions were offered for the terms "primary beneficiary" or "substantially the same." Although it has been argued that intentional avoidance of strict definitions would create a risk area which might serve as a deterrent to those inclined to push the law to its limit,[49] critics contend that such an approach would lead to constant litigation, difficult administration, and unnecessarily difficult estate planning.[50]

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43. *See* notes 14-16 *supra* and accompanying text.

44. This exception recognizes the fact that tax avoidance would not be significant where the combined income is not substantial. It thus relieves such trusts from the complexities of the consolidation approach. *See Hearings on Advisory Group Recommendations on Subchapter C, J and K of Internal Revenue Code Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 178, 184 (1959) [hereinafter cited as *1959 Hearings*].

45. This exception, which amounts to a penalty and illogically results in a "heads I win, tails you lose" proposition for the Government, was dropped in the Senate Finance Committee version. *See* S. REP. No. 1616, *supra* note 42, at 8.

46. This exception is designed to allow some leeway for trusts that may be created for non-tax reasons. The Senate Finance Committee version was more restrictive in exempting only two trusts, and those only if created at a minimum of 8 years apart. *Id.* The logic in having such an exception has been criticized as being arbitrary and inconsistent with the basic premise of the consolidation approach which rejects motivation as the test and assumes that multiple trusts created by the same grantor for the same beneficiary *ought* to be taxed as one. *See, e.g.*, S. SURREY & W. WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 932 (1960 ed.).

47. *See generally Hearings on H.R. 9662 Before the Senate Finance Comm.*, 86th Cong., 2d Sess. (1960) [hereinafter cited as *1960 Hearings*].

48. *See 1959 Hearings, supra* note 44, at 180.

49. *Id.* at 181.

50. *See* Tomlinson, *Multiple Trust Taxation*, 96 TRUSTS & ES. 1180, 1182 (1957).

Perhaps the most substantial criticism of the consolidation approach is that it requires the adoption of too many complex rules which would be left to the discretion of the Treasury Department.[51] It is apparent that intricate rules must be devised to implement the proposal and to answer numerous questions. For example, how is the joint tax to be assessed and allocated in the situation where some, but not all, of the beneficiaries are substantially the same? Is only the share of the beneficiary who is substantially the same to be consolidated or must all the income of each trust be combined so that the beneficiaries who are not substantially the same are taxed at the higher rate? If the former, how is allocation of income within the trust to be made where only some of the beneficiaries are substantially the same, but where the trustee has wide discretion in making distributions to the various beneficiaries? What is to be done where the beneficiaries are as yet unborn or unascertained? If consolidation is to be effected, should "loss carryovers" be allowed? Should the trusts be allowed to balance capital gains and losses among each other, or should each trust compute its own taxable income which is then lumped with the others? Which trustee is responsible for consolidating the returns? How are the offending trusts to be located and identified in the first instance? These unanswered questions represent but a few of the many involved in bringing together for tax purposes trusts which may have different characteristics.

In addition to these complexities, the Advisory Group proposal has been characterized as an overreaction to the existing problem.[52] Whether this is a valid criticism depends upon which statement of the ultimate objective one accepts. If the objective is to prevent flagrant abuses, perhaps the criticism is valid. But if the objective is to restrict even the nominal benefits which flow from utilization of the trust as a legitimate estate planning device, then the criticism is not appropriate.[53]

B. The Ten Year Throwback Rule

The Ways and Means Committee rejected the consolidation approach of the Advisory Group and recommended a vastly different solution.[54] Under the Committee plan, the five year throwback rule would be extended to ten years in cases involving certain multiple

51. *See* Sugarman, *Estates and Trusts*, in 3 HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 1754-55 (Comm. Print 1959).

52. *1960 Hearings*, *supra* note 48, at 116, 120, 151-52.

53. *See* discussion notes 72-74 *infra* and accompanying text.

54. Note 42 *supra*.

trusts,[55] and the present exceptions to the five year throwback rule would be made inapplicable to offending multiple trusts.[56]

This proposal is conceptually unlike the consolidation approach in that the tax is imposed at the beneficiary level rather than at the trust level. Although "accumulation distributions" from the first of the trusts in the designated group remain subject only to the present five year throwback rule with its ill-conceived exceptions, all distributions from the second and succeeding trusts would be "thrown back" to the most recent of the preceding ten years in which undistributed net income presently existed.[57] No exceptions to the ten year rule are made; therefore the beneficiary's tax on accumulation distributions from the second and succeeding trusts is computed as if the distribution had been included in his income in the year in which such amount could have been distributed as current income of the trust.

As proposed by the House, the law would not allow multiple trust distributees the benefits of the character rules[58] applicable to the five year throwback rules.[59] Thus, income which is treated as tax exempt in the hands of the trust would be treated as ordinary income in the hands of the beneficiary. While this approach seems patently discriminatory against the beneficiary of a multiple trust group which may well have been created for non-tax purposes, the inequity could be corrected by a simple change in the proposed law. However, there remain more basic deficiencies in this proposal.

This plan varies significantly from the consolidation approach in that the tax is imposed ultimately on the beneficiary rather than the trust. Therefore, until the distribution is made, each trust is allowed to accumulate income at its own individual rate. Upon distribution, the tax is recomputed at the beneficiary's rate, and credit is given the beneficiary for the tax paid by the trust. The fault here lies in the fact that, for the period of accumulation, the trust enjoys the benefit of the earning power of the difference in the two taxes. Thus, multiple

55. H.R. REP. NO. 1231, 86th Cong., 2d Sess. 64-69 (1960).

56. *Id.* at 65.

57. *Id.*

58. The so-called "character rules" presently provide that where an accumulation distribution subject to the throwback rules is made, such distribution will be treated as ordinary income to the beneficiary if so characterized at the time the trust was taxed on the accumulation, or, if the trust received capital gain treatment, the beneficiary will be taxed similarly. *See* INT. REV. CODE of 1954, § 662(b).

59. H.R. REP. NO. 1231, *supra* note 55, at 64.

accumulation trusts which are created principally for tax avoidance reasons would still be able to effect substantial savings.[60]

The ten year throwback approach is also subject to the criticism that it would require burdensome recordkeeping on the part of the trustee who must account for accumulations on a yearly basis. Under the present throwback rule, this requirement is limited to a period of five years immediately preceding the accumulation distribution. This proposal would produce the undesirable requirement that tax records of the beneficiary be available for the preceding ten years so that the adjusted tax can be computed.

This proposal, too, provides for an easily avoided tax. The imposition of an arbitrary ten year limitation leaves maneuvering room for the patient and skillful planner. Consider the following example: *A* wishes to establish a substantial trust for his son *B*, who is ten years old, but who is not to receive distributions until he is over 21 years of age. *A* creates trust *P* (a "parent trust"). In each of the succeeding twelve years, trust *P* distributes its annual income to a separate subsidiary trust. Each year trust *P*, having distributed its current income, pays no tax, and each distributee subsidiary is taxed at its own lower rate. Beginning in the twelfth year, the first subsidiary trust can make a termination distribution to *B* without further tax on its corpus. In each of the succeeding years, the oldest subsidiary trust can do the same until the last has terminated. In this way the effect of the progressive rate structure is severely limited.

Another objection to the ten-year throwback proposal is its conceptual inconsistency. The plan in effect sanctions income splitting, to a degree, by exempting from coverage the first trust in a multiple trust group. The proposal arbitrarily seems to say, "We recognize the trust as a separate entity, but will allow only one to a beneficiary regardless of the settlor's motives." Instead, Congress should reach the underlying question of whether a trust should be treated as a separate taxable entity at all, and if the answer is no, then impose a throwback rule which reaches back indefinitely and apply it to all trusts without exception.

The ten year throwback proposal does avoid many of the complex rules and undefined standards inherent in the consolidation

60. For example, in the hypothetical case posed in note 7 *supra*, the tax savings through the use of a multiple trust plan amounted to $33,801. If the accumulated income is retained for eight years and then distributed, that $33,801 now payable by the beneficiary would have earned $16,124 at the rate of 5% interest compounded annually. This, of course, would be retained by the trust.

approach. Nonetheless, the Senate Finance Committee was flooded with objections to this proposal[61] and ultimately adopted the consolidation approach.

C. *The Unlimited Throwback Rule*

Possibly with a mind toward the criticisms voiced in the preceding section, the Treasury Department's latest proposals to Congress call for an unlimited throwback rule applicable to all trusts.[62] Ultimately all trust income would be taxed to the beneficiary when distributed and at the beneficiary's own rate. This approach is more than an attack on multiple trusts. In reality the assault is against all accumulation trusts, and the proposal, by virtue of placing the tax at the beneficiary level, intends that ultimately all trust income, whether from multiple trusts or a single trust, be taxed to the beneficiary when distributed and at the beneficiary's own rate.

In order to avoid the complexity of requiring the beneficiary and the trustee to maintain all previous tax records for the life of the trust, this proposal includes a three-year averaging device which is used to determine the rate at which accumulation distributions are taxed. This averaging device works as follows:

> (1) An average annual income is computed by dividing the total accumulated income distributed by the number of preceding taxable years of the trust from which the distribution was deemed to have been made.
> (2) An average annual tax increase is then computed by adding the average annual income (as computed in step (1)) to the beneficiary's income for the present taxable year and the two preceding taxable years; recomputing the beneficiary's tax for those years taking into account the added income; adding the increases in tax for those years together; and dividing by three.
> (3) This average annual increase in tax is then multiplied by the number of preceding taxable years of the trust from which the distribution was deemed to have been made. This amount is the limitation on the beneficiary's tax liability. . . .[63]

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61. *1960 Hearings, supra* note 47, at 116, 120, 134-39, 143-45, 147-51, 164-68, 180-84, 191-99.

62. JOINT PUBLICATION OF HOUSE COMM. ON WAYS AND MEANS AND SENATE FINANCE COMM., TAX REFORM STUDIES AND PROPOSALS OF U.S. TREASURY DEPT., 91st Cong., 1st Sess., pt. 2, at 164-71 (Comm. Print 1969).

63. *Id.* at 170. Application of this procedure is demonstrated by the following example: Assume an accumulation distribution of $9,000 which is deemed to represent three years of accumulation. This amounts to an average income of $3,000 as a result of applying step one ($9,000 ÷ 3). This amount is then added to the beneficiary's taxable income for the present year and the two preceeding years, and a new tax is computed for each of those years. Assume that with the additional $3,000 the beneficiary's tax would be increased by $900, $1,000, and $1,100, in those three years respectively. This amounts to an average tax increase of $1,000 ($900+$1,000+$1,100)÷3. The average ($1,000) times the number of years (3) gives the bene-

This technique has a dual purpose. First, it eliminates the requirement that each beneficiary keep his individual tax records for the life of the trust. Second, it alleviates the harsh effect of the progressive tax rate where income is "bunched" in a single year.

The three-year averaging device is subject to the criticism that it may not accurately reflect the bracket differential of the beneficiary and the trust over the period of accumulation. For example, consider the following graphic examples:

CASE 1

	1966	1967	1968	1969	1970
Trust Income	10,000	10,000	10,000	10,000	10,000
Beneficiary's Income	20,000	20,000	45,000	80,000	100,000

Assume all the accumulated and current trust income is distributed in 1970. Because the beneficiary's other income is rapidly increasing, application of the proposed averaging device results in the beneficiary owing 3,472 dollars more in taxes than if the trust income had been distributed in the years earned.[64] This in effect is a penalty on accumulation. It is submitted that remedial legislation with the purpose of closing the multiple trust loophole should not operate as a penalty on trusts which accumulate income while the beneficiary's other income is taxed at constantly increasing tax rates.

CASE 2

	1966	1967	1968	1969	1970
Trust Income	10,000	10,000	10,000	10,000	10,000
Beneficiary's Income	100,000	80,000	45,000	20,000	20,000

This is the reverse of the first case. Since the lower income years are the three to be used in applying the averaging device, the income accumulated in 1966 and 1967 will not be taxed at the high rates which would have prevailed had the income been distributed when earned. Thus, the weakness inherent in a short-term averaging device is a two-way street.

ficiary's maximum tax liability ($3,000). The beneficiary, however, receives a credit for the taxes paid by the trust at the time of accumulation.

64. These illustrations, for purposes of simplicity, do not take into account any income earned on tbe accumulated income itself.

CASE 3

	1966	1967	1968	1969	1970
Trust Income	10,000	10,000	10,000	10,000	0
Beneficiary's Income	50,000	50,000	0	0	0

Assuming all the accumulated income is distributed in January, 1970, which is three years after the last income received by the beneficiary, the tax rate to be applied is exactly the same as the rate at which the income was accumulated, since there is no other income to be averaged in. Thus the progressive character of the rate structure is avoided.

Carrying this one step further by introducing a multiple trust plan, consider the following hypothetical case: The settlor wishes the beneficiary to have 10,000 dollars per year for a period of nine years. The beneficiary has no other income. To achieve the lowest possible tax burden the settlor creates three trusts. Trust *A* is funded so as to produce 10,000 dollars income per year. Trust *B* will produce 5,000 dollars per year. Trust *C* will produce 3,333 dollars per year. In this way each of the three separate trusts can accumulate income at its own rate, and avoid the progressive rate structure. After three years, trust *A* makes a termination distribution which amounts to 30,000 dollars. This will be taxed to the beneficiary at the rate at which it was accumulated since he has no other income to average in. Three years later, when the beneficiary has exhausted the first distribution, and, more importantly, when he has again had no income for three years, trust *B* makes a termination distribution of the 30,000 dollars it has accumulated (6 years x 5,000 dollars). Again this is taxed to the beneficiary at the same low rate at which it was accumulated. Three years later trust *C* terminates with the same result.

These cases do not demonstrate the only weaknesses in the Treasury's proposal. Like the ten-year throwback rule recommended by the House, this proposal fails to prevent accumulation at the lower rates because it delays collection of the adjusted tax until distribution. This allows each trust to use the temporary tax savings (the difference between the accumulation rate and the adjusted rate) until the accumulation is distributed. This amount alone may represent a substantial tax savings.[65]

65. Note 60 *supra*.

D. *The "Principal Purpose" Statute*

In the cases previously discussed the Government unsuccessfully urged the courts to adopt a rule that where the "principal purpose" of the settlor is to avoid taxes, the trusts will be consolidated and taxed as one.[66] This was the rule applied by the Commissioner who first decided the *Sence* case, but the Court of Claims affirmed on a much narrower holding.[67] The *Estelle Morris* court expressly rejected such a rule[68] on the grounds that any change in the tax laws should be left to Congress.

A statute implementing this type of rule could be drafted in a form similar to that present in other areas of the code. For example, section 269 disallows corporate tax benefits which would otherwise be available by reason of an acquisition if the principal purpose of the acquisition was tax avoidance.[69] Section 1551 disallows the corporate surtax exemption or the accumulated earnings credit, which are normally available with a transfer of assets, if a major purpose in effecting the transfer was to obtain the exemption or credit.[70]

A statute of this type is naturally subject to the criticism that it is too subjective and leaves the taxpayer in the position of having to satisfy undefined standards. It also leaves much to the discretion of the Treasury—a criticism also lodged against the Advisory Group proposal.

Such a statute would allow for flexibility in the use of trusts since it would result in consolidation of only those trusts where tax avoidance was found to be *the* (or *a*) principal purpose. A simply worded statute, avoiding the complexities inherent in the previously discussed proposals and accompanied by interpretive regulations outlining the criteria to be considered, would be sufficient.

V. Recommended Solution

In discussing the various proposed solutions to the multiple trust problem, consideration was given to some of the advantages and disadvantages of each. Before a conclusion can be made as to which is the most advisable approach, other factors merit consideration.

A basic question, although not determinative by itself, is whether

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66. *See* notes 17-40 *supra* and accompanying text.
67. *See* note 29 *supra* and accompanying text.
68. *See* notes 34-37 *supra* and accompanying text.
69. Int. Rev. Code of 1954, § 269.
70. Int. Rev. Code of 1954, § 1551.

multiple trusts for the same beneficiary *should* be treated as separate entities.

There are a number of non-tax reasons why a settlor may wish to establish more than one trust for the same beneficiary. For example, a settlor may want to sample the work of several trustees in order to determine which is the more efficient, or he may wish to give the trustee more authority with respect to one corpus and less over another. It may be desirable that separate trusts be maintained in order to segregate assets or in order to vary the termination and distribution dates. Likewise a settlor may want to establish separate trusts having different purposes; that is, one trust for education, another for maintainance, and so forth. It may also be necessary for the settlor to establish an additional trust rather than add to an existing irrevocable trust which has provisions now considered undesirable.

While there may be legitimate non-tax motivations, it is not so clear that, as a matter of policy, the beneficiary should receive more favorable tax consequences where such multiple accumulation trusts are established. Conceding the justification in creating separate accumulation trusts for one beneficiary in order to sample the work of several trustees, does it necessarily follow that this also justifies taxing each as a separate entity with the result that the effect of the progressive rate structure is greatly diminished? Should the mere fact that a settlor creates one trust for maintenance and another for education result in tax consequences different from those which would follow had only one trust been created? Those who answer these questions in the affirmative argue that a consolidation approach would restrict the legitimate use of such trusts.[71] Consolidation, however, would merely attempt to close a present loophole which results in the beneficiary receiving a windfall in the form of tax savings under the present "separate entity" theory.

Our examination of the proposed solutions reveals that the present separate entity theory should be retained. However, it is submitted that a simply worded statute authorizing consolidation where tax avoidance is the principal purpose should be enacted. This conclusion is based not upon the conceptual soundness of the separate entity theory, but rather on the complexities, inconsistencies, and weaknesses of the available alternatives.

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71. *See* Soter, *Federal Tax Aspects of Multiple Accumulation Trusts*, 31 U. CIN. L. REV. 351, 400 (1962).

The Casner Advisory Group proposal falters largely on its lack of definable criteria which could be reasonably administered by the Treasury,[72] and the necessity for complex rules which must accompany the proposal.

The suggested changes in the throwback rules, although sound in the theory that separate trusts for the same beneficiary ought not to be considered separate taxpaying entities, are themselves subject to avoidance, or the need for complex implementing rules, or both. As proposed, neither prevents accumulation at the lower rates before the tax is adjusted upon distribution.

A "principal purpose" statute avoids these pitfalls. Although the statute is weakened somewhat by its subjective nature, it is believed that the Treasury could fairly encourage a cautious, but reasonable, approach in the use of multiple trusts. Such a proposal would allow continued income splitting to a degree, but would decrease the flagrant misuses of multiple trusts.[73] This limited tax advantage does not warrant a wholesale attack on all trusts, or even on all multiple trusts, where a change would place a terrible burden of complex procedures and bookkeeping on the trustee, the beneficiary, and the Treasury. Mr. Norman Sugarman, a noted tax authority, has said that "everytime we attempt to produce more answers in the statute we seem to create more problems."[74] For this reason, and others, he has advocated a simply worded statute such as has been recommended here.[75]

A "principal purpose" statute would also achieve consistency with other areas of the code. Sections 269 and 1551, discussed above, do not take an "overkill" approach, but, rather, are limited in scope to those cases where the principal purpose of tax avoidance is expressly found to exist. A more restrictive rule in the trust area would be unsound.

Finally, it is suggested that if such a statute were enacted, provision could also be made for an advance ruling in cases where the settlor is uncertain of the tax results of his plan. This has been effectively done with section 357 of the Code.

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72. *See* notes 47-51 *supra* and accompanying text.

73. *See* Sugarman, *supra* note 51; *1960 Hearings, supra* note 47, at 116, 120, 151-52.

74. *Panel Discussions Before the House Comm. on Ways and Means*, 86th Cong., 2d Sess. 940 (Comm. Print 1960).

75. *Id.* at 945-46.

VI. EFFECTIVE DATE

Consideration of a solution to this problem would not be complete without a discussion of the effective date such legislation might impose. At the outset it should be noted that a change in the income tax laws which apply to trusts already in existence is not retroactive taxation unless made applicable to distributions or accumulations made prior to passage.[76] If such legislation, however, is made effective on a date before the formalities of passage are completed, as, for example, January 1 of that year, it is generally conceded that such a measure is retroactive in its application.[77]

Retroactive tax legislation is not necessarily unconstitutional. The Supreme Court has never declared a federal tax law unconstitutional because of retroactive provisions.[78] On the contrary, the Court has held that retroactivity for a two-year period was valid.[79] It is generally conceded that retroactivity within the current calender year is unobjectionable.[80] Moreover, it has been stated that as a practical matter the only real limitation on retroactive application of a tax measure is legislative self restraint.[81] This latter assertion could be an overstatement if the legislature should proceed with far-reaching retroactive application. In this event the constitutional concept of "due process" would appear to be applicable,[82] but even this restriction would be satisfied if adequate notice were provided.

With these basic principles in mind it is worth noting the proposed effective dates of the Casner Advisory Group proposal and the recent Treasury Department proposal for an unlimited throwback rule.

The Casner consolidation approach was to be applied to all offending trusts created after December 31, 1956, in view of the notice given the public just prior to that date.[83] It was not to be applied, however, to accumulations made by those trusts before the year of passage. The proposal went further, however, in the cases of so-called flagrant abuses where five or more offending trusts had been created in the same year. These trusts would be consolidated regardless of

76. *See generally* Novick & Petersberger, *Retroactivity in Federal Taxation*, 37 TAXES 407-32, 499-530 (1959).

77. Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916).

78. Williams, *Retroactivity in the Federal Tax Field*, 1960 S. CAL. TAX INST. 79, 84.

79. Welch v. Henry, 305 U.S. 134 (1938). This involved, however, a state tax law.

80. *See* Williams, *supra* note 78, at 88.

81. *Id.* at 79.

82. United States v. Hudson, 299 U.S. 498 (1937).

83. *See 1959 Hearings*, *supra* note 44, at 179.

when created.[84] In response to questions from Chairman Mills of the House Ways and Means Committee regarding the constitutionality of this approach, the Treasury's representative pointed out that since the trusts would be consolidated only for the year of passage and all future years, the tax would not be objectionable under the prior Supreme Court decisions.[85] Chairman Mills then stated that he believed the proposal should apply to all trusts since that was within the power of Congress.[86]

The present Treasury Department proposals appear to have adopted Chairman Mill's view since the recent proposal for an unlimited throwback rule is to apply to all trusts, whenever created, but only with respect to distributions made after the date of enactment of the proposal.[87]

In view of the fact that both the Senate Finance Committee and the House Ways and Means Committee have in the past approved multiple trust legislation which would apply to trusts already in existence, it seems fair to conclude that if legislation is passed it will apply to existing trusts regardless of any reliance the settlor, trustee, or beneficiary may have placed on present law. This does not seem unfair when one considers that Congress has been attempting to deal with the problem for well over 30 years. If the recommended approach is adopted by Congress, it would not be objectionable to consolidate trusts, whenever created, if the principal purpose of the settlor was to avoid taxes. With this in mind, a future settlor would do well to avoid practicing "brinksmanship" if he contemplates the use of multiple trusts in his estate planning.

VII. Conclusion

The problem of the use of multiple trusts to avoid the progressive tax rates is real and demands solution. The *Estelle Morris* court properly recognized that the solution lies with Congress. Proposals which have attempted to resolve the problem through the elimination of most, if not all, possibilities of avoidance are overly complex and unworkable. Although a settlor may have legitimate non-tax reasons for creating multiple trusts for the same beneficiary, this is hardly a

84. *Id.* at 188.
85. *Id.*
86. *Id.* at 189.
87. Note 62 *supra*, at 171.

persuasive argument for retention of the separate entity theory. Nonetheless, the absence of a satisfactory alternative militates toward retention of the present approach except where tax avoidance is the principal purpose in creating multiple trusts. Congress should therefore enact a short, simply stated law to that effect and leave to the Treasury the publication of adequate guidelines and regulations. This approach would help meet the great need for simplicity in our tax laws.

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