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Income Splitting as a Means of Avoiding Taxes

Allen T. Malone

NOTES

Income Splitting as a Means of Avoiding Taxes

I. Introduction

A popular belief seems to have grown up of late that, under our present graduated income tax structure, it is almost impossible to attain any great degree of wealth, that the millionaire is largely of a past era. Present economic facts, however, contradict this belief. A news magazine recently reported:

> The U. S. still offers countless opportunities for the man who wants to accumulate a personal net worth of one million dollars or more—and thousands seize them every year. The number of U. S. millionaires, reports the Federal Reserve Board, has swelled from 40,000 in 1958 to nearly 100,000 at present.[1]

It is apparent that many persons today are finding ways to avoid the top bracket income tax rates. The methods of avoidance are nearly as numerous as the ways to attain wealth in the first place. Conversion of potential ordinary income into capital gain by such means as the incorporation of an expanding enterprise or the adoption of qualified stock option plans, is probably the most popular technique employed.[2] *Eisner v. McComber*[3] notwithstanding, this modern-day alchemy is not a matter of inherent right. In most instances, it is a privilege conferred by Congress to further certain socially desirable policies, and it is carefully regulated by the Treasury Department and Congress so as to prevent abuse.[4] The loss in revenue is, in the eyes of the government, justified by certain economic or social benefits which the conferred privilege is calculated to stimulate.

Not all means of avoiding the top tax brackets, however, necessarily further a socially desirable policy. The method of income splitting, for example, is used to distort congressional tax policy.[5] "Income split-

1. Time, Dec. 3, 1965, p. 88.
2. See, *e.g.*, note 4 *infra*.
3. 252 U.S. 189 (1920).
4. *E.g.*, Stock option plan, Int. Rev. Code of 1954, §§ 42-1425; Preferred stock ballot, Int. Rev. Code of 1954, § 306; Stock redemption, Int. Rev. Code of 1954, §§ 302-304. See also Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 Nat'l Tax J. 12 (1949).
5. Ever since Justice Holmes characterized the assignment of income as "an arrangement by which the fruits are attributed to a different tree from that on which they grew," Lucas v. Earl, 281 U.S. 111, 115 (1930), high income taxpayers have been greatly concerned with ways to transfer the "trees" to separate related entities—*i.e.*,

ting" is the dividing or filtering or radiating of income among two or more tax entities. Two characteristics of our federal income tax structure make the tax advantages gained by income splitting axiomatic. First, personal income taxes are graduated and a measurable increase in annual earnings is necessarily accompanied by a correlative increase in the amount of personal income taxes required. Thus, greater distribution of high income among several tax entities results in lower individual tax rates, and therefore less ultimate aggregate tax payable. Second, an income tax exemption is allowed for each taxable entity, so the more diversified the distribution of income, the greater the amount of tax exempt income. Furthermore, as a means of avoiding high taxes, income splitting is potentially more effective than the several available techniques employed to convert potential ordinary income into capital gain. If the tax burden for a given amount of income is split among enough entities, the aggregate tax payable can be brought below capital gain tax on the same amount of income. Theoretically, because of multiple tax exemptions, the total tax payable could even be zero.

The purpose of this note is to examine the present tax treatment of the three most popular income splitting devices used to avoid taxes: the family partnership, multiple trusts, and multiple corporations. In Part II, the various congressional and judicial limits and sanctions imposed upon these devices will be discussed along with recently proposed regulatory legislation. Part III will consist of an evaluation of the suggested limitations upon the use of income splitting devices. The ultimate concern of this note is to arrive at some conclusions as to the general approach and the specific methods best suited (1) to regulate what are often deemed "sham"[6] devices to split income and thus avoid taxes, and at the same time (2) to reduce the great amount of uncertainty and confusion which now exists in this field.

The three income splitting devices upon which this note focuses have certain common elements. Principally, each is used to divide income which is ordinarily taxed to a single entity among several, separate, taxable entities, thereby achieving an income tax saving. There are, however, also subtle differences in the way each device achieves its tax saving. A few introductory remarks on these devices will perhaps elucidate the more extensive discussion of them in Part II.

The family partnership is the most obvious and the most direct way

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to members of the family or to closely-held corporations—and thus preserve the greatest amount of "fruit" within their ultimate control. The various devices employed to accomplish this feat may be broadly characterized as "income splitting devices."

6. For a brief discussion of the sham doctrine, as applied to income splitting devices, see notes 126 (multiple trusts) and 203 (multiple corporations) *infra* and accompanying text.

to split income. It is typically a means by which high income normally taxable wholly to the head of the family is diverted to other members of the family by transfers to them of capital connected with the business, thereby making the transferees partners, taxable on their shares of the business income at lower tax rates.

The multiple trust arrangement is a method by which income normally taxable to a single taxpayer is diverted by transfers of high-yield property to several, separate accumulation trust entities, each having the same beneficiary. Such an arrangement accomplishes both a radiation and a subsequent conversion of income, which is taxable to each trust as it is received. Multiple accumulation trusts thus may not only split the income of the grantor, but also of the trust beneficiary.

Multiple corporation, in which, for example, several related corporations may be formed to do the business previously accomplished by a single corporation, may also achieve a tax saving, not because of a graduated rate structure, as in the previous two devices, but because of the 25,000 dollar surtax exemption allowed for each corporate entity. Furthermore the separate 100,000 dollar minimum accumulation earnings credit allowed for each corporation provides an additional tax benefit. Multiple corporations are of two general types: the parent-subsidiary arrangement, in which each new subsidiary corporation is created by transfers from the parent corporation; and the brother-sister arrangement, in which sister corporations are formed by transfers from shareholders of a single brother corporation.[7]

II. Three Income Splitting Devices — Their Uses and Their Limits

A hypothetical family spanning three generations, and involving a prosperous, expanding business enterprise will be used from time to time in Part II in order to illustrate the functional aspects of the three income splitting devices to be discussed. The relevant facts are as follows:

The family is composed of the father, Horace Alger, Sr., his wife Hilda, and their two sons—Horace, Jr., who has recently received an advanced degree in electrical engineering, and Hal, who is presently teaching economics at State University. Both sons are married, and each has four children.

The father, Horace, Sr., while working faithfully for twenty years as a research physicist for a large electronics corporation, conducted experiments in his home workshop which eventually culminated in the invention of a highly advanced, portable computer. His employer,

7. For studies of the area of income splitting, see Bittker, Federal Income, Estate, and Gift Taxation, 330-430 (3d ed. 1964). Specialized studies are cited hereafter.

however, was unimpressed, so Horace, Sr., decided late in life to leave the electronics corporation, apply for a patent, and go into business for himself, manufacturing and selling his computer.

Although urged by his lawyer to incorporate his new enterprise, Horace, Sr. said that he had "had enough of corporations," and that he was going "to go it alone." His life savings, in addition to a large loan were used to purchase and equip a plant for manufacturing the computers and to hire three skilled employees. In the first two years expenses were high, but Horace, Sr. quickly built up a market for his computers, and during the third year, his net income began to "skyrocket." Horace, Jr. decided to help his father out in the new enterprise, and began work during this third year as both manufacturing supervisor and sales representative.

The following year, income from the enterprise exceeded expenses (including monthly payments on the debt and a 10,000 dollar per year salary for Horace, Jr.) by 300,000 dollars. It was not until Horace, Sr. filed the final installment of his income tax, however, that he suddenly realized he had paid seventy per cent of his year's income in federal income taxes, an amount with which he would have liked to expand his business.

Disappointed over his lack of tax planning, Horace, Sr. returned to his lawyer's office, seeking a way to reduce his income taxes while keeping his income "in the family." The following alternatives with their respective limitations, were fully explained to him.

A. *The Family Partnership*

One available alternative which Horace, Sr. could utilize to lower his business income taxes, particularly if he is still adverse to incorporating, is to change the form of enterprise from a sole proprietorship to a partnership, making himself, Horace, Jr., and Hal, partners.

1. *History of Limitations Imposed.* — The history of income tax treatment accorded to family partnerships prior to the passage of the 1951 Internal Revenue Code is filled with abrupt changes, and reversals. Writers have divided this confusing era into three separate periods.[8]

The first includes the years prior to 1946. Before 1930, family partnerships, if valid under state law, were generally recognized for federal income tax purposes, even if they were formed for no other reason than to avoid taxes.[9] In 1930, however, *Lucas v. Earl*[10] decided that income

8. Barrett & Seago, Partners and Partnerships—Law and Taxation 546 (1956); Willis, Handbook of Partnership Taxation 426 (1957).

9. See, *e.g.*, C. W. Crane, 19 B.T.A. 577 (1930); J. E. Briggs, 15 B.T.A. 1092 (1929); E. C. Wilson, 11 B.T.A. 963 (1928).

10. *Supra* note 5.

must be taxed to the one who earns it, and a mere assignment of income by a husband to his wife is not sufficient to shift the incidence of the tax. Thereafter,[11] courts began to scrutinize carefully family transfers in general, and family partnerships in particular.[12] By 1944, many courts were refusing to recognize family partnerships, even though valid under state law, especially where the partnership was formed by gifts to members of the family who contributed no services.[13] The Supreme Court finally reviewed the issue in 1946 in the *Tower*[14] and *Lusthous*[15] decisions. In *Tower*, the court stated:

> When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.[16]

A few pages later, it said:

> There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all these things she may be a partner . . . .[17]

Thus, apparently the Court set out two distinctly different tests for recognition of a family partnership — one based upon the subjective intent of the parties, and one based upon objective standards.

During the second period — 1946 to 1949 — both the courts and the Internal Revenue Service seized upon and assiduously applied the objective standards test, requiring a contribution of original capital or of vital services from each member.[18] Also during this period, the

11. *Ibid.*

12. *Family Partnerships and the Revenue Act of 1951*, 61 YALE L.J. 541, 542-43 (1952).

13. W. P. Sewell, 3 CCH Tax Ct. Mem. 106 (1944); R. W. Carfield, 3 CCH Tax Ct. Mem. 123 (1944). For Tax Court decisions in the same year that seemed to follow conflicting principles, see J. D. Johnston, Jr., 3 T.C. 799 (1944); Robert P. Sherer, 3 T.C. 776 (1944).

14. Commissioner v. Tower, 327 U.S. 280 (1946). Tower owned 90% of the stock in a close corporation. He gave his wife a portion of the stock, on condition that when the corporation was liquidated, she would transfer her portion of the assets to a partnership, in which she was to be a limited partner. She contributed no appreciable services.

15. Lusthaus v. Commissioner, 327 U.S. 293 (1946). Here, the husband sold his wife a one-half interest in his business (operated as a sole proprietorship) for $100,000, after which he gave her $50,000 to be used for partial payment, the balance to be paid by her out of further profit. Her services to the business were nominal.

16. 327 U.S. at 286-87.

17. *Id.* at 290.

18. See, *e.g.*, Larson v. Kramer, 84 F. Supp. 313 (D. Conn. 1949); Sam Averbuch, 12 T.C. 32 (1949); N. B. Drew, 12 T.C. 5 (1949). See also I.T. 3845, 1947-1 CUM. BULL. 66.

Revenue Act of 1948 was passed, and for the first time, under section 301 (d), a husband and wife were permitted to file a joint return, computing their income tax as if each had received half of their combined income.[19] This provision nullified the tax saving of a husband-wife partnership, but failed to lessen the mounting litigation concerning family partnerships involving children.[20]

In 1949, the Supreme Court decided *Commissioner v. Culbertson*,[21] which began the third period. There the Court specifically disavowed the strict "objective standards" test, stating that original capital and vital services were only two factors to be considered. The new proposed test was: "whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[22] It is not surprising that more confusion resnlted in applying this test, based upon subjective criteria, than the previous "objective standards" test.[23] Courts began looking to a variety of factors in order to ascertain whether the taxpayers formed their partnership "in good faith" or "for a business purpose," but there was little agreement as to the weight accorded any one factor.[24]

2. *Present Limitations.* — In order to settle the many judicial disputes over the income tax consequences of family partnerships formed by gifts of capital (frequently to the donor's minor children), Congress, in 1951, set its own standards for recognition and taxation of family partnership income. It amended the definition of "partnership" to read as follows:

> A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.[25]

And in a new section, namely 704(e), it delineated the limits of a "family partnership":

> (e) Family Partnerships
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> (2) In the case of any partnership interest created by gift, the dis-

19. Revenue Act of 1948 ch. 168, § 301(d), 62 Stat. 114, (now INT. REV. CODE OF 1954, § 2(a)).
20. I BARRETT & SEAGO, *op. cit. supra* note 8, at 549.
21. 337 U.S. 733 (1949).
22. *Id.* at 742.
23. *E.g., Compare* Le Sage v. Commissioner, 173 F.2d 826 (5th Cir. 1949) *and* Moore v. Commissioner, 170 F.2d 191 (4th Cir. 1948), *with* Graber v. Commissioner, 171 F.2d 32 (10th Cir. 1948) *and* Kent v. Commissioner, 170 F.2d 131 (6th Cir. 1948).
24. See *Income Taxation of Family Partnerships*, 50 COLUM. L. REV. 68 (1950) for a discussion of judicial decisions under the *Culbertson* rule.
25. Revenue Act of 1951, ch. 521, § 340, 65 Stat. 511.

> tributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.[26]

Both of these sections were re-enacted in the 1954 Code,[27] and a "fourth period" of the family partnership has continued from 1951 to the present.

Congress' objective in passing the new family partnership legislation was, principally, to make the general rules for taxation of income earned from property or business applicable to family partnership income. More specifically, it was to tax income from property to the real owner, and to tax income from services to the person rendering such services.[28] The most significant element of the 1951 legislation lies in its rejection of the confusing "subjective intent" test as expressed in *Culbertson*, and its substitution of an objective criterion, based upon general tax principles, to determine when family partnerships are to be recognized for income tax purposes. The Committee report stated:

> Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him. . . .[29]

The regulations interpreting section 704(e) set forth the requirements for income tax recognition of the family partnership formed by gifts of capital: (1) capital must account for a "substantial" amount of gross income to the business in order to be a "material income producing factor," and (2) the transfer of a capital interest to the new partner must be complete.[30] The focus is upon the great multitude of factors to be considered for determining when there has finally been a complete transfer. Thus, according to the regulations, certain controls retained by the donor, such as control over distribution of income,[31] over essential assets,[32] or disproportionate control over management,[33] may vitiate the partnership for tax purposes, although no one of these

26. Revenue Act of 1951, ch. 521, § 3406, 65 Stat. 511 (now Int. Rev. Code of 1954, § 704(e) (2)).
27. Int. Rev. Code of 1954, § 704(e) (2).
28. See House Ways and Means Committee, *Revenue Act of 1951*, H. R. Rep. No. 586, 82d Cong. 1st Sess. 32 (1951).
29. *Ibid.*
30. Treas. Reg. § 1.704-1(e)(1)(iii),(iv) (1956).
31. Treas. Reg. § 1.704-1(e)(2)(ii)(a) (1956).
32. Treas. Reg. § 1.704-1(e)(2)(ii)(c) (1956).
33. Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956).

factors in conclusive. Other factors helpful in determining whether the donee actually owns a capital interest in the partnership, for purposes of section 704(e), include: whether the donee participates in management;[34] whether he is held out as a partner;[35] and even whether there is a tax avoidance motive behind the transfer.[36] Once a valid partnership is established, section 704(e)(2) provides guidelines to assure the proper allocation of the family partnership income. It allows the donee of capital to be taxed on his distributive share, after allowance has been made for compensation for the donor's services and the share attributable to the donor's capital.[37] The regulations interpret this section to mean that priority should be given to the share attributable to the donor's services, requiring it to be deducted before computing the donee's share of partnership income.[38]

3. *Advantages and Use as an Income Splitting Device Today.*[39] Under the 1951 legislation, formation of a section 704(e) family partnership by distributing gifts of capital interests to members of the donor's family is virtually certain to split the income of the donor. However, formation of a closely-held corporation, and distribution of stock among family members, may well accomplish the same result just as effectively, and even though many other tax and non-tax factors will enter into the ultimate choice of business form, there will be no imposition of the limitations required under section 704(e).[40] While that section gives fairly definite guidelines for income taxation of family partnerships, strictly from the standpoint of income splitting, the corporate form provides a more certain means of spreading income among shareholding members of the family. The price for such, however, is the so-called double tax on corporate income — once at the corporate level and again at the shareholder level. But this can be avoided by a subchapter S election by the corporation, which will be discussed later as an alternative to the family partnership.[41]

Turning again to the predicament of Horace Alger, Sr., one can readily see that using the family partnership is one method that he can employ to reduce his taxes on business income. Since Horace, Jr. per-

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34. Treas. Reg. § 1.704-1(e)(2)(iv) (1956).
35. Treas. Reg. § 1.704-1(e)(2)(vi) (1956).
36. Treas. Reg. § 1.704-1(e)(2)(x) (1956).
37. Int. Rev. Code of 1954, § 704(e)(2).
38. Treas. Reg. § 1.704-1(e)(3)(i)(b) (1956). See Beck, *Use of the Family Partnership as an Operating Device — The New Regulations,* N.Y.U. 12th Inst. on Fed. Tax, 603, 608-28 (1954) for an analysis of the family partnership regulations.
39. For a recent discussion of this area, see Strecker, *When Will the Corporate Form Save Taxes?,* 18 Vand. L. Rev. 1695 (1965). See also Caplin, *Partnership or Sub Corporation? A Check List of the Tax Factors in the Choice,* 12 J. Taxation 32 (1960).
40. *Ibid.* Bnt see note 62 *infra.*
41. See note 61 *infra* and accompanying text.

forms substantial services for the business, there is no problem in qualifying him as a partner. However, Horace, Sr. might also like to give his other son, Hal, an interest in his lucrative enterprise. Although Hal might be able to perform some services in the capacity of business advisor, a gift of capital under section 704(e) will manifestly be necessary to assure Hal a substantial partnership interest. This might be accomplished by a transfer of the manufacturing plant and equipment to both Hal and Horace, Jr. as tenants in common.

In order to maximize chances of income tax recognition of the family partnership, several precautions might be taken.[42] First, the agreement should recite the percentile share of earnings for each partner. In addition, it should state that reasonable compensation for services performed by Horace, Sr. and Horace, Jr. was considered in computing their respective shares, and that Hal's share represents that portion of the partnership income attributable to his one-half interest in the business capital. Another wise precaution is to incorporate the language of the regulations under 704(e) into the agreement, particularly with reference to the partners' participation in management;[43] freedom to withdraw their distributable share of earnings;[44] and right to withdraw from the partnership altogether.[45]

Assuming that the partnership shares recited in the agreement are one-half for Horace, Jr., one-fourth for Horace, Sr., and one-fourth for Hal, and assuming further that the enterprise produces 300,000 dollars of net income for the second straight year, Horace, Sr. will pay approximately 30,570 dollars[46] in federal income tax, as opposed to the 180,980 dollars[47] paid the previous year when he was sole proprietor. The total tax saving, including the additional taxes now incurred by the two sons, is 42,860 dollars annually.[48]

(a) *Use of Trusts in the Family Partnership.* — The income tax saving afforded by the above family partnership is significant, but in order to realize the maximum tax advantages from a family partnership, the trust device is often used. The regulations recognize that a trustee may be a partner in a family partnership where the trustee is either independent of the grantor or actively represents the beneficiaries in a fiduciary capacity.[49]

To illustrate how trusts are used, we will return to the Alger family.

42. See suggestions in Beck, *supra* note 38, at 625-28.
43. Treas. Reg. § 1.704-1(e)(2)(iv) (1956).
44. Treas. Reg. § 1.704-1(e)(2)(ii)(a) (1956).
45. Treas. Reg. § 1.704-1(e)(2)(ii)(b) (1956).
46. Computed according to 1965 rates for joint returns, INT. REV. CODE OF 1954, § 1(a).
47. *Ibid.*
48. Horace, Jr. will pay $76,980; Hal, $30,570 annually. *Ibid.*
49. Treas. Reg. § 1.704-1(e)(2)(vii) (1956).

Horace, Sr., delighted at the prospect of splitting his business income among members of his family by gifts of capital, might begin to wonder why he should not extend these gifts to his eight grandchildren instead of merely to his two sons. There would be two principal advantages in making the eight grandchildren partners. First, such a plan obviously will spread the income out even further than the three-man partnerships described above, thus saving a greater amount of tax dollars. Second, an even more significant advantage may be that this plan will help to reduce the property in the estates of Horace, Sr. and his sons, thus "skipping a generation" for estate tax purposes. Also, Horace, Sr. will be allowed 36,000 dollars more in gift exemptions by transferring the property to his eight grandchildren rather than to his two sons.[50]

The regulations state that unless minors are capable of managing their own partnership interests, they will not be recognized as partners for income tax purposes.[51] One possible way to surmount this difficulty is to make the minors limited partners. However, family partnerships involving minors whose interests are not protected by any fiduciary are often looked upon with suspicion by the courts.[52] Nevertheless, as above stated the regulations also recognize that trustees can be members of a family partnership. [53] Thus, perhaps a more advisable method for Horace, Sr. to include the grandchildren in the family partnership is to set up eight separate trusts for them, thereby dividing that portion of the partnership income attributable to the property transferred to the trustee among eight separate taxable entities. Each trust instrument could provide for accumulation of income or distribution for non-support items to further the education and maintain the standard of living of the beneficiary until he attains majority, at which time all accumulated income and corpus (*i.e.*, the beneficiary's legal interest in the trust property) will be distributed to the beneficiary.[54]

The sons, Horace, Jr. and Hal, could be made trustees. This course, however, would leave the partnership vulnerable to attack by the Commissioner on the ground that the trustees are amenable to the donor's will, and thus possibly cause the income attributable to the trust prop-

50. INT. REV. CODE OF 1954, §§ 2503(b), 2513.

51. Treas. Reg. § 1.704-1(e)(2)(viii) (1956).

52. See, *e.g.*, Pflugradt v. United States, 310 F.2d 412 (7th Cir. 1962). See also Treas. Reg. § 1.704-1(e)(2)(iv) (1956).

53. *Supra* note 49. For cases in which trusts for minors were held to be valid, see, S. H. Hartman, 43 T.C. 105 (1964); P. Pearlstone, 60-1 U.S. Tax Cas. ¶ 9360 (W.D. Texas 1960); J. Smith, 32 T.C. 1261 (1959).

54. These provisions will assure that Horace, Jr. and Hal will not be taxed on the trust income expended for the beneficiaries. INT. REV. CODE OF 1954, § 677(b). The ultimate distributions of the trust property, including accumulated income, will be tax free to the beneficiaries. INT. REV. CODE OF 1954, § 665(b)(1).

erty to be taxed to Horace, Sr.[55] To avoid this problem, an independent trustee should be appointed. He probably should be made a limited partner so that (1) the trusts will be protected against unlimited liability, and (2) control and management will be retained by the partners actively engaged in the business. The regulations specifically recognize limited partners in the family partnership and require only that state law be complied with; that the transfer be complete; and that, in allocating partnership income, consideration be given to the fact that the risks taken by limited partners are less than those taken by general partners.[56]

Not only does the trust device in a family partnership which includes minors provide a more reliable means to split income, and thus lower income taxes, but other benefits also result. First, the terms of the trusts specifically exempt the grantor from income taxation on the trust property[57] and likewise exempt the property from being included in his gross estate.[58] Second, since the trust distributions are within one of the exceptions to the throwback rules, the distributions are tax free.[59] A further advantage in using trusts, as opposed to direct transfers, in the family partnership lies in the possibility of resorting to multiple trusts, which will be discussed in Section C.

4. *Alternatives to the Family Partnership.* – The family partnership is, of course, only one method of splitting business income. Similar results may be achieved by using at least two other devices: the Subchapter S election, which, as stated above, is available to the corporate form of business, and the gift and lease back, which may be used by a proprietorship or a partnership. As stated earlier, a large variety of tax and non-tax factors enter into the ultimate choice of a business form.[60] The focus here is only upon the single factor of income splitting.

(a) *The Subchapter S Election.* – In the event that Horace, Sr. decides to incorporate his business, income splitting would be simply a matter of transferring shares of stock to his children and grandchildren and later distributing the stock dividends. As noted earlier, however, this plan entails a "double tax" on the same income, once on the

55. INT. REV. CODE OF 1954, § 674. However, § 674(d) provides an exception if the power of the trustees to distribute, apportion, or accumulate income is limited by an ascertainable standard.

56. *Supra* note 52.

57. INT. REV. CODE OF 1954, §§ 671-77. It provides for accumulation of income or distribution for non-support items limited by an ascertainable standard, with no power to control, administer or revoke retained by the grantor, and distribution of accumulated income and corpus as each child reaches majority.

58. INT. REV. CODE OF 1954, §§ 2036, 2038.

59. INT. REV. CODE OF 1954, § 665(b)(1).

60. See note 39 *supra*.

corporate income and again on the shareholders' dividends. Other disadvantages of the corporate form include taxable liquidation, unfavorable loss treatment, and the threat of the accumulated earnings tax. Subchapter S of the Code[61] removes all of these objections for certain defined corporations.[62]

When a corporation, by the unanimous consent of its shareholders,[63] makes a subchapter S election, the business continues to be treated as a corporation for most tax purposes. There are, however, four important exceptions. The "subchapter S corporation" is not subject to corporate income tax.[64] The shareholders are taxed currently on dividends and undistributed net income of the corporation.[65] Losses of the corporation "pass through" to the shareholders, and may be used to offset their ordinary income.[66] Capital gains to the corporation also pass through, retaining their character in the hands of the shareholders.[67] These four exceptions permit a corporation to operate as a partnership for most income tax purposes, and thereby present to many businesses a method of splitting income more advantageously than the family partnership.

Subchapter S is not without its limitations and drawbacks, however. Election is limited to the "small business corporation," which the Code defines as a domestic corporation, not a member of any affiliated group (not a subsidiary 80 per cent owned and controlled by a separate parent corporation), having only one class of stock, and having no more than ten shareholders, no one of whom is a non-resident alien and none of whom is a corporation, partnership, or trust.[68] Two other prerequisites for a subchapter S election that limit its availability, and that are not mentioned in the sections defining the "small business corporation," are the requirements that less than twenty per cent of the subchapter S corporation's income be personal holding company income (which includes rent and interest)[69] and that less than eighty per cent of the business income be from outside the United States.[70] Another factor that may persuade a businessman to split his income by

61. INT. REV. CODE OF 1954, §§ 1371-77.

62. For a discussion of subchapter S, see Stein, *Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958*, 72 HARV. L. REV. 710 (1959). See also Caplin, *supra* note 40. To curb the use of subchapter S as a way around the family partnership rules of § 704(e), § 1375(c) provides for allocation of dividends among family members if necessary to reflect services rendered by them.

63. INT. REV. CODE OF 1954, § 1372(a).

64. INT. REV. CODE OF 1954, § 1371(b)(1).

65. INT. REV. CODE OF 1954, § 1373(a).

66. INT. REV. CODE OF 1954, § 1374(a).

67. INT. REV. CODE OF 1954, § 1375(a)(1).

68. INT. REV. CODE OF 1954, § 1371(a).

69. INT. REV. CODE OF 1954, § 1372(e)(5).

70. INT. REV. CODE OF 1954, § 1372(e)(4).

use of the family partnership rather than the subchapter S corporation is the possibility of unilateral termination, such as the transfer by a single share holder of his stock to a trust.[71] In the event of such termination, there is the possibility that undistributed net income may be taxed twice, once when earned and again if and when received after the Subchapter S election is terminated.[72]

(b) *Gift and Lease Back.* – A method by which Horace, Sr. could lower his income taxes and yet continue to operate his enterprise as sole proprietor is to transfer the plant and equipment to a trust for the benefit of his grandchildren, and subsequently lease the plant back from the trustee. Horace, Sr. could thereby deduct the rent (which is paid to his grandchildren's trusts) from his business income, and thus lower his taxes and achieve a similar income splitting effect to that of the family partnership.[73]

At one time there was considerable disagreement as to whether the gift (or sale) and lease back device could or should produce the desired tax effects.[74] In two landmark cases involving the question whether rent deductions should be allowed in the gift and lease back situation, the taxpayers prevailed.[75] In a third case, however, the deductions were disallowed.[76] Yet a subsequent shift in position by the majority of the Tax Court[77] and acquiescence by the Commissioner[78] seemed to establish the principle that "if business property were given to an independent trustee and the property was then leased back at a reasonable rent, the donor would be allowed to deduct the rent paid to the trustee."[79]

Three recent cases[80] have reopened litigation in this field. Each involved the gift of an office-building in trust by a physician to his

71. INT. REV. CODE OF 1954, § 1372(e).

72. See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 416-17 (1959).

73. It should be recognized, however, that a partnership interest based upon ownership of capital might result in much more income to the owner than the fair rental value of the property, and thus produce a greater amount of income splitting thau the sale and lease back device. See Treas. Reg. § 1.704-1(3)(i)(b) (1956).

74. See Carey, *Current Problems in Sale, or Gift, and Lease-Back Transactions,* 29 TAXES 662, 669 (1951); Note, *The Gift and Leaseback: A New Tax Avoidance Gimmick,* 59 YALE L. J. 1529 (1950).

75. Deductions allowed in Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).

76. White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951).

77. Albert T. Felix, 21 T.C. 794 (1954) (four judges dissenting).

78. John T. Potter, 27 T.C. 200 (1956), *acq.,* 1957-2 CUM. BULL. 6.

79. Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust,* 51 CORNELL L.Q. 21 (1965).

80. Van Zandt v. Commissiouer, 341 F.2d 440 (5th Cir.), *cert. denied,* 382 U.S. 814 (1965); Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962); Alden B. Oakes, 44 T.C. 524 (1965).

children, with a lease back from the trustee. Significantly, in each the donor transferred the property to a short-term trust with reversion after ten years.[81] In two of the cases rent deductions were disallowed; one on the ground that the transaction was merely an assignment of income,[82] and the other because the transaction involved no business purpose,[83] and thus the rent paid was not an "ordinary and necessary incident in the conduct of the business."[84] The third case, *Alden B. Oakes,*[85] involved an eleven-year trust, with an independent trustee, and reversion to the grantor's wife instead of to the grantor. The rent deductions were allowed in this case. Judge Dawson, who also wrote the Tax Court's opinion in *Van Zandt,* held that the fact that there was no business purpose was not controlling; "actual independence" of the trustee is a "pivotal factor."[86] Another important factor in the taxpayer's favor was that the reversionary (or remainder) interest was held by his wife, rather than by him.

Thus, although the section 704(e) family partnership may often split a greater fraction of business income than the gift and lease back (which cannot split an amount in excess of the reasonable rent of the property transferred), the latter device has the advantage of a more limited commitment when the short-term trust is used. It is extremely doubtful that the trustee of a short-term trust would be eligible as a partner in a family partnership since the requirement of real ownership by the donee would not be met.[87] The short term trust is, however, by no means certain to succeed even in the gift and lease back situation since the rent deduction, if disallowed, will be taxed twice—once to the grantor and again to the trustee.[88]

5. *Proposed Legislation.* — Unlike multiple trusts and multiple corporations, relatively little has been written about the family partnership during the past decade, and the number of reported cases in this area has also declined. This waning of interest over the family partnership is probably due to several factors. First, Congress' rules, set out in the 1951 code,[89] which base tax recognition of partnership interests created by gifts of capital upon the completeness of the transfer rather than upon the intent of the donor, are relatively unambiguous and easy to apply. The legislation seems fair and has worked infinitely

81. A short term trust is an exception to the general rule that a revocable trust is taxable to the grantor. See INT. REV. CODE OF 1954, §§ 673(a), 674(b)(2).
82. Van Zandt v. Commissioner, *supra* note 80.
83. Hall v. United States, *supra* note 80.
84. 341 F.2d at 443.
85. *Supra* note 80.
86. *Ibid.*
87. Treas. Reg. § 1,704-1(e)(2) (1956).
88. See Oliver, *supra* note 79, at 46.
89. INT. REV. CODE OF 1954, § 704(e).

better than the various judicial rules formulated during the pre-1951 era, both from the standpoint of providing clear and equitable guidelines for tax treatment of family partnership income and of preventing undue tax avoidance.

Another reason for the waning interest in family partnerships is the tremendous increase in popularity of the corporate form. A whole host of tax saving advantages, open only to the corporate form of business account for this present popularity, such as qualified deferred compensation[90] and stock option plans[91] and many sections giving special economic advantages to the small business corporation.[92] Also, as has been mentioned, the subchapter S election[93] allows many proprietorships to adopt the corporate form and split income by transferring shares to family members with substantially the same income tax effects as if the business were a partnership.

Nevertheless, the family partnership continues to be used today as an effective income splitting device,[94] and no serious proposals have lately been made to change the legislation that has regulated family partnerships for the past fifteen years.

C. *Multiple Trusts*

The multiple trust, referred to here as a device to split income, most often involves a series of separate accumulation or "complex" trusts, set up by a single grantor for a single beneficiary. To illustrate one way this device might be used, we will again return to the Alger family. Let us assume that Horace, Sr. decides to transfer the plant and equipment used in his business to trusts for his eight grandchildren, with the trustee as a limited partner and one-sixteenth of the partnership income attributable to each trust. It is obvious that if the partnership income continues to increase, even though a large portion of the increase undoubtedly will have to be attributed to the services of Horace, Sr. and Horace, Jr. (particularly if the trustee is a limited partner), the income tax rates for each trust will climb into correspondingly higher brackets. Thus, in order to lower the taxes payable by trustee, and thus preserve for the beneficiaries as much of the partnership income attributable to the trust property as possible, Horace, Sr. might create three separate trusts for each grandchild instead of just one. This arrangement will result in twenty-four separate trusts, each taxable on only one-forty-eighth of the partnership income.

90. INT. REV. CODE OF 1954, §§ 401-07.
91. INT. REV. CODE OF 1954, §§ 421-25.
92. *E.g.*, additional first year depreciation allowances, INT. REV. CODE OF 1954, § 179; three year net operating carryback, § 172(b); losses on small business stock, § 1244.
93. See note 61 *supra* and accompanying text.
94. See note 52 *supra* and the authorities cited therein.

Where the total income is high, a considerable tax saving will result, due both to the imposition of lower tax rates on the income attributable to each trust, and the additional 1600 dollars exempt from income annually.[95]

It can readily be seen that, while the family partnership is a device by which the donor of capital can lower his own income taxes, the multiple trust device may be used to effect a tax saving on the next level of income – that is, to lower taxes paid by the *donees*. The multiple trust device is not restricted to use in the family partnership, however. Numerous and often elaborate ways have been devised to utilize multiple trusts to avoid taxes, some of which will be considered below.

1. *Past and Present Limitations Imposed* – (a). *Legislative Limitations.* – Under the early tax law, the trust had no separate, taxable status, all income merely being taxed to the beneficiary.[96] It soon became apparent, however, that accumulation trusts with several contingent beneficiaries could be used to avoid income taxes altogether, since a taxable beneficiary could not be ascertained. To close this loophole, Congress amended the law to make the trustee a separate, taxable person.[97] With the era of the graduated income tax, this amendment created a new "loophole," however, in the form of accumulation trusts, and particularly *multiple* accumulation trusts.

Initially there were two central aspects of this loophole. First, as demonstrated above, multiple accumulation trusts could be used to accumulate income, potentially taxable to the grantor or beneficiary at high rates at the lower rates of the separate trust entities.[98] Second, the ultimate distributions of the accumulated trust income were taxable to the beneficiary *only to the extent of the untaxed trust income in the year of distribution,* thus completing the transformation from high to low bracket income. Also, often the trustee could deem at least part of this distribution corpus rather than income, and to that extent the beneficiary would be taxed at the more favorable capital gain rate.

At one time Congress imposed no limitations whatsoever upon the use of multiple accumulation trusts, even though the Treasury Department has been aware of the tax avoidance possibilities inherent in this

95. Each accumulation trust is allowed a $100 income tax exemption. See Int. Rev. Code of 1954, § 642(b).

96. Revenue Act of 1913, ch. 16, § 11(D) 38 Stat. 114. See Note, *Multiple Trusts and the Minimization of Federal Taxes,* 40 Colum. L. Rev. 309 (1940).

97. Revenue Act of 1916, ch. 463, § 2(b) 39 Stat. 756. U.S. Treas. Reg. 33, Art. 27, 29.

98. In *Hearings before Joint Committee on Tax Evasion and Avoidance,* 75th Cong., 1st Sess. 278 (1937) is an example of the tax savings possibilities of accumulation of income in multiple trusts. By using 56 accumulation trusts, 4 separate, related grantors were able to save $701,227 in taxes over a three year period.

device since before 1937.[99] Strangely, today there are still no direct prohibitions against the first aspect of the multiple accumulation device—*i.e.*, the right to accumulate income in multiple trusts.[100] The second aspect of multiple accumulation trusts—tax free distribution of accumulated income—however, was recently subjected to a direct, but not very far-reaching statutory restriction.[101]

Turning first to the right to accumulate taxable income in multiple trusts, the only restrictions upon the grantor's right to set up such an arrangement are embodied in the general Code provisions for taxation of income to grantor trusts.[102] These sections were passed by Congress in order to prevent a grantor from shifting the incidence of taxation on income earned from property in a "Clifford-type" trust – whether of the accumulation or mandatory distribution variety – while retaining substantial incidents of ownership over the trust property.[103] They define the specific powers and interests which, if retained by the grantor, would cause him to be taxable upon the trust income. As long as the burden of income tax on the trust property is shifted away from the grantor by compliance with these Code sections, then his right to provide for accumulation of taxable income in multiple trusts for a single beneficiary has never been restricted by Congress.[104]

The first legislation directed specifically to limiting the tax avoidance capabilities of accumulation trusts was passed in 1937.[105] Congressional hearings conducted during that year revealed that six families had evaded a total of 1,891,822.88 dollars through the use of 98 separate accumulation trusts.[106] For example, one taxpayer created on a single day sixty-four trusts, with his wife and three children as beneficiaries, and transferred 277,500 shares of Pan-American stock to the trusts. The stock was immediately sold, and by having sixty-four trusts instead of just four, the capital gains tax on the sale was reduced by $485,000 dollars.[107]

Strangely enough, the only legislation to result from these hearings

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99. See note 106 *infra* and accompanying text.

100. See Ervin, *Multiple Accumulation Trusts and Related Problems Under the Income Tax*, 29 So. CAL. L.R. 402, 405 (1956).

101. See note 111 *infra* and accompanying text.

102. INT. REV. CODE OF 1954, §§ 671-77.

103. See Pedrick, *Grantor Powers and Estate Taxation: The Ties That Bind*, 54 Nw. U. L. REV. 527 (1959).

104. Congress has made this right less attractive, however, by passage of the "throwback rule." See note 111 *infra* and accompanying text. See also Ervin, *supra* note 100, at 405; Soter, *Federal Taxation Aspects of Multiple Accumulation Trusts*, 31 U. CINC. L. REV. 351, 363-84 (1962).

105. INT. REV. CODE OF 1939, ch. 2, § 163(b) 53 Stat. 67. For corresponding section in the present code, see note 95 *supra*.

106. See *Hearings*, *supra* note 98.

107. *Id.* at 264, cited in Soter, *supra* note 104, at 354. See also Fillman & Barnet, *Recent Proposals on the Taxation of Estates and Trusts*, 41 B.U.L. REV. 35, 36 (1961).

was a reduction of the accumulation trust's income tax exemption from 1,000 dollars to 100 dollars.[108] This legislation restricted one aspect of the tax avoidance capabilities inherent in the accumulation of income in multiple trusts (multiple tax exemptions), but it left completely unrestricted the right to accumulate potentially high bracket income in multiple, low-bracket trust entities for a single beneficiary. One possible explanation for this failure may lie in the statement of Representative Vinson, a member of the tax committee, and later to become Chief Justice of the Supreme Court, to the effect that the gift tax is a sufficient check on the tax avoidance possibilities of multiple trusts.[109] It should be noted here that the gift tax is always a factor to consider when making inter vivos transfers. However, the gift tax is the same, whether property is transferred to a single trust, or to multiple trusts for the same beneficiary.[110] Thus, it is difficult to comprehend how the gift tax restricts the multiple trust device.

The only other legislative restrictions to be imposed upon the tax avoidance capabilities of the accumulation trust was directed to restricting the second aspect of this device—tax free distribution of accumulated income. This restriction, passed in 1954, is called the "five year throwback rule."[111] Like the reduction of the income tax exemption, this limitation applies to single and multiple accumulation trusts. The throwback rule does not impose any restriction on accumulating income in trusts. It does, however, provide that whenever distribution is made to the beneficiary of an accumulation trust, the beneficiary is taxable on the "distributable net income" to the trust during the five years prior to distribution. The term "distributable net income" is a term of art, formulated by Congress principally for two reasons: first, to prevent the trustee's discretionary allocation of distributions, among beneficiaries to either income or corpus, and thereby to provide a rational basis on which to compute income taxation of trust distributions; and second, to provide the maximum distribution deduction that a trustee may take in computing trust income.[112]

The five-year throwback rule, in bringing the trust's distributable net income during the prior five years into the distributee's taxable income, effectively restricts frequent, tax-free distributions of accumulation

108. *Supra* note 105.

109. "[U]nder the law whenever a gift is made, it is not in the picture as to what income the gift will produce. The gift tax settles that. Under the law a person has a right to give away his property, if he pays the gift tax." Statement by Rep. Vinson, *Hearings, supra* note 98, at 286.

110. Treas. Reg. § 25.2503-2 (1958).

111. Int. Rev. Code of 1954, § 666.

112. On the effect of the throwback rule on multiple trusts, see Ervin, *supra* note 100, at 406; Soter, *supra* note 104, at 369-74; Note, *Taxation of Multiple Trusts*, 24 U. Chi. L. Rev. 156 (1956).

trusts, whether multiple or single. It can readily be seen that, although the multiple trust might be a marvelous method to lower taxes on high income property, no one will get the benefit of the tax saving unless distributions are eventually made. Thus, it would seem that the throwback rule would discourage the use of multiple trusts merely to split income and avoid taxes. Such is not the case, however, simply because the throwback rule is so easily avoided.[113] Avoidance is generally accomplished through one of the rule's five exceptions, which exempt from it's operation: (1) accumulation distributions accumulated before the birth or during the minority of the beneficiary;[114] (2) distributions for emergency needs;[115] (3) certain periodic distributions of pre-1954 trusts;[116] (4) accumulations for a nine-year period, distributed in complete liquidation of the trust, if no property was transferred to the trust during the nine-year-period;[117] and (5) accumulation distributions not in excess of 2000 dollars.[118]

Today, there are still no direct statutory restrictions upon intentional tax avoidance by the use of multiple accumulation trusts. Furthermore, as discussed above, the only indirect limitations are the requirements that the grantor relinquish enough incidents of ownership and control over the trust property to himself escape taxation on its income, and that any distribution of accumulated income to the beneficiary, if not within the several exceptions to the rule, be subject to the five-year throwback rule.

The present status of multiple accumulation trusts as an income splitting device, however, is extremely tenuous. This device has lately been under the close scrutiny of Congress and the courts, and the rules applicable to multiple trusts are almost certain to undergo extensive revision in the near future. The Treasury's interest in multiple trusts as a tax avoidance device, so apparent thirty years ago,[119] was revived in 1956,[120] and led to the introduction of a bill in Congress directed specifically against the use of multiple trusts to avoid taxes.[121] This bill will be discussed below.

(b). *Court-Made Limitations.* — The method traditionally used by

113. See Ervin, *supra* note 100, at 406.
114. INT. REV. CODE OF 1954, § 665(b)(1).
115. INT. REV. CODE OF 1954, § 655(b)(2).
116. INT. REV. CODE OF 1954, § 665(b)(3).
117. INT. REV. CODE OF 1954, § 665(b)(4).
118. INT. REV. CODE OF 1954, § 665(b).
119. See *Hearings, supra* note 98.
120. See STAFFS OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AND THE TREASURY DEPARTMENT, 84TH CONG., 2D SESS., LIST OF SUBSTANTIVE UNINTENDED BENEFITS AND HARDSHIPS FOR TECHNICAL AMENDMENTS ACT OF 1957, 8 (Comm. Print 1956).
121. See note 152 *infra*.

courts to determine income tax consequences of multiple trusts merely involved construction of the trust instrument to determine how many trusts the grantor intended to create.[122] Where the grantor manifested an intent in the trust instrument to create multiple trusts, even when the trusts were created solely to avoid taxes, courts have usually upheld the separate trust entities for tax purposes.[123] A 1954 decision written by Judge Learned Hand modified the "intent test" by requiring that the grantor must not only intend multiple trusts, but also he must comply with the form required by local law in order to effectuate this intent.[124] This test is generally satisfied when the grantor executes a separate instrument for each trust.[125]

At least one court has gone even farther. In *Boyce v. United States*,[126] the taxpayer engaged in a rather risky attempt to split income, involving both a sale and lease back and a multiple trust arrangement. This optimistic taxpayer, a physician, executed ninety identical inter vivos instruments, each naming his son as beneficiary and each having the same trustee. To these trusts, the taxpayer transferred ninety separate checks, totaling 17,740 dollars, and the next day, in consideration of the 17,740 dollars, transferred his office building to the trustee and immediately leased the building back. Thereafter, the taxpayer paid 400 dollars a month rent to the trustee, which the trustee allocated among the ninety trusts. After ten months, distributions were made to the beneficiary by ninety different checks, totaling 4000 dollars. In subsequent years, however, the trustee was less careful in preserving the form of the multiple trust arrangement, withdrawing distributions on behalf of the beneficiary in lump sums.

In spite of the fact that the taxpayer's intent to create multiple trusts was undisputed and the form of the trusts satisfied local law, the court sustained the Commissioner's contention that the trusts must be consolidated for trust purposes. The court stated that the intent test is limited to multiple trusts with *different* beneficiaries.[127] It noted that courts have often struck down tax avoidance schemes by extension of the "business purpose doctrine," made to realign transactions undertaken with the intent to avoid taxes. Rather than expressly apply the business purpose (or in this case, trust purpose) doctrine to multiple trusts, however, the court purported to follow a different test—the "sub-

122. *E.g.*, Hale v. Dominion Nat'l Bank, 186 F.2d 374 (6th Cir. 1951); E. B. Hiecke Trust, 6 T.C. 30 (1946). See also Soter, *supra*, note 104 at 356-60; Note, *supra* note 96, at 311; Note, *supra* note 112, at 161-62.

123. *E.g.*, Commissioner v. McIlvaine, 78 F.2d 787 (7th Cir. 1935).

124. McHarg v. Fitzpatrick, 210 F.2d 792 (2d Cir. 1954).

125. See Note, *supra* note 112, at 162.

126. 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961), 46 Minn. L. Rev. 1111 (1962).

127. 190 F. Supp. at 952.

stance-form" test, or what has also been called the "sham doctrine."[128] In applying this test, the court said that close scrutiny is to be given to all family transactions, such as multiple trusts set up by a father for his son, and that where the "entire scheme is but a mockery of our tax laws . . . [where] it is obvious on the facts that we are confronted with shams, not realities, shadows and not substance,"[129] then "substance must and does prevail over form,"[130] and the trusts will be consolidated and taxed accordingly.

Since the *Boyce* case, no other reported decision has applied the "sham doctrine" to multiple trusts, leaving the status of the multiple accumulation trust with a single beneficiary more uncertain than ever. In fact, there has been very little litigation involving this device in recent years, which could be due either to the taxpayers' wariness of this device or to the Commissioner's willingness to wait for Congress to act upon the pending multiple trust legislation before using judicial rules such as the sham doctrine to attack this device.

2. *Present Advantages and Uses.* — The income tax advantages of multiple trusts—accumulation of income in low-bracket entities and tax-free distribution of the accumulated income—have already been illustrated. There are, however, many situations in which multiple trusts are used to achieve non-tax purposes.[131] Often, for example, a grantor may want to select different trustees for different types of property. Or, if his properties are far apart, he may need separate trusts in order to provide better management of his land. Also, he may have a different reason for establishing each trust; *i.e.*, one for a child's education, one for his maintenance, one for insurance, and so on, with a different trustee for each purpose. Generally, if each trust has the same beneficiary, but a different remainderman, the multiple trusts are formed for a non-tax purpose. They may, however, be formed to serve limited business purposes; for example, to facilitate a leasing arrangement, to obtain loans, or to foreclose mortgages.[132] These possible alternatives might help refute a Government argument that the multiple trust device was formed only to avoid taxes. It is difficult, however, to imagine a situation in which multiple trusts for the same beneficiary, each with the same trustee, and each encompassing interests in substantially the same property, could serve a legitimate non-tax purpose.

128. *Id.* at 956.
129. *Id.* at 957.
130. *Id.* at 958.
131. Indeed, multiple trusts were used long before the federal income tax was passed. *E.g.*, Thelluson v. Woodford, 11 Ves. 112, 31 Eng. Rep. 117 (1805). See HARRIS, FAMILY ESTATE PLANNING GUIDE 290, 291 (1957).
132. See Ervin, *supra* note 100, at 412-18.

We have already seen how multiple trusts were used by the Alger family to accumulate income at a considerable tax saving. To assure the maximum tax benefit, however, the Algers must still provide for distribution of the accumulated income so as to avoid the five-year throwback rule.[133] One possibility is for Horace, Sr. to set up a master trust as a partner, and seven subsidiary trusts for each of his eight grandchildren. In the first year, the master trust would distribute all of its income equally to the first of each grandchild's seven trusts; in the second year it would distribute to the second of each grandchild's seven trusts; ultimately, in the seventh year, the first trust of each grandchild would distribute to him its accumulated earnings over the past seven years, and assuming an undistributed net income of less than 2000 dollars, this distribution would be tax-free.[134] The next year, the cycle would begin anew. Another less complicated plan could be utilized in the trust arrangement originally described—that is, three trusts for each grandchild—with tax free distribution as each grandchild attains the age of twenty-one.[135]

Outside of the family partnership, the multiple trust device is most advantageous when used pursuant to a transfer of high-yield property to a single donee. Thus, an elderly man, such as our friend Horace, Sr., who is interested in making inter vivos transfers of a large bloc of high yield securities—in order to reduce his own income taxes,[136] to reduce his gross estate[137] and to take advantage of annual gift tax exemptions[138] — might transfer his stock in separate trusts for the same beneficiary at the end of every year. Each trust could accumulate income for nine years and distribute tax free in the tenth year.[139] Finally, as writers in this field have often suggested, the logical end of the multiple trust arrangement would be to transfer property to enough trusts so that no one trust would have more than 100 dollars in annual income. In this way, no trust would be taxable, because of the 100 dollar income tax exemption.[140] Furthermore, annual distributions would also be tax free,[141] resulting in complete tax avoidance. Of course, one difficulty with such a plan is that the expense of trustees' fees alone would probably far exceed the highest tax rate on the total income.

133. *Supra* note 111. The specific statutory exceptions to the throwback rule provide clear guides for avoiding the rule. See notes 114-18 *supra*.

134. *Supra* note 111.

135. *Supra* note 114.

136. INT. REV. CODE OF 1954, §§ 671-77.

137. INT. REV. CODE OF 1954, §§ 2036, 2038.

138. INT. REV. CODE OF 1954, § 2503(b).

139. *Supra* note 117.

140. *Supra* note 95.

141. *Supra* note 118.

As an income splitting device, the future of the multiple accumulation trust arrangement is tenuous at best. Even if Congress fails to pass regulatory legislation, it seems likely that the courts, by extending the sham or business purpose doctrines, will take an initiative in limiting this device.[142] Under the present statutory law, however, the taxpayer can take certain precautions which may support his multiple trust arrangement under even the closest scrutiny of the judiciary.[143] To illustrate, let us assume that Horace, Sr. adopts a plan by which three separate trusts of equal property interests are created for each of his eight grandchildren, with distribution of accumulated income and corpus as each attains majority. In order to maintain the separate identity of each of the twenty-four trusts, Horace, Sr. should begin by executing a special instrument for each trust. The three trusts for each grandchild should be as different from each other as feasible. This means that there should be different non-tax purposes set out in each trust instrument, different provisions, different combinations of remaindermen; and probably a different trustee for each.[144] As to management of the trusts, each should have a separate bank account, a separate set of records, and separate income tax returns. In spite of the obvious expense that such a plan would involve, if the partnership income is high, it could create a sufficient tax saving to make the plan worthwhile.

3. *Proposed Legislation.*—A report was submitted in 1956 to the House Ways and Means Committee by the Advisory Group on Subchapter J, headed by Professor Casner, recommending, among other things, legislation to restrict the use of multiple accumulation trusts for a single beneficiary.[145] The Advisory Group proposed an amendment to the Code[146] which would provide that multiple

142. *E.g.*, Boyce v. United States, *supra* note 126. See Somers, *First Case on Multiple Trusts Suggests That Code Revision May Not Be Needed*, 14 J. TAXATION 363 (1961). It is mere speculation whether any of these arrangements would stand up under a liberal application of either of these doctrines.

143. See Ervin, *supra* note 100, at 404; Soter, *supra* note 104, at 362.

144. No real reason appears, however, why three trustees should not manage all 24 trusts between them.

145. Subsequent reports were submitted in later years. See *Hearings on Advisory Group Recommendations on Subchapter C, J, and K of Internal Revenue Code Before the Committee on Ways and Means, House of Representatives*, 86th Cong., 1st Sess. 247, 249, 263-71 (1959).

146. Section 641 provides:

641(c) Multiple Trusts

(1) If a grantor establishes at any time or times separate intervivos trusts, to the extent that during any year or portions of a year the primary beneficiary or beneficiaries of the currently accumulated income or taxable income allocated to corpus of the separate trusts are substantially the same, the total tax payable . . .

(A) shall be computed as though the separate trusts were one trust, . . .

trusts created for substantially the same primary beneficiary are to be consolidated and taxed as one trust. This solution has been called the "consolidation approach."[147] It would restrict the principal tax avoidance aspect of the multiple trust device—the accumulation of income in low-bracket entities. Three exceptions listed are: (1) where income of the combined trusts does not exceed 2000 dollars; (2) where there are no more than three trusts, created at five-year or longer intervals; and (3) where the tax produced by consolidation is greater than the total tax on the separate trusts.[148] The second of these recognizes that non-tax purposes occasionally motivate the formation of multiple trusts.

Despite the Advisory Group's proposals, the House Ways and Means Committee in 1960 suggested a different approach to solve the multiple trust problem.[149] It proposed stiffer limitations upon the second tax avoidance aspect of multiple trusts—that is, the tax-free distribution of accumulated income. The new Code section 669[150] was recommended, under which accumulated income of multiple trusts (two or more trusts with a common beneficiary set up by the same grantor), when distributed to the same beneficiary as a "section 669 distribution,"[151] would be subject to a new ten-year throwback rule. This throwback rule would not qualify for the various exceptions by which taxpayers can avoid the old five-year throwback rule. The proposal was incorporated into H.R. 9662,[152] a lengthy tax revision bill which was reported out of the Ways and Means Committee and passed by the House on January 28, 1960.

Later in 1960, H.R. 9662 reached the Senate Finance Committee. There, the ten-year throwback rule was abandoned, and the Advisory Groups' consolidation approach was adopted. It was made even more stringent, however, by restricting the number of permissible trusts to two, and requiring that they be created at least eight years apart.[153] The bill failed to reach the Senate floor in 1960, and was twice passed over after it subsequently reached the Senate calendar.

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except

(i) when such income or such taxable income or both are less than $2,000, or

(ii) when the separate trusts do not exceed three in number and no two of them were created within a period of sixty months . . . . Methods of assessment and allocation of this to be made under regulations of the Secretary of the Treasury. *Id.* at 263.

147. See Fillman & Barnet, *supra* note 107, at 38; Gordon, *Multiple Trusts: The Consolidation Approach,* 4 Wayne L. Rev. 25 (1957).

148. See note 146 *supra.*

149. H.R. Rep No. 1231, 86th Cong., 1st Sess. 64 (1960).

150. *Id.* at 121.

151. *Id.* at 122.

152. *Id.* at 101-71.

153. H.R. 9662, 86th Cong., 1st Sess. § 101(c)(i)(A)(ii) (1960).

It has been suggested that the controversy over the multiple trust provision was the main reason that H.R. 9662 was not passed in 1960.[154] The New York Bar in 1959 opposed the Advisory Group's solution, mainly on the ground that the important determination of beneficiaries who are "substantially the same," would be extremely difficult.[155] After the House took a different approach to solving the multiple trust problem, the American Bar Association recommended that the portions of H.R. 9662 relating to multiple trusts not be enacted until parties affected had become more familiar with the new provisions. This position was based on the ground that these changes would have a material and disruptive effect upon tax planning.[156] The Advisory Group, however, recommended that its proposals be given immediate effect, since it was publicly announced in 1956 that legislation dealing with multiple trusts would be submitted to Congress.[157] At the present time, the Treasury Department, for unexplained reasons, has ceased to urge legislative reform in the field of multiple trusts.

D. *Multiple Corporations*

Use of the corporate form of doing business presents yet another device to split income, that of multiple incorporation. As stated earlier, a consideration of the many factors to be considered in choosing the business form is outside the scope of this note.[158] However, focusing again on the enterprising Horace Alger, Sr., we might look briefly at a few reasons why he might decide to incorporate his business, which is now being operated as a family partnership. Disregarding the many tax advantages unique to corporations, there are two factors which alone might persuade Horace, Sr. to incorporate. First, incorporation will prevent personal income tax liability on undistributed net earnings plowed back into the business for expansion purposes.[159] Second, the corporate form is an excellent device by which the business can be perpetuated and kept under competent, family management. This goal can be accomplished by a transfer of voting stock to Horace, Jr., either directly or in trust, with Horace, Sr. as trustee, and either the distribution of non-voting stock or long-term bonds to other members of the family.

154. See Somers, *supra* note 142, at 363.
155. *Hearings, supra* note 145, at 1009-11.
156. A.B.A., SECTION ON TAXATION 148, 149 (1960).
157. *Hearings, supra* note 145, at 271.
158. See Strecker, *When will the Corporate Form Save Taxes?* 18 VAND. L. REV. 1695 (1965). See also Caplin, *Partnership or S Corporation? A Check List of the Tax Factors in the Choice,* 12 J. TAXATION 32 (1960).
159. Partnership earnings are taxed to the partners whether distributed or not. INT. REV. CODE OF 1954, § 702(c).

In order to illustrate how multiple incorporation saves taxes, let us now assume that Horace, Sr. was finally persuaded to incorporate and transfer the voting shares to himself and Horace, Jr. in exchange for cash, and the non-voting shares to the trustee for the grandchildren's trusts in exchange for the plant and equipment.[160] We will assume further that the year after incorporation, the corporation's taxable income, after deduction of salary, depreciation, and interest expense, was 300,000 dollars, all of which Horace, Sr. and Horace, Jr. decided to use to purchase new equipment for the business. The tax on this amount, at 1966 corporate tax rates,[161] would be 5500 dollars (twenty-two per cent) on the first 25,000 dollars of income and 132,000 dollars (twenty-two per cent plus twenty-six per cent surtax) on the balance, for a total of 137,500 tax dollars. This amount represents no tax saving when compared with the taxes payable when the business was operated as a partnership.[162] Therefore, Horace, Sr. will be interested in lowering taxes further, in order to release a greater amount of the corporate income for expansion and improvement in his highly competitive field of business. One way to accomplish such a tax saving may be multiple incorporation.

The following discussion of multiple corporations will proceed in an order slightly different from the discussions of the other two income splitting devices. To make the discussion of legislative and judicial limits on multiple incorporation more meaningful, its various tax and non-tax advantages will be discussed first; its limits second; and last, a recent proposal for legislative reform.

1. *Advantages of Multiple Incorporation.*—From an income splitting point of view, the chief advantage of multiple incorporation lies in the 25,000 dollar surtax exemption granted to every corporation.[163] As we saw in the example above, the first 25,000 dollars of taxable corporate income is subject to the relatively low tax rate of twenty-two per cent, or 5500 dollars, while all taxable income in excess of 25,000 dollars is taxed at a rate of forty-eight per cent.[164] Thus, it would appear that for each new corporation the Algers can form and to which at least 25,000 dollars of business income can be attributed,

160. No gain will be recognized on this transaction. See INT. REV. CODE OF 1954, § 351.
161. INT. REV. CODE OF 1954, § 11(b)-(d).
162. See notes 46-48 *supra* and accompanying text. It should be noted that the figures for taxation of the family partnership were based upon $300,000 net income including the partners' compensation, while the corporate tax figures are based upon $300,000 excluding salaries deducted.
163. INT. REV. CODE OF 1954, § 11(d).
164. INT. REV. CODE OF 1954, § 11(b),(e).

there will be a tax saving of 6500 dollars, an amount equal to the surtax (twenty-six per cent) on 25,000 dollars. Thus, the Algers could incorporate their business and form ten subsidiary corporations, each to manage sales in a separate section of the country, leaving the manufacturing to the parent corporation. Theoretically, this scheme could save 65,000 dollars in income taxes annually because of the ten additional surtax exemptions. However, a tax saving would not necessarily result, as we shall see in the next part.[165] It is, in fact, extremely difficult to discuss the practical uses of multiple incorporation as an income splitting device without examining in some detail the restrictions that both Congress and the courts have placed upon this device. Before discussing these limitations, however, we should look briefly at some of the other advantages offered by multiple corporations.

The second main tax advantage of multiple corporations involves the possibility of multiplying the 100,000 dollar accumulated earnings credit.[166] Section 531 of the Code[167] prevents corporations from being used to shield high earnings from high-bracket personal income tax by imposing an almost confiscatory accumulated earnings tax on earnings accumulated by corporations for reasons other than "reasonable business needs." Section 535(c),[168] however, allows every corporation a lifetime accumulation of 100,000 dollars, which is exempt from the accumulated earnings tax regardless of the reason for the accumulation.

It is obvious that when the Alger enterprise ceases to expand, if there is only a single, high-income corporation, then earnings will soon have to be distributed to shareholders in order to avoid the accumulated earnings tax, thus subjecting the business income to "double taxation."[169] As stated earlier, the Subchapter S election is one way to avoid such a double tax.[170] This option is not open to the Alger corporation, however, for two reasons: it has issued two

165. In addition to the various Code sections (notes 180, 185, 195 *infra*) and *judicial* doctrines (note 203 *infra*) which may disallow the entire $65,000 savings, 1964 legislation applies an additional 6% tax to members of certain controlled corporate groups as a price for multiple surtax exemptions, which results in a tax saving of $3,500 for the second corporation in a controlled group, and $5,000 for each additional member thereafter (note 211 *infra*).

166. INT. REV. CODE OF 1954, § 535(c).

167. INT. REV. CODE OF 1954, § 531.

168. INT. REV. CODE OF 1954, § 535(c).

169. See GOODE, THE CORPORATE INCOME TAX (1950).

170. INT. REV. CODE OF 1954 §§ 1371-77. For a discussion of subchapter S, see Stein, *Optional Taxation of Closely Held Corporations Under the Technical Amendment Act of 1958*, 72 HARV. L. REV. 710 (1959). See also Caplin, *supra* note 158. To curb the use of subchapter S as a way around the family partnership rules of § 704(c), § 1375(c) provides for allocation of dividends among family members if necessary to reflect services rendered by them.

classes of stock;[171] and part of the stock is held by a trustee.[172] Accumulation of earnings in the corporation might result in a greater tax saving than a Subchapter S election anyway, since the latter often entails very high personal income tax rates, while the former are taxed at no more than the maximum corporate rate of forty-eight per cent.[173] Furthermore since accumulations will enhance the value of the corporate stock, it is even possible that, in the event the stock passes through an estate,[174] there will be no double income tax on the accumulations, though of course the enhanced value of the stock will increase the estate tax. Also, earnings on the accumulated income are taxable at corporate rates instead of potentially higher personal income rates.[175] Thus, at least theoretically, if the Alger corporation forms ten subsidiaries, an additional 1,000,000 dollars can be accumulated and retained in the family business.[176]

There are a few other minor tax advantages that result from multiple incorporation,[177] and some non-tax advantages which should be discussed in order to ascertain whether the use of multiple corporations must necessarily stem from tax avoidance motives.[178] Principally, these are: (1) to protect the business assets by diffusing tort and contract liability among separate corporate entities; (2) to separate various aspects of the business into autonomous, administratively convenient divisions; (3) to separate the enterprise into geographical divisions, in order to build up local or sectional identification with the various names of the subsidiaries; (4) to permit executives of each subsidiary to acquire proprietary interest in their own division of the business; and (5) to promote outside investment by facilitating investment in limited portions of the business.

2. *Limitations Imposed.*—Having looked at the tax advantages offered by splitting business income among several corporations, we can now discuss the many intricate and overlapping rules promulgated by both the courts and Congress to restrict multiple incorporation from being used solely to obtain these advantages.

(a). *The Pre-1964 Era.*—(1). *Legislative Limits.* Before passage

171. INT. REV. CODE OF 1954, § 1371(a).

172. INT. REV. CODE OF 1954, § 1371(2).

173. INT. REV. CODE OF 1954, § 11(b)-(j).

174. INT. REV. CODE OF 1954, § 1014.

175. But see personal holding company tax seetions, INT. REV. CODE OF 1954, §§ 541-47.

176. For the various ways in which these accumulated earnings credits may be wholly disallowed, see notes 180, 185, 195, 203 *infra.*

177. Increased qualified investment tax credits, INT. REV. CODE OF 1954, § 38; possible elimination of estimated corporate income tax under, § 6016; easier withdrawal of accumulations at capital gain rates pursuant to liquidation, § 331. See also, Note, 18 VAND. L. REV. 1338, 1341-43 (1965).

178. *Note,* supra note 177.

of the amendments in the 1964 Code dealing with "controlled corporate groups,"[179] only one Code section, 1551,[180] had been passed specifically to restrict tax avoidance via multiple corporations. This section, whose predecessor first appeared in 1951,[181] disallows the two principal tax advantages of multiple incorporation to transferee corporations receiving property, other than money, from a transferor, where "a major purpose"[182] of the transfer was to obtain either of these two tax benefits. Before 1964, it applied only to intercorporate transfers of the parent-subsidiary type.[183] The taxpayer had to demonstrate that non-tax, business purposes were the substantial, motivating factors behind the transfer.[184]

Two other Code sections have also been used by the Commissioner to disallow tax benefits derived from multiple incorporation, although neither was passed with multiple corporations specifically in mind. In 1944, the predecessor of what is now section 269[185] was passed, primarily to prevent the acquisitions of loss corporations for the purpose of using the loss carryover of an acquired "loss corporation" to offset future income of the acquiring corporation.[186] Like section 1551, the *sine qua non* for application of this section lies in the purpose or intent of the taxpayer. Section 269 provides that where an individual or corporation acquires control of a corporation and

> the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance.[187]

It should be noted that the sanctions imposed by section 269[188] are broader than those imposed by section 1551, but the application of these sanctions is narrower in that the Commissioner must show that tax avoidance was "*the* principal purpose."[189] Despite this heavier

179. INT. REV. CODE OF 1954, §§ 1561-63.

180. INT. REV. CODE OF 1954, § 1551.

181. Revenue Act of 1951, ch. 521, § 15(c), 65 Stat. 468. See Streeker, *Multiple Corporations*, 2 CORP. PRAC. COMMENTATOR, Aug. 1960, p.1.

182. INT. REV. CODE OF 1954, § 1551(a).

183. See, *e.g.*, Airlene Gas Co. v. United States, 58-2 U.S. Tax Cas. ¶ 9805 (D. Ky. 1958). But see 1964 amendment, INT. REV. CODE OF 1954, § 1551(a)(3).

184. See, *e.g.*, Camelot Realty Co. v. United States, 60-1 U.S. Tax Cas. ¶ 9132 (W.D. Pa. 1959); Sno-Frost, Inc., 31 T.C. 1058 (1959).

185. Revenue Act of 1944, ch. 63, § 129, 58 Stat. 47. See INT. REV. CODE OF 1954, § 269.

186. S. REP. No. 627, 78th Cong., 1st Sess. 58-60 (1943).

187. INT. REV. CODE OF 1954, § 269. See Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing?*, 103 U. PA. L. REV. 579 (1955).

188. *Ibid.*

189. *Ibid.*

burden of proof, section 269 has been an important weapon in the Commissioner's arsenal. One reason for this is that until the 1964 amendments, section 1551 applied only to parent-subsidiary corporations,[190] leaving section 269 as the main weapon against the brother-sister type of multiple incorporation.

Originally, application of section 269 was further restricted by two case law doctrines. The first, called the "Alprosa Watch doctrine,"[191] was that the sanctions of section 269 apply only to *acquiring* corporations, and not to the *acquired* corporation. This doctrine, however, has generally been refuted by recent cases.[192] A second argument occasionally made by taxpayers was that section 269 does not apply to the formation of new corporations, as does section 1551, but only to the acquisition of an existing corporation.[193] This view too has been refuted.[194]

The third pre-1964 weapon used by the Commissioner against multiple incorporation is section 482.[195] This section gives the Commissioner authority to allocate "income, deductions, credits, or allowances" among related businesses "if necessary to prevent evasion of taxes or clearly reflect the income of such . . . businesses."[196] The predecessor of section 482 was passed in 1921 to enable the Commissioner to require consolidated returns for income or profits arbitrarily shifted to avoid taxes among businesses owned by common interests.[197]

Section 482 has traditionally been applied to reallocate income among corporations only in rather extreme cases, involving fraudulent transactions of improper bookkeeping among commonly controlled corporations.[198] However in a recent case, *Hamburgers York Road, Inc.*,[199] the Tax Court upheld an allocation by the Commissioner of all the net income of a new suburban clothing store to its brother corporation, a long-established clothing store nearby, owned by the same shareholders. There was no doubt that the suburban store had

190. See note 183 *supra* and accompanying text.
191. Alprosa Watch Co., 11 T.C. 240 (1948).
192. *E.g.*, Commissioner v. British Motor Car Distrib., Ltd., 278 F.2d 392 (9th Cir. 1960); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959).
193. *E.g.*, J. E. Dilworth Co. v. Henslee, 98 F. Supp. 957, (M.D. Tenn. 1951).
194. Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957); James Realty Co. v. United States, 176 F. Supp. 306 (D. Minn. 1959). See Strecker, *supra* note 181, at 20-27.
195. INT. REV. CODE OF 1954, § 482.
196. INT. REV. CODE OF 1954, § 482.
197. Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260.
198. See Commissioner v. Chelsea Prod., Inc., 197 F.2d 620 (3d Cir. 1952). See also Cooper, *Section 45*, 4 TAX L. REV. 131, 166 (1948); Pomeroy, *Allocation of Income, Deductions, Credits, and Allowances Among Related Taxpayers*, 15 W. RES. L. REV. 250 (1964).
199. 41 T.C. 821 (1964).

actually earned the income attributed to it. The court, however, sustained the consolidation of income under section 482, apparently on two grounds: that not all dealings between the two corporations were strictly at "arm's length";[200] and that the suburban store was incorporated principally to obtain tax benefits.[201] As a consequence of this recent extension of section 482, the future of multiple corporations, even if they serve valid, business purposes, is extremely uncertain.

(2). *Court-Made Limitations.*—Courts have often been disturbed over intentional tax avoidance accomplished by various income splitting devices, particularly in intra-family transactions. To restrict these practices, the courts have developed devices variously deemed the "sham" or "business purpose" or "assignment of income" doctrines, and apply them today with a vigor matched only by the vagueness of the principles upon which these doctrines rest. These "common law" weapons against income splitting devices will be discussed more fully in Part III.[202]

A good example of a court-made rule being used by the Commissioner is found in the Tax Court case of *Aldon Homes, Inc.*[203] This case involved a realty development project in which the brother corporation, Aldon Homes, transferred real estate to fifteen sister alphabet corporations, owned by the same investors who owned Aldon Homes. The Commissioner contended that these fifteen corporations should be disregarded as shams, since they "were not formed for any business purpose, did not function in income producing capacities, and lacked substance and reality."[204] In sustaining the Commissioner's contention, the court began with the proposition "that taxpayers have the right to mold business transactions in such a way as to minimize the incidence of taxation,"[205] and it cited cases to this effect. It continued:

> The above cases make it clear that a taxpayer may adopt any form he desires for the conduct of his business and that form cannot be ignored merely because it results in a tax saving. However, to be afforded recognition, the form the taxpayer chooses must be a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity.[206]

200. *Id.* at 835-37.
201. *Id.* at 838.
202. See notes 231-33 *infra* and accompanying text. See also, Strecker, *supra* note 181, at 29-32.
203. 33 T.C. 582 (1959).
204. *Id.* at 595.
205. *Id.* at 596.
206. *Id.* at 596-97.

Thus, by relying solely upon the court-made "sham" doctrine, the Commissioner was able to disallow a potential 375,000 dollars in surtax exemptions and 1,500,000 dollars in accumulated earnings credits.[207]

(b). *The 1964 Amendments.*—As is demonstrated above, the statutory and judicial limitations imposed upon multiple corporations are couched in vague terms, often involving determination of the taxpayer's subjective intent, or the "reality" or "substance" of the transaction in question. Thus, they have been fertile ground for opaque, confusing and contradictory judicial decisions, leaving the tax status of multiple corporations in considerable doubt.

Several amendments to the 1964 Code affect the status of multiple corporations.[208] Unfortunately, rather than clearing the air by giving objective guidelines the 1964 amendments merely present a series of incredibly complex rules designed to prevent members of controlled corporate groups from acquiring increased benefits from multiple surtax exemptions caused by the reduction of the ordinary corporate tax (on the first 25,000 dollars) from thirty per cent to twenty-two per cent.[209] This new legislation neither eliminates the tax advantages of multiple incorporation nor does it supersede the various statutory and court-made limitations upon multiple corporations discussed above.

The most important changes in the tax treatment of multiple corporations made by the 1964 Revenue Act were summarized in a recent article:[210]

> These changes are: (1) the limitation of controlled corporate groups to a single surtax exemption unless an election is made to claim a surtax exemption for each member of the group, and each member pays an additional tax of 6 per cent on its first 25,000 dollars of income,[211] (2) the amendment of code section 1551 extending its application to transfers to brother-sister corporations,[212] (3) repeal of the 2 per cent tax on consolidated returns,[213] and (4) the amendment of code sections 243 to allow corporations to deduct 100 per cent of the dividends received from affiliated corporations.[214]

207. See Shaw Constr. Co., 35 T.C. 1102 (1961) for a similar case. The Tax Court has indicated that it will not construe these cases as authority for disregarding the corporate entity, merely because its formation was tax motivated. Armais Arutunoff, 22 CCH Tax Ct. Mem. 931 (1963).

208. See statutes cited, notes 210-13 *infra*. On the 1964 legislation, see Colquhoun, *Multiple Corporations*, 15 W. Res. L. Rev. 242, 247-50 (1964); Hamovitt & Schlesinger, *New Treatment of Multiple Corporations*, 16 W. Res. L. Rev. 317 (1965); Note, 18 Vand. L. Rev. 1338 (1965).

209. H.R. Rep. No. 749, 88th Cong., 1st Sess. 117-18 (1963).

210. Note, *supra* note 177, at 1351.

211. Int. Rev. Code of 1954, §§ 1561-63.

212. Int. Rev. Code of 1954, § 1551(a)(3).

213. Revenue Act of 1964, § 234, 78 Stat. 113.

214. Int. Rev. Code of 1954, § 243(a)(3).

These legislative changes not only reduce the value of additional surtax exemptions for the "controlled group of corporations,"[215] they also encourage the use of consolidated returns for affiliated parent-subsidiary corporations by repealing the two per cent tax on consolidated income[216] and allowing a deduction of 100 per cent of dividends received from affiliated domestic corporations.[217] Together with the broad judicial interpretations of sections 1551, 269, and 482, these amendments definitely tend to discourage multiple incorporation. Nevertheless, for the courageous taxpayers who successfully cross this legislative and judicial minefield, multiple incorporation continues to be an important tax-avoidance device.

3. *A Legislative Proposal.*—In 1958 Professor Stanley S. Surrey, working on the American Law Institute Tax Project,[218] presented some fresh views on how Congress should treat the problem of tax avoidance via multiple incorporation. Professor Surrey recognized that "explicit statutory protection against multiple corporation distortion has been based almost entirely on a tax-avoidance standard."[219] He questioned whether tax avoidance is even relevant in answering the question of when tax benefits accruing because of multiple incorporation should be disallowed.

The method pursued by Professor Surrey in answering this question begins with a determination of the policies which motivated Congress to pass the two main tax benefits utilized by multiple corporations to avoid taxes—that is, the surtax exemption and the minimum accumulated earnings credit. He gives the obvious answer: These provisions were designed to provide financial aid to "small businesses."[220] Thus, the determinative question should not be whether

215. A "controlled group" is defined as (1) parent-subsidiary corporations with 80% of ownership and control of the subsidiary corporations in the hands of one or more of the member corporations, and at least 80% ownership and control of at least one subsidiary corporation in the hands of the parent corporation; and (2) brother-sister corporations in which at least 80% ownership *or* control is in the hands of a single individual, trust or estate, with far-reaching constructive ownership rules applicable. INT. REV. CODE OF 1954, § 1563(a).

216. INT. REV. CODE OF 1954, § 1551(a)(3).

217. INT. REV. CODE OF 1954, § 1503.

218. This project was pursued jointly by the ALI and ABA from 1956-1958. See REPORT OF WORKING VIEWS OF A STUDY BY THE AMERICAN LAW INSTITUTE STAFF AND AMERICAN BAR ASSOCIATION LIASON COMMITTEE, ALI FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS, 367 (1958). For a good summary of this report, see Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project-American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1, 37 (1958).

219. Surrey, *supra* note 218, at 38.

220. H.R. REP. No. 2198, 85th Cong., 2d Sess. 2-5 (1957); H.R. REP. No. 1662, 83d Cong., 2d Sess. 71-2 (1954) (accumulated earnings credit); H.R. REP. No. 586, 82d Cong., 1st Sess. (1951); S. REP. No. 781, 82d Cong., 1st Sess. 15 (1951)(surtax

there was a tax-avoidance purpose, but whether multiple corporations controlled by the same individual or group should each be considered "small business," entitled to the above tax benefits. As Professor Surrey points out, "although each separate corporation may be small, the whole operation is not."[221]

Professor Surrey follows his method to its logical conclusion. Since it is obvious that multiple corporations under common control were not the intended recipients of small business tax benefits, then corrective legislation should be principally concerned with restricting these benefits to small businesses. To accomplish this, Professor Surrey would treat parent-subsidiary and brother-sister corporations as a unit for purposes of the surtax exemption and accumulated earnings credit, but only where there is the requisite common control. In defining the degree of control necessary for disallowing these tax benefits, he would rely upon the eighty per cent stock ownership for the parent-subsidiary corporate group; and for brother-sister corporations, he would require that eighty per cent of the stock of each corporation be owned by no more than the same five individuals, and that the business activities of the corporations be conducted in an integrated manner.[222]

Although Professor Surrey's proposals were included in the President's 1963 Tax Message to Congress,[223] they were not included in the 1964 amendments to the Code. Consequently, taxpayers today continue to avoid taxes by splitting and accumulating business income among multiple, related corporate entities.

III. Evaluation of Limits Imposed Upon Income Splitting Devices

A. *Three Approaches to the Problem*

All of the income splitting devices discussed in this note utilize the same general method to avoid taxes: the fragmentation of income, potentially taxable to a single taxpayer, among numerous, related tax entities. As we have seen, this method often produces a far greater tax saving than the more familiar method of converting ordinary income into capital gains.

The important question remains: When should the related, taxable entities formed pursuant to the income splitting devices described

exemption). See Surrey, *supra* note 218, at 38. See also Sharp, *Multiple Tax Benefits Through Multiple Incorporation: Some Thoughts on the Law As It Is and As It Ought to Be,* 40 B.U.L. Rev. 375 (1960).

221. Surrey, *supra* note 218, at 40.

222. *Id.* at 42. Compare the definition of a "controlled group of corporations" in the 1964 amendments, *supra* note 215.

223. *Hearings before the House Committee on Ways and Means on Tax Recommendations of the President,* 88th Cong., 1st Sess., pt. 1 at 14 (1963).

in Part II be recognized for tax purposes? Put another way: When should the tax benefits resulting from income splitting be disallowed?

There are three general approaches that Congress and the courts have taken at various times in answering this question. In evaluating the relative merits and defects of each, two main criteria will be used. First, applying the empirical method, we will determine how effective each approach has been when applied in the past in terms of the ease with which it has been applied, the certainty of the resulting rules, and the consistency of the results reached by these rules. Second, using the *a priori* method, we will examine the logic behind each method to determine to what extent each is capable of producing rational, equitable solutions to the problem of tax avoidance via income splitting.

1. *Motive or Intent of the Taxpayer.*—The first of the three approaches is based upon the subjective motive or intent of the taxpayer. The rule under this approach is: Whenever the income splitting device in question was utilized with the principal motive of avoiding taxes, then the resulting tax benefits should be disallowed.

Congress has often passed statutes indicating that the taxpayer's intent is critical in determining the tax consequences of particular transactions.[224] We have examined two such statutes in Part II—sections 1551[225] and 269.[226] Even in section 704(e),[227] which was designed to provide objective guidelines for tax consequences of family partnerships, the regulations make the taxpayer's intent one of the factors to consider in determining whether there was a complete transfer of capital to the donee-partner.[228] This approach is often stated in terms of what the taxpayer *intended,* though in actual fact "motive" would be a more accurate term, since courts applying this approach are interested ultimately in the principal reasons that impelled the taxpayer's acts (motive) rather than the objects to be attained by his acts (the usual definition of intent). This is admittedly a narrow distinction, but in view of the ambiguity of the term "intent," it is an important one in understanding the first approach to the tax avoidance problem of income splitting.[229]

The courts have also occasionally made the motive of the taxpayer

224. See, *e.g.,* INT. REV. CODE OF 1954, § 306(b)(4)(preferred stock bailout); § 367 (reorganization involving foreign corporation); § 355(a)(1)(D)(ii) (spin-off reorganization).

225. INT. REV. CODE OF 1954, § 1551.

226. Revenue Act of 1944, ch. 13, § 129, 58 Stat. 47. See INT. REV. CODE OF 1954, § 269.

227. Revenue Act of 1951, ch. 501, § 340, 65 Stat. 511.

228. Treas. Reg. § 1.704-1(e)(3)(i)(b)(1956).

229. See PAUL, *Motive and Intent in Federal Tax Law,* in SELECTED STUDIES IN FEDERAL TAXATION 255 (1938).

the critical factor in determining tax consequences, even when the relevant statute does not mention motive. As has been demonstrated by several recent cases discussed in Part II, the courts today go to great lengths to deny tax benefits to transactions "tinged with tax-avoiding motives."[230] Nevertheless, these same courts continue to pay homage to the old rule that the taxpayer's motive, even of tax avoidance, is irrelevant in determining tax consequences. The most notable example of this type of court decision is the long line of cases purporting to follow what has been deemed the "business purpose doctrine." After reciting carefully that the taxpayer's motive is irrelevant, the Supreme Court in *Gregory v. Helvering*[231] held that when a corporate reorganization serves no business purpose other than as a tax avoidance device, even though the Code requirements are carefully followed, the tax benefits are to be disallowed. The court stated that "[t]he rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction on its face lies outside the plain intent of the statute."[232] Thus, it appears that the business purpose test, as it was first formulated, purported to look to the business purposes and functions served by the transaction in question and not to the taxpayer's subjective motive for engaging in the transaction. This method closely conforms to the second general approach, or to what has been called the "sham doctrine," to be discussed below. However, subsequent applications of the business purpose doctrine have often placed great emphasis upon the taxpayer's motive in determining whether his transaction served a business (non-tax) purpose.[233] Apparently many courts have interpreted the "purpose" of the business purpose doctrine to mean the taxpayer's *motive* in engaging in the transaction, instead of the business *function* served by the transaction.

Another example illustrating that the taxpayer's motive is determinative of the tax consequences of an income splitting deviee is to be found in the *Culbertson* case. There it was held that tax recognition of partners in a family partnership formed by gifts of capital depends upon whether the partnership was formed "in good faith . . . for a business purpose."[234] This test was superseded in 1951 by what

230. *Id.* at 290.
231. 293 U.S. 465 (1935).
232. *Id.* at 470.
233. Judge Learned Hand stated that *Gregory v. Helvering* "has sometimes been understood to contradict the doctrine that the motive to avoid taxation is never, as such, relevant. In fact it does not trench upon that doctrine; it merely declares that to be a separate, jural person for purposes of taxation, a corporation must engage in somo industrial, commercial, or other activity besides avoiding taxation." National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944).
234. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

is now section 704(e).[235]

Evaluation.—Turning first to the usefulness of this approach in terms of the results it has heretofore produced when applied, we have seen a notable instance of the confusion and uncertainty it can cause in the line of cases following *Culbertson,* where the taxpayer's motive was the critical factor in determining whether or not to recognize a family partnership for tax purposes. Similarly, there has been neither consistency nor certainty in the application of sections 1551 and 691, which disallow certain tax benefits accruing to multiple corporations according to the degree of the taxpayer's tax avoidance motive. Finally, the height of confusion has resulted when courts have construed the sham or business purpose doctrine so as to superimpose a requirement of non-tax, business motives in order that tax recognition be accorded to any transaction.

Another element to consider is the ease with which this approach can be avoided. One familiar justification for the use of motive in determining tax consequences is that objective standards for tax benefits can easily be avoided, and that the requirement of a non-tax motive prevents such distortion of tax statutes.[236] This reasoning is, however, often shown to be fallacious. For example, in Part II we saw various ways in which taxpayers can use multiple trusts and multiple corporations principally to avoid taxes while appearing to use these devices for legitimate, non-tax purposes.

It is, however, in the second phase of our evaluation—the logic behind this approach—that it proves to be most defective. It is submitted that the motives which impel a taxpayer to act, though possibly of some evidentiary value in determining certain issues, are not relevant to the ultimate issue of whether the taxpayer is entitled to the tax benefits attained by his actions. For example, let us suppose a rather unlikely situation outside of the field of income splitting, in which a man and wife decide to have a child solely for the purpose of obtaining an additional income tax exemption. Regardless of their motive, the parents must undertake the additional expenses of supporting their newly-born child. It was in recognition of such additional burdens on parents that Congress, in attempting to apportion the tax burden as equitably as possible, passed exemptions for dependents. Obviously the parents will be allowed an exemption regardless of their motive, since the reason for the exemption does in fact exist. Exactly the same reasoning should be applied to tax treatment of each of the income splitting devices discussed in this note.

2. *The Business Purpose or Substance-Sham Approach.*—The second

235. Revenue Act of 1951 ch. 521, § 191, 65 Stat. 511.
236. See Paul, *supra* note 229.

approach which has been employed in determining when to disallow tax benefits produced by income splitting is based not upon the taxpayer's intent or motive, but upon the "reality" or "substance" or business function of the taxable entity formed to accomplish the splitting of income. The rule under this approach is: Whenever the income splitting device in question serves no legitimate business function other than tax avoidance, it should be disregarded for tax purposes, and the resulting tax benefits should be disallowed. This is the approach implicit in the court-made "sham doctrine." Although some courts have distinguished between the sham doctrine and the business purpose doctrine, it is submitted that the differences are illusory unless the business purpose doctrine is intepreted to refer to the taxpayer's motive. In applying either of these doctrines to cases involving income splitting devices, courts generally attempt to determine whether the additional tax entities are "shams not realities, shadows and not substance."[237] To make this rather vague determination, courts usually ascertain whether the entities perform any non-tax business purpose, though, as stated above, many courts have also tended to place unwarranted if not sole emphasis on the motives of the taxpayer. We have seen instances in which the sham or business purpose doctrine has been applied by courts to disallow tax benefits accruing to multiple trusts,[238] gift and lease back transactions,[239] and multiple corporations.[240]

Another court-made rule which applies the "substance-sham approach" in a slightly different way is the *Lucas v. Earl*[241] "assignment of income doctrine." *Lucas v. Earl* held that mere assignment of income is not sufficient to shift the incidence of income taxation. The important principle of this case is that income must be taxed to the one who earns it—if from services, to the one who performs them, and if from property, to the property owner. Thus, the approach is much like that of the business purpose or sham doctrine in that it seeks to distinguish between the real and the sham income earner on the basis of business realities.

The *Lucas v. Earl* application of the "substance-sham" approach is reflected in section 704(e), which recognizes partners in a family partnership formed by gifts of capital only when capital produces a substantial amount of partnership income and the gift to the donee-partner is complete. The two-pronged test of section 704(e) is mani-

237. *Ibid.*
238. Boyce v. United States, 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961), 46 Minn. L. Rev. 1111 (1962).
239. Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962).
240. *Supra* note 203.
241. 281 U.S. 1116 (1930).

festly designed to set out guidelines for determining when the partner is "real" and when he is merely a "sham."

This approach is also reflected in section 482, which authorizes the Commissioner to allocate "income, deductions, credits and allowances" among related businesses "to . . . clearly reflect the income of such . . . businesses."[242] As pointed out in Part II, a recent judicial interpretation of this section has made it an important weapon against multiple incorporation.[243]

Evaluation.—The substance-form or business purpose approach seems to be a more logical approach to the problem of determining when to allow tax benefits accruing to multiple, related entities. Unfortunately, experience has demonstrated that this approach yields even greater uncertainty than the motive approach. As we have seen, its most notable example is found in the court-made sham doctrine. The uncertainty and lack of uniformity produced by this doctrine is not inherent, but stems largely from the vague language of the courts which have applied it. Such vagueness has been caused by a regrettable failure of analysis, leading Judge Hand to characterize the reasoning of the "substance-sham" approach as "anodynes for the pains of reasoning."[244] As long as judicial or statutory rules based upon this approach give no objective definitive standards for determining "substance" or "business purpose," the taxpayer can frequently enjoy the tax benefits accruing to multiple, related entities by simply establishing apparent substantial business purposes to be performed by the device in question.

The logic of this "substance-sham" approach is, however, somewhat stronger than the logic of the "taxpayer's motive" approach. It seems pre-eminently logical that multiple, related entities formed pursuant to any of the aforementioned income splitting devices which serve no legitimate, non-tax purpose should not be entitled to the tax benefits which would ordinarily accrue, on the simple ground that the benefits were not intended for such "sham" transactions. The reasoning of the courts, however, has rarely included a consideration of whether Congress intended the tax benefits to be extended to the transaction in question. Generally, as soon as the court finds that no valid business purpose exists the tax benefits are automatically disallowed. There is virtually no recognition of the fact that the mere failure to serve business or even non-tax purposes does not necessarily indicate that the device is entitled to no tax recognition. For example, even though the gift and lease back device generally does not perform

242. INT. REV. CODE OF 1954, § 482.
243. *Supra* note 199.
244. Commissioner v. Sansome, 60 F.2d 931 (2d Cir. 1932).

a non-tax function, this fact alone does not indicate that the device is unworthy of tax recognition. On the contrary, it is submitted that if the requisite amount of the grantor's control over the trust property is relinquished so as to shift the incidence of income taxation under the statutory standards, then, by congressional standards,[245] the device is necessarily entitled to its desired tax effects.

3. *Definite Standards Based Upon Congressional Intent.*—The third possible approach to the problem of tax avoidance via income splitting is based upon determination of congressional intent in order to ascertain whether multiple, related tax entities are entitled to the tax benefits claimed. The rule under this approach is: Whenever it appears that congressional federal tax policy is distorted by the accrual of certain tax benefits to the multiple, related tax entities, then such benefits should be disallowed. This approach is similar in many respects to the second approach. But instead of basing allowance or disallowance of tax benefits upon vague principles, it involves a two-step process. First, the reasons initially prompting Congress to create the tax benefits are ascertained. Second, definite, objective standards are formulated for determining the circumstances under which multiple, related entities may avail themselves of these benefits and still be consistent with basic tax policy, as outlined by Congress' purposes in establishing the benefits. These standards may then be applied to the related entities in question to determine whether they should be treated as separate entities (thus allowing the tax benefits) or as a unit (thus disallowing the tax benefits).

This approach has rarely been used by either Congress or the courts in attempting to solve the tax problems of income splitting. It is, however, the general approach of the recent proposals for tax reform by two noted experts.[246]

The Advisory Group for Subchapter J, headed by Professor James Casner recently devised legislation to combat the tax avoidance aspects of multiple trusts.[247] It proposed an objective guideline for consolidation of multiple trusts, suggesting that all trusts created for the "same primary beneficiary" be treated as a unit for purposes of federal income taxation, with three minor exceptions. Presumably, the basic premise of this proposal is that multiple trusts for the same primary beneficiary were not intended to be the recipients of the tax rates as the lowest end of our graduated tax rate structure.

245. See note 251 *infra* and accompanying text.

246. Professor James Casner, chairman of The Advisory Group for Subchapter J, and Professor Stanley S. Surrey, chairman of the A.L.I. Tax Project.

247. *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of Internal Revenue Code Before the Committee on Ways and Means, House Representatives,* 86th Cong., 1st Sess. 247, 249, 263-71 (1959).

Professor Stanley S. Surrey, head of the A.L.I. Tax Project, took a similar approach in proposing legislative reform to correct the tax avoidance possibilities of multiple incorporation.[248] He determined that Congress passed the two main tax benefits accruing to multiple corporations—the surtax exemption and the minimum accumulated earnings credit—in order to aid small businesses. Therefore, congressional intent is distorted when these benefits accrue to commonly-owned, multiple corporations. To avoid such distortion, Professor Surrey set out objective guidelines for consolidating multiple corporations for the limited purpose of disallowing multiple surtax exemptions and accumulated earnings credits. These guidelines, it will be remembered, are based principally upon the degree of common ownership between the corporations. Like those standards set out by the Advisory Group for consolidating multiple trusts, Professor Surrey's guidelines were designed to restrict the tax benefits accruing to multiple, related tax entities within the bounds of basic federal tax policy.

Evaluation.—The third approach is one that, strangely has rarely been used in actual practice in attempting to solve the tax problems of income splitting. Thus, we cannot look to past experience to determine the results of such an approach. However, the approach taken by Congress in regulating family partnerships formed by gifts of capital (section 704(e)), may give us some guidance. In section 704(e), reasonably definite standards, based upon "rules . . . generally applicable to other forms of property"[249] determine whether family partners are to be accorded tax recognition. Application of this section by the courts has yielded fairly consistent and certain results, effectively eliminating the problem of tax avoidance via the family partnership. Since the third approach also involves application of objective standards, it seems reasonable to believe that this approach can produce equal certainty and consistency. Also, it is submitted that circumvention of definite, far-reaching standards would be much more difficult than circumvention of the "subjective intent" approach or "vague principles" approach. Presumably, if the taxpayer succeeded in placing his income splitting transaction outside of the scope of the standards set by the third approach, the transaction would, by congressional definition of the tax policy on which the standards are based, be entitled to the benefits. For example, applying Professor Surrey's proposal, if the common ownership of a certain group of multiple, subsidiary corporations were intentionally diluted below eighty per cent, then each one would qualify for an additional surtax

248. *Supra* note 218.
249. H.R. REP. No. 586, 82d Cong., 1st Sess. 32 (1951).

exemption and minimum accumulated earnings credit, since each would be sufficiently independent "small business" to become entitled to the multiple tax benefits, consistent with Congress' intent.

As for the logic inherent in this third approach, it is the only one that provides a truly rational basis for determining whether multiple, related tax entities formed by income splitting devices are entitled to tax recognition. In formulating definite standards based upon a determination of who is to receive the various tax benefits, this third approach most effectively prevents income splitting devices from being used to distort basic federal tax policy.

B. *Proposals for Limiting Income Splitting*

This section will consist of a brief evaluation of present restrictions upon tax avoidance capabilities of the income splitting devices discussed in Part II and recommendations for improvements. The premise for this discussion is that the third approach to the problem discussed above is the most effective and rational one. Thus, this approach will be both a measure for the evaluation of present statutory and judicial restrictions and a guideline for the proposed improvements.

1. *The Family Partnership.*—As we have seen, the family partnership is a device which may be created by transfers of capital to family members in order to split business income and thus lower the total taxes payable. Section 704(e) was designed to restrict the tax avoidance capabilities of this device by setting up definite standards for determining when the donee-partners are entitled to recognition for tax purposes. The approach of this section is similar to the second approach described above, in that it seeks to distinguish between "sham" and "real" partners based upon the realities of the situation after the transaction is completed. But it is also like the third approach in that definite, legislative standards were formulated to aid courts in making this distinction.

Section 704(e) has effectively regulated tax avoidance via the family partnership since its passage in 1951. It seems logical that, as this section provides, the true owner of the partnership capital is entitled to become a partner regardless of how or why he acquired the capital. The multitude of factors listed in the regulations to determine whether the requisite degree of ownership exists,[250] though potentially a source of confusion, seems to have aided courts in applying this section to reach fairly consistent results. Resort to the regulations could have been avoided by a more precise statutory definition,

250. Treas. Reg. § 1.704-1(e)(2)(ii)(a),(c),(d)(1956); Treas. Reg. § 1.704-1(e)(2)(iv),(vi),(x)(1956).

however. Nevertheless, since section 704(e) has proved to be free from substantial ambiguities, no need for changes is indicated.

One brief remark as to the tax treatment accorded to one of the income splitting alternatives to the family partnership—the gift and lease back devise—should be made at this point. The degree of completeness required of a transfer of property for purposes of a section 704(e) partnership is greater than that required under the sections for determining the taxability of income to trust property. For example, a transfer of property to a short term trust will not qualify for a partnership interest under section 704(e), since the beneficiary's interest in the business would be too limited for him to be deemed a real partner. However, in the gift and lease back situation, there is no reason why the donee should be required to have the same powers and interests as those of a partner in order that the transaction be recognized for tax purposes. In section 671–677,[251] Congress defined the minimum degree of ownership of trust property necessary to shift the income tax burden on the trust income. It is submitted that these requirements should be determinative as to the tax consequences of the gift and lease back device. Thus, if an office building is transferred to a short term trust which satisfies the requirements of sections 673(a) and 674(b)(2),[252] the trust would be taxed upon rental payments, and the taxpayer allowed to deduct the reasonable rent paid as a business expense, regardless of the taxpayer's rather obvious avoidance motives.

2. *Multiple Corporations.* The two sections most often invoked to prevent unwarranted tax avoidance via multiple incorporation, sections 1551 and 691, base disallowance of tax benefits upon the determination of whether the taxpayer's motive was to attain these benefits. As has been pointed out, this method has produced inconsistency among court decisions as well as uncertainty among taxpayers. But worse, this method is not even capable of rational results, since the taxpayer's motive is not necessarily relevant to the issue of whether multiple corporations are entitled to the various tax benefits intended to aid small business. The second general method used to limit tax avoidance by multiple incorporation is reallocation or consolidation of income, either under section 482 or under the court-made "business purpose" or "sham" doctrine. Although this method may provide a more rational basis for determining when to disallow tax advantage, its application has often been inconsistent and hopelessly vague.

These confusing restrictions suggest the need for legislation which will give clear, certain, and rational guidelines for when to disallow

251. INT. REV. CODE OF 1954, §§ 671-77.
252. INT. REV. CODE OF 1954, §§ 173(a), 674(b)(2).

the tax advantages of multiple corporations. It is submitted that Professor Surrey's approach, which would apply definite standards by which to consolidate multiple corporations for the purpose of disallowing certain tax benefits, with the main purpose being to prevent the benefits from being used to distort the congressional policy behind the benefits, is an excellent guideline for filling this legislative void. However, the scope of Professor Surrey's proposals should be expanded in three areas.

First, Professor Surrey's approach should not be limited only to the two major tax advantages of multiple incorporation. Legislation should specifically state that corporations coming within the purview of the statutory standards are to be consolidated for the purposes not only of disallowing multiple surtax exemptions and accumulated earnings credits, but also any other tax advantages intended to benefit small business.

Second, as for legislative standards to define "multiple corporations" for purposes of determining when the tax advantages should be disallowed, Professor Surrey requires at least eighty per cent common ownership of stock for both parent-subsidiary and brother-sister corporations.[253] The purpose of this eighty per cent standard is to give the courts a definite guideline for determining to what degree related corporations must be under independent control in order to be entitled to small business tax benefits. It is submitted, however, that the mere fact that common ownership among a group of related corporations becomes diluted by more than twenty per cent is no valid indication that each member of the group is therefore entitled to small business tax benefits. It would seem that fifty per cent common ownership of voting stock would be a more realistic standard, particularly if one accepts the premise that the ultimate purpose of these tax benefits is to promote business competition.[254] In addition to the stock ownership requirement, under Professor Surrey's proposals the standard to be applied to brother-sister corporations requires that the business of the corporations be integrated. Apparently the reason that there is no integration of business requirement for parent-subsidiary corporations is that it is presumed that the business of subsidiary corporations is necessarily integrated with the parent's business. On the ground that this requirement of integrated business is too vague to be applied with any degree of certainty, it is suggested that it would be both logical and administratively practicable if the business of brother-sister corporations, with at least fifty per cent

253. Surrey, *supra* note 218, at 42.

254. The policy of promoting competition has been more clearly spelled out in other legislation. See Small Business Act, 67 Stat. 232 (1953), as amended, 15 U.S.C. § 63 (1958).

common control among ten or fewer shareholders, were also conclusively presumed to be integrated.

Third, it is submitted that this proposed legislation should completely supersede sections 1551 and 691, since; as has been pointed out, these sections are incapable of determining accurately when multiple corporations should be entitled to tax benefits. Section 482 might be retained, but its application should be limited to situations in which gross income, deductions, credits, and allowances to related corporations which do not qualify for consideration under the proposed legislation must be reallocated in order to reflect accurately the income statement of any of these related corporations.

3. *Multiple Trusts.*—It has been pointed out that the principal tax avoidance aspect of multiple trusts—accumulation of potentially high bracket income in numerous low bracket trusts—is not directly restricted by any tax legislation. Yet when income is accumulated in numerous low bracket trusts set up by the same grantor for the same beneficiary, the basic policy behind our graduated tax rate structure is patently distorted. On this ground alone, the need for restrictive legislation is manifest. We have examined in Part II three possible solutions to this problem. The relative merits of these solutions will be examined below.

First, some feel, on the basis of the recent *Boyce* case,[255] that legislation may not be needed, since broad judicial interpretation of the sham doctrine could effectively prevent undue tax avoidance via multiple trusts.[256] This would be true if all instances of tax avoidance via multiple trusts were as flagrant as in the *Boyce* case. But, as was demonstrated in Part II, the sham doctrine is not only capable of avoidance by careful tax planning, it is also so vague as to make its application extremely uncertain.

The other two possible solutions are embodied in the two recent legislative proposals examined in Part II: the ten year throwback approach of the House Ways and Means Committee, and the Advisory Group's consolidation approach, adopted by the Senate Finance Committee. Since only the consolidation approach prevents accumulation of income in multiple trusts set up by one grantor for one beneficiary, it is submitted that this is the one that should be adopted by Congress in regulating this device.

The principle problem with the consolidation approach is similar to the problem implicit in formulating legislation to restrict tax advantages enjoyed by multiple corporations. The Advisory Group's

255. *Supra* note 238.

256. See, *e.g.*, Somers, *First Case on Multiple Trusts Suggests That Code Revision May Not Be Needed*, 14 J. TAXATION 363 (1961).

answer is simply to consolidate all trusts created by the same grantor in which "the primary beneficiary or beneficiaries are substantially the same."[257] This definition is not as definite as the proposed standard for consolidating multiple corporations.[258] The problem is whether it can be applied with any degree of definiteness by the courts without resulting in inequities. For example, if there are three accumulation trusts created by the same grantor: the first for A, B, and C; the second for A; and the third for B; it would seem that consolidation of all three trusts and the subsequent higher tax rates, would be prejudicial to C. Nevertheless, failure to consolidate the trusts allows income to be accumulated for A and B at artificially low rates, prejudicing and distorting the aims of our graduated tax system.

In spite of the difficulties of applying and administering the Advisory Group's proposals, their adoption would prevent what is unquestionably a great amount of undue tax avoidance. There are several ways, however, in which it is believed that the Advisory Group's proposals could be improved. First, the standard for consolidation might be clarified by definitive examples of what constitutes "primary beneficiaries" of a trust. One possible definition could be "any beneficiary whose probability of receiving an interest in the accumulated income of the trust exceeds fifty per cent," computed according to actuarial tables. Second, since most of the inequities and difficulties with this consolidation approach stem from trusts with multiple beneficiaries, as in the example above, it is submitted that use of the separate share concept[259] might remove these difficulties. Using this concept, when various trusts for multiple beneficiaries are consolidated, the tax on each beneficiary's share would be computed separately. Thus, in the example above, the consolidated income of the three trusts would be segregated into three shares—one each for A, B, and C—and the tax payable on the consolidated trust income would equal the sum of the taxes payable on the three shares. This provision would also eliminate the difficulties of determining when beneficiaries of multiple trusts are "substantially the same." Third, it is submitted that the Advisory Group's main exception to the rule of consolidation (three trusts created at five year intervals) is unncessary. Since the consolidation approach is based upon the premise that, under our income tax system, multiple trusts created by the same grantor for the same beneficiary ought to be treated as a unit for income tax purposes, there is no logical reason to make exceptions to the rule, even though the multiple trusts in question may have been formed for entirely legitimate, non-tax reasons.

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257. *Hearings, supra* note 247.
258. Surrey, *supra* note 218, at 42.
259. INT. REV. CODE OF 1954, § 663(c).

C. *Conclusion*

Restrictions imposed upon the tax avoidance capabilities of income splitting devices have been haphazard and largely ineffective. The first device examined—the family partnership formed by gifts of capital—was at one time used to lower tax rates on high income even when the incidents of ownership and control over the property transferred were substantially unchanged. Today, intelligent statutory regulation based upon the basic tax policy of taxing the true owner of the "tree" on the "fruits" of the "tree" restricts the taxes saved by this device within the bounds of congressional tax policy.

The other two principal income splitting devices examined, however, are still definitely capable of distorting basic tax policy. The multiple trust device can be used to lower the tax rates on potentially high bracket income accumulated in several trusts for the same beneficiary. Multiple corporations are capable of multiplying various tax benefits intended for "small business" and placing them at the disposal of "big business." It is submitted that Congress should carefully regulate these devices in order to prevent such distortion of tax policy. The general method submitted for regulating these devices is: (1) to determine whether the tax advantages utilized by each device distorts any well-defined tax policy; (2) guided by this determination, to formulate definite standards for tax recognition of related tax entities formed pursuant to the income splitting devices; and (3) to consolidate for either specific or general income tax purposes those related entities which fail to meet these standards. Until income splitting devices are properly restricted, willful and undue tax avoidance by high bracket tax payers will continue to cause inequitable shifts in the tax burden, and various tax advantages conferred by Congress will continue to be used to undermine the very ends they were intended to foster.

ALLEN T. MALONE