Tax Problems of Revocable Trusts

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http://www.repository.law.indiana.edu/facpub/1723
YOUR CONCEPT of a revocable trust before you became more expert in the field of taxes was, I dare say, that such a trust was in the nature of a glorified agency—a sort of Gorgeous Gussie, fancy-pants arrangement. How disarming can be our thinking prior to the time when the full bloom of understanding comes to us!

For income, gift and estate tax purposes, the term “trust” has a varied meaning. A trust must, of course, comprise property. It must be something with sufficient objective existence to permit the concept of one person holding title to it while, at the same time, another person owns a beneficial interest in it.

Whether or not the trust is revocable or irrevocable is a question to be determined only by the weighing and analyzing of a host of factors, many of which will be peculiar to the particular situation at hand. The taxation of gifts in trust is dependent upon the factors which determine the extent of the donor’s relinquishment of the property. Among these factors are the powers of revestment and amendment. For gift tax, estate tax and income tax purposes, however, the tests do not necessarily coincide. Our discussion will be confined to various facets of the problems surrounding revocable trusts.

A revocable trust is generally treated for income tax purposes as if no trust existed at all. It is sufficient that the language of the trust be construed to mean that the trust is revocable in practical effect, though technically it may not be. If the grantor retains by some action on his part or by an action which he can exercise in conjunction with another person, whose interests are not substantially adverse to the taking of such action, the power to get the res back, he has created a revocable trust within the definition of Code Section 166. It is interesting, perhaps, to note that Senate Finance Committee Report No. 396, Sixty-eighth Congress, describes a revocable trust as the creation of a trust constituting nothing but an assignment of the right to receive future income. Even though the grantor expressly provides that the trust shall be irrevocable, the retention by him of certain rights and powers may amount to the substantial equivalent of a power to revest. The determining factor is the intent of the grantor, which must be gathered from an analysis of the trust instrument in its entirety and from circumstances attendant upon its creation. The test of the applicability of Section 166 is the existence of a power rather than its exercise. The controlling factor is not what the grantor does, but what he can do. Since a revocable trust is taxed to the grantor as if the trust did not exist, it follows that the loss of the trust corpus is a loss of the grantor which may be deducted on his individual return.

Control over Corpus Rather Than Income

Section 166 relates to those powers which are connected with control over the corpus of the trust rather than over its income. Where the present right to reacquire the property rests in the grantor’s sole discretion, he is taxable upon the trust income. The creation of the trust is not taxable as a gift, and the trust corpus is includible in his estate.

The grantor named in the instrument may be grantor in name only, the real grantor,
who furnished the property or consideration leading to the creation of the trust, not appearing as such in the formal wording of the instrument. The test applicable to a determination of who is the real grantor is the same for both income and estate tax purposes, namely, the ascertainment of who furnished the consideration for the creation of the trust. On the negative side of this rule, the following recent case is of interest: Alice G. Preston Estate, CCH Dec. 17,772, 14 TC —, No. 158. The decedent’s brother-in-law had set up a trust for the decedent, the income to be paid to her for life. The grantor gave the trustee a check for $125,000, the only asset of the trust. On the following day, the trustee loaned the grantor $125,000, for which he gave the trustee his note or personal bond agreeing to repay within a time certain with interest. The trust instrument gave the trustee the power to lend to the grantor. The decedent died intestate. No income tax returns had been filed by or for her for four years prior to her death. The administratrix filed the returns but did not include the income from the trust. The Commissioner determined deficiencies for the years in question. The petitioner claimed that the trust was revocable and that under Section 166, the income was not taxable to the decedent but to the grantor. The court, however, upheld the Commissioner, taxing the income to the decedent.

Adverse Interest

I have summarized the general rules applicable to various types of reserved powers. If the grantor’s power to reacquire the trust corpus is exercisable in conjunction with another person, it is important to determine whether the latter has a “substantial adverse interest.” If he has not, the income, estate and gift tax consequences are the same as though the grantor could exercise such power alone—he is taxable upon the trust income under Section 166, the trust corpus is includible in his estate and no gift tax is incurred. Where the power is exercisable only with an adverse interest, the grantor avoids income tax on the trust income, but the trust corpus in nonetheless includible in his estate under Code Section 811(d). Probably the creation of such a trust also constitutes a taxable gift. A recent example is that of a decedent grantor who established a trust on December 3, 1936, under the terms of which the income of seven ninths of the trust estate was payable to his wife for life and, after her death, payable to the grantor for life. The trust was irrevocable but could be revoked or terminated by the written consent of “all of the then living beneficiaries” twenty-one years or more of age. The Commissioner held the value of the trust estate includible in the gross estate of the decedent under Section 811(d)(1). The court found that the grantor was a beneficiary and that under the trust agreement, he actually had the power, in conjunction with other beneficiaries of the same class, to revoke or terminate the trust. Estate of A. Frank Seltzer v. Commissioner, 49-1 ustc ¶10,719 (CA-6), aff’d CCH Dec. 16,408, 10 TC 810 (1948).

Let us assume that the grantor’s reacquisition of the trust corpus is dependent upon the exercise of another’s discretion (where the grantor is not required to join in the exercise of the power). Here, the adverse or nonadverse character of the other person’s interest is again important. If that person is not adverse to the grantor, the grantor remains taxable on the trust income, and the creation of the trust is probably not a taxable gift. Note, however, that in this case, the trust corpus appears not to be includible in the grantor’s estate for estate tax purposes. If the other person has an adverse interest, the grantor avoids both income tax and estate tax and is probably subject to gift tax upon the creation of the trust.

Where a person has a “substantial adverse interest” in the corpus of the trust or in the income from it and if his consent is required before the grantor may reacquire the trust property, the grantor is not taxable upon the trust income. The courts have held that a life beneficiary or a vested remainderman is clearly adverse with respect to the portion of the trust from which his interest is derived. There are, however, many borderline situations in which the beneficiary’s interest is contingent or is, in turn, dependent upon another’s discretion. Generally speaking, a person has no adverse interest merely because he has a natural incentive to preserve the interest of the present beneficiaries. It has been held that even a beneficiary may not be “adverse” where he is closely related to the creator. The fiduciary relationship of a trustee does not constitute an adverse interest, and his right to commissions does not make his adverse interest substantial. In Cohen, CCH Dec. 17,845, 15 TC —, No. 40 (1950), the taxpayer as the settlor trustee of a trust, the life beneficiaries of which were his wife and daughter, was not taxable on the net income of the trust, since he did not retain control over the properties transferred. He had no power
powers would' have been exercisable by the may attach, however, where such contingent revestment was subject to a contingency at not be subject to estate tax if the power of to the taxable year. The trust corpus may avoided by the device of making revocation to his control, but the tax may not be pendent upon a contingency not subject of an adverse party, he may, nevertheless, the reservation by the settlor of the power to the grantor, his reservation of power be- The court held that the income was taxable and upon any of the trust fund for such consideration to himself the right to sell to or buy from the trust estate at his own price and to direct the disposition to himself of all or any of the trust fund for such consideration and upon such terms as he might direct. The court held that the income was taxable to the grantor, his reservation of power being equivalent to the right to revoke the trust. The court stated that, in its opinion, the reservation by the settlor of the power to deal with the trust assets for his own benefit was irreconcilable with the fundamental principle underlying all fiduciary relationships, that the fiduciary must act solely in the interest of the cestui que trust and, therefore, may not have personal dealings with the trust property. As owner of the assets, the grantor, of course, had the right to reserve such a power. His doing so, said the court, clearly indicated that he did not intend to impose upon himself fiduciary restraints enforceable by the trust beneficiaries. Even where the grantor's power of revestment does not depend upon the consent of an adverse party, he may, nevertheless, avoid income tax where the power is dependent upon a contingency not subject to his control, but the tax may not be avoided by the device of making revocation dependent upon the giving of notice prior to the taxable year. The trust corpus may not be subject to estate tax if the power of revestment was subject to a contingency at the time of the grantor's death. The tax may attach, however, where such contingent power would have been exercisable by the decedent alone or with a nonadverse interest. In Estate of Paul Loughridge v. Commissioner, 50-1 USTC ¶10,766, 183 F. (2d) 294 (CA-10), cert. den. October 9, 1950, the decedent's mother transferred property to him by a deed of gift which contained a request that decedent make provision for his children with such portion of the property as he should determine was proper. The decedent set up a trust the day after the gift was received from his mother. He and his wife were trustees and had the power to alter, amend or extend all or any of the terms of the trust. Subsequently, the trust was amended and the decedent and his wife resigned as trustees, a bank being named as successor trustee. Article 12 of the agreement provided that any trustee was to resign upon written notice from the decedent not less than thirty days after receipt of such notice and that the decedent might appoint a successor trustee. The court held that the decedent must be considered the creator of the trust and not merely a conduit for the passage of the property from decedent's mother and that therefore, the trust property was taxable on account of the reservation of a power to terminate and thus shift beneficial interests. The court further held that at the decedent's death he was possessed of a power to remove the trustee of the trust created by him and appoint himself as successor trustee. Although a thirty-day notice had to be given to the existing trustee in order to obtain the trustee's resignation, the right to require the resignation was held not to be subject to substantial conditions. There was, however, a dissenting opinion filed holding that since no notice had been given at the time of the decedent's death to remove the trustee and appoint a successor, Code Section 811(d)(3) was not applicable. If the grantor reserves the power to amend the trust even though he may not reacquire the corpus himself, the trust is subject to estate tax. Such powers include the designation of beneficiaries by will and the reallocation of beneficiaries' interests during the grantor's lifetime. The tax attaches even though the power is exercisable only in conjunction with a person having an adverse interest. Decedent and his wife, domiciled in Texas, executed in 1937 and 1938 five trust agreements for the benefit of their daughters. Under the terms of each of the trusts, the decedent had the power at any time to terminate the trust and deliver the trust estate to the beneficiary or beneficiaries then entitled thereto. From 1937 to 1942 inclusive, the grantors transferred cer-
tain community property to such trusts as gifts. The decedent died in 1942. The question before the court was whether the Commissioner erred in including in the value of the decedent's gross estate the value of the five trusts as of the date of his death. The court held for the Commissioner, stating that a donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which Section 811(d)(2) requires in order to avoid the tax.

It is interesting to note that the court also found that the value of the wife's one-half interest in community property originally transferred and also the value of properties acquired with trust income were includible in the decedent's gross estate, since his power to terminate extended to the entire estates and the death of the decedent completed the inter-vivos trusts. Showers, CCH Dec. 17,651, 14 TC —, No. 111 (1950), citing Commissioner v. Holmes, 46-1 ustc ¶ 10,245, 326 U. S. 480.

With further respect to the power to amend without revestment, the power of amendment may be one factor in determining the grantor's liability for income tax as the "owner" of the trust property, but the power of amendment alone does not impose the tax. Where the grantor's power of amendment extends to a reapportionment among beneficiaries, no gift tax is incurred until the grantor relinquishes such power.

The income from the trust may constitute a gift when the right to such income vests in a beneficiary.

**Power to Allocate Income**

For liability for estate tax because of reservation of the power to allocate income, see Commissioner v. Hager Estate, 49-1 ustc ¶ 10,715, 173 F. (2d) 613, holding that the grantor retained to himself, as trustee, sufficient alteration or amendment power to affect very substantially the interests of the life tenants and the remaindermen, even though he could not, unless he lost all of the money of the trust by unfortunate investments, completely eliminate the remaindermen.

**Discretionary Powers**

With respect to the reservation of discretionary powers, see Estate of Mary H. Hays v. Commissioner, 50-1 ustc ¶ 10,762, 181 F. (2d) 169 (CA-5), in which the grantor-trustee reserved the right to withhold trust income from the beneficiary and add it to the principal. The court held that no arbitrary power to accumulate income was vested in the trustee but that such power was discretionary and governed by determinable standards, namely, the best interests of the beneficiaries and the trust.

Another case of interest is that of the Estate of Henry J. Mollenberg v. Commissioner, 49-1 ustc ¶ 10,715, 173 F. (2d) 698 (CA-2), aff'g CCH Dec 16,183(M), 6 TCM 1298, involving the transfer of business interests to sons of the grantor, allegedly for a consideration. The grantor, as trustee, retained the power to make withdrawals from the principal of the trust for the benefit of any of the beneficiaries and also to terminate the trust at any time and pay the principal to the income beneficiaries. The court held the trust property includible in the gross estate of the decedent and pointed out that the word "sale" means an exchange resulting from a bargain, one in which the beneficiary gives or the grantor receives something of a money value or a binding promise. In this instance, the grantor paid a gift tax at the time of the creation of the trust, and the court found this to be an additional circumstance indicating that there had been no sale.

**Gain or Loss**

The rules of basis for determining gain or loss with respect to revocable trusts are set forth in Sections 113(a)(2), 113(a)(3) and 113(a)(5). Since Section 113(a)(4) pertains to transfers before January 1, 1921, for practical purposes we may disregard it.

Section 113(a)(2) provides that if the property was acquired by gift after December 31, 1920, the basis shall be the same as if it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. However, for the purpose of determining loss, if the adjusted basis is greater than the fair market value of the property at the time of the gift, the basis shall be the fair market value.

The basis under Section 113(a)(3), applicable likewise to transfers in trust after December 31, 1920 (other than transfers in trust by gift, bequests or devise), is the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor, adjusted to the year in which the transfer was made.

Prior to the 1942 Revenue Act, all transfers in trust, with the exception of those...
having a basis determined pursuant to Section 113(a)(5), were given a basis determined in accordance with Section 113(a)(3). The 1942 Revenue Act provided that transfers in trust by gift during the grantor's lifetime are to be given a basis in accordance with Section 113(a)(2). This, in effect, overruled *Newman*, CCH Dec. 14,184, 4 TC 226 (1944), following the purport of the dissenting opinion in that case. Transfers in trust other than by gift, bequest or devise are accorded a basis in accordance with Section 113(a)(3).

With respect to a trust having a basis determined either by Section 113(a)(2) or 113(a)(3), the fact that the trust later is taxed under Section 811(c) or 811(d) for federal estate tax purposes has no effect upon the basis except as hereinafter noted. The constitutionality of compelling the donee to use the donor's cost in a case where the gift was held taxable as made in contemplation of death was upheld by the Supreme Court in *Taft v. Bowers*, 1 USTC ¶ 368, 278 U. S. 470 (1929).

The exception hereinafter referred to arises where a trust is revocable, the grantor retaining the right to income or the right to control its disposition, and where the basis upon the death of the donor is determined after his death under Section 113(a)(5). Such a trust pays an estate tax, and the basis shifts as of the donor's death to the value of the trust property either as of the date of his death or one year thereafter if optional values are used pursuant to the provisions of Section 811(j). In order for the basis to shift, it is essential that both of the requirements of Section 113(a)(5) be met, namely, that the trust be revocable and that the grantor retain control over the income. Since this is an exception to the general rule, Section 113(a)(5) cases should be narrowly construed.

If for basis purposes the trust is taxable under Section 113(a)(5) after the donor's death, the holding period of the trustee or of the beneficiary begins with the date of the donor's death. This is set forth in GCM 19347 (1938-1CB-218), supported by *Dewees*, CCH Dec. 13,048, 1 TC 791 (1943). However, this interpretation may be subject to some question in view of the language in *Helvering v. Gambrill*, 41-1 USTC ¶ 9360, 313 U. S. 11, in which the Supreme Court states that the holding period "embraces not only full ownership but also any interest whether vested, contingent or conditional." While the latter case did not involve the question of the shifting of basis under Section 113(a)(5) and the Court's language is dictum, it may be regarded, however, as a possible direction pointer.

Conversely, it has been decided that the holding period does not begin until the decedent's death where the property was transferred by the decedent to a revocable trust and, therefore, had as its basis the value at the time of death. *Fifth Avenue Bank v. U. S.*, 41-2 USTC ¶ 9722, 41 F. Supp. 428 (Ct. Cls.), cert. den. 315 U. S. 820 (1942). Where the property was purchased after death by the fiduciary, the holding period, of course, begins on the date of such purchase. It would seem that the holding period is not affected by the valuation of the estate for estate tax as of one year after death.

Where a beneficiary may have received shares of stock in distribution of a trust and was also the owner in his own right of other shares of stock of the same company, in the absence of specific identification of shares sold, the sale of shares acquired at different times or at different prices is controlled by the "first-in, first-out" presumption. *Helvering v. Campbell*, 41-1 USTC ¶ 9359, 313 U. S. 15.

**1950 Revenue Act Problems**

I should like to pose a problem which may arise by reason of the 1950 Revenue Act amendment covering the treatment of literary, musical or artistic compositions, etc. (See Sections 117(a)(1) and 117(j)(1), as amended.) Let us assume that Smith, a lawyer, writes a television show. He assigns his interest in the show to a trust, reserving the right to dispose of the income and the right to revoke. After his death, pursuant to the terms of the trust, the income is payable to his son, and his son has the right to direct the sale of the property in the trust and to terminate the trust at any time. May it not be argued that, after Smith's death, the proceeds of a sale of the television show will be subject to the basis provided in Section 113(a)(5) and will be treated as a capital asset in the hands of the son rather than as ordinary income as is would have been treated if Smith himself had sold the show?

**Marital Deduction**

To the extent that property passing by a revocable trust may qualify as an "interest in property passing from the decedent," it may qualify for the marital deduction. If
the decedent has created an *inter-vivos* trust taxable under Section 811(d) with property which would qualify for the marital deduction, it must still qualify under Section 812(e) in order that the deduction may be allowed. If an interest in property is includible in the gross estate and if that interest "passes" to the surviving spouse, the deduction is generally the value of that interest at the date of death. If, however, the executor elects to value the estate under Section 811(j) (one year after death), the interest in property qualifying for the marital deduction will likewise be valued under that section.

Whether an individual is a "surviving spouse" of the decedent depends upon the marital status at the time of death. A legal separation which has not terminated the marriage does not affect such status. If an *inter-vivos* transfer subject to estate tax was made by the decedent to an individual to whom he was not then married, the deduction is nevertheless allowable if they were married at the time of the decedent's death.

Conversely, if such an *inter-vivos* transfer was made to an individual to whom the decedent was then married, the deduction is not allowable if they were not married at the time of death. This latter result is apparently intended to apply whether the marriage has been terminated by divorce or by the donee's death.

If, after this condensed treatment of a relatively narrow area of trusts subject to so many vagaries, you fear that you are now in a seemingly advanced state of mental confusion, you might test yourself as a certain member of the Chicago bar of some three score years and ten was recently tested. He was mentally confused and his doctor had him in the hospital for treatment. One day, the two of them were walking down the corridor, when a particularly attractive nurse passed them. The lawyer turned, as though he were suddenly coming out of nowhere, and was heard to exclaim, "Pretty neat!" At which point, his doctor commented, "You're cured." [The End]

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**Liquidating a Shareholder's Interest in a Closely Held Corporation**

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A SHAREHOLDER in a publicly owned corporation who desires to dispose of his shares merely calls his broker and a sale is promptly effected on a securities exchange. Any amount realized in excess of cost is taxed under Section 117 (a) of the Internal Revenue Code as capital gain. Disposing of stock in a closely held corporation, however, is not generally this simple. There is no established market for such stock. It will usually not be possible to find a purchaser outside the existing group of stockholders. Indeed, it will often be found that even the other shareholders in the corporation will not wish to purchase additional shares, particularly if the deal must be financed out of their personal funds. However, it may happen that the corporation, despite the restrictions of Code Section 102, has accumulated surplus, not required in the conduct of its business, sufficient to purchase the shares desired to be disposed of. Having the corporation purchase the shares appears at first blush a happy solution to the problem. Indeed, in many situations it may be the only feasible one. At this point, however, Code Section 115 (g) rears its ugly head. To the extent that the corporation has accumulated earnings, the shareholder may find to his dismay that what he considered to be a sale was, for tax purposes, not a sale at