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RECENT DEVELOPMENTS CONCERNING INCOME TAXATION OF ESTATES AND TRUSTS

By DON L. RICKETTS

Last Spring, when I was invited to speak, the suggested topic related to the provisions of the Tax Reform Act of 1976 affecting the income tax treatment of estates and trusts. Because there were indications that technical corrections would be considered by the Congress, the speech topic was changed to generally cover recent developments concerning the income tax treatment of estates and trusts. Although the 1976 Act was enacted more than a year ago, enactment of the provisions of that Act is still a relatively recent development of substantial significance. Therefore, in this speech, I will attempt to cover some of the principal provisions of the 1976 Act which affect the income tax treatment of estates and trusts.

The changes made by the 1976 Act with respect to the treatment of redemptions of stock in a closely held business to pay death taxes and the basis of property acquired from a decedent will undoubtedly have a significant impact on the income taxation of estates and trusts. As you know, these changes are not limited to the income taxation of estates and trusts. Therefore, the topics under present law to be covered are those recent developments which relate to subchapter J of the Code and other provisions specifically involving estates and trusts. However, because of the importance of the carryover basis rules for estates and trusts, it might be appropriate to generally describe some of the proposals relating to carryover basis which are likely to be considered when the Senate considers H.R. 6715, the Technical Corrections Act.

In addition, since it is likely that H.R. 6715 will be considered by the Senate early next year, some of the provisions of that bill, as passed by the House of Representatives, will be described when the corrections or clarifications relate to 1976 changes which are covered. This bill is of special interest because a number of problems under existing law would be resolved by its provisions.

Carryover Basis Proposals

With respect to the carryover basis provisions, the technical corrections bill would make several correcting and technical changes. For example, section 3(c)(1) of the bill would provide a formula for determining a minimum basis which reflects the fresh start adjustment for the December 31, 1976, value in the case of tangible personal property. Under the formula, it would only be necessary to establish the estate tax value (without regard to alternate valuation) and the fact that the decedent owned the property on December 31, 1976. This provision is intended to deal with the problems an executor would face in trying to determine the decedent's cost basis in types of property acquired before 1977 for which it is unlikely that records would have been maintained. Another bill, S. 1954, which was introduced by Senator Curtis, provides for the repeal of carryover basis. Another bill, S. 2227, which was introduced by Senators Byrd of Virginia and Dole, provides for a 2-year suspension of carryover basis so that it would apply only with respect to property acquired from a decedent dying after December 31, 1978.

In addition to these bills, several bills have been introduced to simplify the carryover basis provisions. These bills include S. 2228, introduced by Senators Byrd of Virginia and Dole, and S. 2238, introduced by Senator Hathaway. Both bills would increase the $60,000 minimum basis adjustment to $175,000 after it is fully phased in by 1981. Initially, for 1977, the amount would be $120,000 which roughly approximates the exemption equivalent of the unified estate and gift tax credit. The bills also provide that the minimum basis adjustment is to be made before the adjustment for death taxes attributable to appreciation. By these changes, it has been estimated that only 2 percent of estates would be affected by carryover basis.

These bills would also modify the adjustment to basis for death taxes by combining the separate adjustments for Federal estate taxes, State death taxes paid by the estate, and State death taxes paid by the beneficiary into a single adjustment determined under Federal estate tax inclusion rules at the marginal rate rather than the average rate. It is understood that the Treasury Department may recommend an even simpler method of making a rough justice determination of the death tax adjustment. Generally, under the Treasury approach, the adjustment would be made by simply multiplying the amount of appreciation in carryover basis property by the highest Federal estate tax rate applicable to the estate.

It would appear that the proposals under these simplification bills with the Treasury modifications would solve some of the major administrative problems associated with the carryover basis provisions.

Accumulation Trusts

Returning to the 1976 Act, one of the important provisions under the Act relates to the treatment of trust distributions of accumulated income. As you know, beneficiaries generally are taxed on distributions of previously accumulated income from trusts in substantially the same manner as if the income had been distributed currently as earned by the trust. This treatment is accomplished through the so-called "throwback rule" under which accumulation distributions are taxed to the beneficiary as if the income had been distributed currently. Prior to the 1976 Act, the tax on accumulation distributions was computed under either an "exact" method or a "shortcut" method. Under the exact method, the beneficiary's tax on an accumulation distribution could not exceed the tax that would have been payable if the income had actually been distributed in the prior years when earned. The exact method required complete trust and beneficiary records for all past years.

Under the shortcut method, a fraction of the accumulated income distributed by the trust was added to the beneficiary's income for each of the three immediately preceding years for purposes of computing the beneficiary's tax on the distribution. The fraction of the income included in each of the three preceding years was based on the number of years in which the income was accumulated by the trust which was "grossed-up" by the amount of taxes paid by the trust on the accumulated income.

The alternative methods of computing the beneficiary's tax on an accumulation distribution created a number of administrative problems for both the Internal Revenue Service, fiduciaries, and beneficiaries. As a result, the Congress decided in the 1976 Act that it was desirable to have one simplified method of applying the throwback rule rather than two alternative methods.

Under the new shortcut method as under the old shortcut method, the tax attributable to the distribution is determined by averaging the distribution over the number of years over which the income was earned by the trust. This portion of the total accumulation distribution is added to the beneficiary's taxable income for three taxable years during the preceding five-year period. For this purpose, the year with the lowest amount of taxable income and the year with the highest amount of taxable income during the five-year period would not be taken into account. The average increase in tax for the three years is then multiplied by the number of years to which the trust income relates. The tax previously paid by the trust is offset against this amount, in determining the tax liability, or partial tax on the accumulation distribution, for the year of distribution. The offset for taxes paid by the trust cannot be used against the beneficiary's regular income taxes on other income and cannot give rise to a refund to the beneficiary. The net effect of the rule is to tax accumulated income at the higher of the trust's or beneficiary's highest tax brackets.

Section 2(o) of H.R. 6715 would amend the definition of taxes imposed on the trust (sec. 665(d)) by providing that, in the case of domestic trusts, this term includes foreign taxes as well as U.S. taxes which are allocable to the trust's accumulated income, with the result that the foreign taxes may be credited against the beneficiary's additional tax on the accumulation distribution. However, the foreign taxes taken into account are only those foreign taxes (including carryovers and carrybacks) which were allowed as foreign tax credits to the trust for the relevant years after applying the foreign tax credit limitation provisions (sections 904 and 907). Foreign taxes which exceed the limitation for any year, or foreign taxes that were deducted by the trust for any year, will not be considered taxes imposed upon the trust. A separate rule is provided under which the foreign tax credit is allowed with respect to accumulation distributions from foreign trusts.

The 1976 Act provided or continued a number of special rules for calculating the partial tax on an accumulation distribution. First, the beneficiary's taxable income for a prior year is not to be treated as less than the zero bracket amount even if a loss were incurred for that year.

Second, as a *de minimis* rule, the number of years for which an accumulation distribution is treated as distributed does not include a taxable year if the undistributed net income for that year is less than 25 percent of the aggregate distribution divided by the total number of years otherwise determined with respect to the distribution. Third, accumulation distributions previously made are to be reflected in the beneficiary's taxable income. Fourth, multiple distributions from more than one trust in a year are deemed to be made consecutively in the order determined by the beneficiary.

Under section 3(o) of H.R. 6715, the tax imposed on a beneficiary would be adjusted to take into account the estate tax or generation-skipping tax attributable to the accumulated income. The effect of the adjustment would reduce the beneficiary's income tax by the approximate amount that the transfer taxes would have been reduced if the transfer tax base had been determined after payment of income taxes on the accumulated income at the beneficiary's rates rather than the trust's rates. The purpose of the provision is to minimize differences in the overall tax burden between a case where distributions are included in a beneficiary's income and then subject to a death tax and the case where accumulated income is subject to a death tax and then is distributed to another beneficiary.

Under the bill, this result is accomplished by reducing the partial tax on the accumulation distribution by the product of the "pre-death portion of the partial tax" multiplied by a fraction. The numerator of the fraction is the estate tax or generation-skipping tax attributable (on a proportionate basis) to amounts included in the accumulation distribution. The denominator is the amount of the accumulation distribution subject to estate or generation-skipping tax. The pre-death portion of the partial tax is the amount which bears the same ratio to the partial tax as the accumulation distribution attributable to the period prior to the death of the decedent, or the date of the generation-skipping transfer, bears to the total accumulation distribution.

This provision of the bill would appear to have its greatest impact in the case of generation-skipping trusts which accumulate income. For other trusts, it may not have great applicability because the value of the trust would not ordinarily be included in the grantor's or predecessor beneficiary's gross estate for estate tax purposes. One situation where some benefit could be obtained for a beneficiary would be where the grantor retained a reversionary interest that satisfied the Clifford trust rules for income tax purposes but all or a portion of the value of the trust is includible in the gross estate of the grantor for estate tax purposes because of the retention of the reversionary interest.

As a simplification change, the 1976 Act eliminated the provision that the character of income to the trust for accumulation distributions passed through to the beneficiary. However, the tax-exempt status of income, such as State and municipal bond interest, would continue to flow through to the beneficiary because, under section 667(a), the amount included in the beneficiary's income would be the amount includible if the trust had distributed it on the last day of the trust's taxable year in which earned, taking the character of tax-exempt interest into account. Generally, one of the most significant aspects of the change would appear to be where capital gains are not allocated to corpus and lose their characterization if accumulated and later distributed to a beneficiary. Another aspect would be where a trust receives payments from a retirement plan or other amounts treated as income in respect of a decedent which might be treated as earned income for purposes of the maximum tax but lose their character as earned income when distributed to a beneficiary. In this situation, planning for the current distribution of income might be advisable because, under section 662(b), the characterization of income would then flow through to the beneficiary for distributions of income made during the taxable year in which earned by the trust (or considered to have been made during the taxable year under section 663(b) for distributions made within 65 days after the close of that year).

The 1976 Act provides a special rule to deal with multiple trusts where a beneficiary receives an accumulation distribution from more than two trusts with respect to the same year. Under this rule, in the case of a distribution from the third trust (and any additional trusts), the beneficiary is to recompute his tax under the revised shortcut method except that the distribution is not grossed-up for taxes paid by the trust and no credit is to be given for any taxes previously paid by the trust with respect to this income. These rules would appear to be a substantial deterrent to using multiple trusts to achieve rate bracket splitting. The effect is to tax income at both the trust and beneficiary levels much like taxing corporate income to a corporation and then taxing dividends at the shareholder level. For example, assume that a trust makes an actual distribution of $70X of accumulated income and that it had paid income taxes of $30X with respect to that income. If the beneficiary is in the 50-percent bracket and the multiple trust rules do not apply, the net tax imposed on the beneficiary would be $20X. That is, a tax of $50X on a distribution of $100X after being grossed up for taxes of $30X, reduced by the credit of $30X. However, if the multiple trust rules apply with respect to the distribution, the beneficiary would incur a tax of $35X, or 50 percent of the $70X dollars actually distributed. In other words, the beneficiary's after-tax benefit would be $50X, or $70X less an additional net tax of $20X, if the multiple trust rules do not apply, but only $35X if the multiple trust rules do apply.

The Act also provides a *de minimis* exception to the multiple trust rule under which the special multiple trust rule is not to apply where an accumulation distribution from a trust, including all prior accumulation distributions from the trust, to the beneficiary for that same year is less than $1,000.

In addition, the 1976 Act provided a number of special rules relating to refunds of taxes paid by the trust, minority accumulations, and distributions which do not exceed accounting income for the current year. Under these provisions, no refund or credit is allowed by reason of a deemed distribution of taxes by a trust (Code sec. 666(e)). In other words, the credit or offset for taxes paid by the trust cannot exceed the partial tax determined before taking the offset into account. Also, except for multiple or foreign trusts, an accumulation distribution does not include income accumulated for an unborn beneficiary or a beneficiary who has not attained age 21 (Code sec. 665(b)). Finally, no accumulation distribution is considered to be made if distributions do not exceed accounting income although the distribution may exceed distributable net income. Typically, this rule will come into play when fees chargeable to corpus are deducted in determining taxable income and, therefore, distributable net income.

Transfers of Appreciated Property to a Trust

Another significant change made by the 1976 Act relates to the treatment of transfers of appreciated property to a trust. The 1976 Act repealed the capital gain throwback rule and adopted a new provision, section 644, under which gains from the sale or exchange of appreciated property within two years of its transfer to the trust are taxed at the grantor's tax rates rather than the trust's tax rates. In effect, the gain is treated as if it had been realized by the grantor and then the net after-tax proceeds had been transferred to the trust. The new provision does not apply if the transferor dies within the two-year period and before the sale or exchange is made by the trust.

Section 2(n) of H.R. 6715 would make several technical changes to the provision. First, H.R. 6715 provides that the tax computation is to be made without regard to any loss or deduction which is carried (either back or forward) to another year of the transferor. Also, the tax is to be computed without regard to any net operating loss carrybacks to the transferor's taxable year used to determine the applicable tax rate. Second, H.R. 6715 provides that the new rule applies only when the trust "recognizes" gain rather than when it "realizes" gain. Substitute property received in a tax-free exchange is then subject to the special rules to same extent as the original property.

Foreign Trusts[1]

The 1976 Act also made several changes relating to the treatment of foreign trusts and transfers to foreign trusts. The Act contained a new grantor trust provision under which a U.S. grantor transferring property to a foreign trust is treated as the owner of the property transferred to the trust if there is a U.S. beneficiary. In addition, in cases where the income of a foreign trust is not taxed to the grantor under the grantor

[1] See, Zimmerman, "Using Foreign Trusts in the Post-1976 period: what possibilities remain" 47 J. of Tax 12 (July 1977).

trust rules, the Act imposes an interest charge for the period the payment of tax was deferred because the trust accumulated income. Finally, the Act increased the excise tax imposed on certain transfers of property to foreign trusts and other foreign entities from 27½ percent to 35 percent. This provision was also expanded to cover transfers of property generally rather than just stock and securities. The Act also added a new provision, section 1057, under which the transferor could elect to recognize gain on the transfer rather than pay the section 1491 excise tax.

Minimum Tax

For purposes of the minimum tax, the 1976 Act added a new preference for adjusted itemized deductions to the extent they exceed 60 percent of adjusted gross income. The application of this provision (section 57(b)(2)) to estates and trusts is unclear at the present time primarily because the application of the concept of adjusted gross income for estates and trusts was not prescribed. H.R. 6715 would clarify the application of this minimum tax preference for estates and trusts. The bill makes it clear that the concept of "adjusted gross income" applies to estates and trusts in essentially the same manner as for individuals. Thus, all trade or business deductions would be taken into account in determining adjusted gross income. The bill also provides that administration expenses and certain charitable deductions are treated as deductions in determining adjusted gross income. For this purpose, the charitable deductions taken into account are those for estates, wholly charitable trusts, pooled income trusts, and those attributable to transfers to a trust before January 1, 1976. No exception is required for charitable remainder trusts created after the Tax Reform Act of 1969 if the requirements of section 664 are satisfied because these trusts are generally exempt from both the income tax and the minimum tax.

The bill also provides that the personal exemption for an estate or trust is not taken into account in determining adjusted itemized deductions. For individuals as well as trusts and estates, the bill provides that the deduction for estate taxes attributable to income in respect of a decedent is not taken into account in determining adjusted itemized deductions. As under present law, distribution deductions under sections 651 or 661 are not taken into account as an itemized deduction.

Pecuniary Bequests

Another significant provision of the 1976 Act related to the use of carryover basis property to satisfy a pecuniary bequest. Under the 1976 Act, the amount of gain recognized by an executor in transferring carryover basis property in satisfaction of a pecuniary bequest was limited to post-estate tax valuation date appreciation (Code sec. 1040). H.R. 6715 would make several changes to coordinate the gain recognition provision (Code sec. 1040) with the special use valuation rules (Code sec. 2032A). First, the bill makes it clear that property distributed to a qualified heir is considered to pass from the decedent and, if otherwise eligible, will be eligible for the special valuation rule for farm and closely held business real property. Second, the bill provides that the special use valuation is not to be taken into account for purposes of measuring the post-estate tax valuation date appreciation. Under the literal application of the present law, any reduction in the estate tax value of property eligible for special valuation which is used to satisfy a pecuniary bequest would be subject to income tax since the executor's recognizable gain would be the difference between fair market value at the time of distribution and the estate tax valuation.

In connection with the Senate hearing on H.R. 6715, the Treasury Department recommended that the application of various recapture provisions (e.g., sec. 1245 or 1250) be limited with respect to transfers in satisfaction of a pecuniary bequest. It was recommended that the amount recaptured as ordinary income to the executor should be limited by the gain recognized on the transfer. Under section 1040 with this modification, the maximum amount recaptured to the estate as ordinary income would be the post-estate tax valuation date appreciation. In the absence of legislation, an executor should be wary of this possible problem in satisfying a pecuniary bequest with property which could give rise to ordinary income recapture. This is especially true because the recapture provisions generally apply notwithstanding any other provision and the amount may be measured by reference to the full fair market value rather than post-estate tax valuation date appreciation for these dispositions.

Split-Interest Gifts

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity. In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust.

H.R. 6715 would have permitted amendment of the governing instruments of charitable lead trusts to be effective for purposes of the income, gift, and estate tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977. Similarly, the bill would have permitted amendment of the governing instruments of charitable remainder trusts to be effective for purposes of the income and gift tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977.

Assuming the Senate would extend the time for amendment when it considers H.R. 6715 next year, practitioners faced with this problem will want to follow this legislation closely.

Other Rules Related to Carryover Basis

There are a number of rules affecting the income tax treatment of estates and trusts that have not been changed recently but have added significance because of the carryover basis provisions. The first one I would like to mention concerns the basis rules for distributions to a beneficiary. Under Regs. §1.661(a)-2(f), the basis of property in the hands of a beneficiary which has been distributed by a trust is its fair market value at the time distributed to the extent included in the beneficiary's gross income. The trust's or estate's deduction for distributions is the fair market value of the property at the time of distribution. Further, distributions in kind are treated as distributions of distributable net income only to the extent the distributable net income exceeds the cash distributions.

It has been suggested that the impact of carryover basis can be minimized by properly timing distributions of cash and other property. For example, assume: distributable net income of $100X, cash of $100X, and property worth $100X with a zero basis. If the property is distributed in a taxable year, the beneficiary will have a basis of $100X and income of $100X (which he would have had in the case of a cash or property distribution). In the following year, the cash is distributed with no income tax consequences if there is no distributable net income for that year. On the other hand, if the cash is distributed first, the income tax consequences are the same but the beneficiary would have a zero basis in the property distributed.

If a trustee engaged in a practice of accumulating income and distributing property in kind, the Service might question the application of Regs. section 1.661(a)-2(f).

In addition, if property distributed to a residuary legatee is not included in a legatee's income under the *Bohan* rule, the step-up for property distribution from an estate will not be achieved. Under *Bohan*, 325 F. Supp. 1356 (W.D. Mo. 1971) *aff'd* 456 F. 2d 851 (8th Cir. 1972), a partial distribution of property was not included in the distributee's income since the property was still considered part of the estate subject to recall if necessary to pay debts which had not been settled to allow final determination of the residue. In the past, a number of commentators have criticized the *Bohan* rule and the Service has ruled that it will not follow *Bohan* (Rev. Rul. 72-395). However, in the future, the Service might find it advantageous to assert *Bohan* to prevent avoidance of the carryover basis rules by using the basis rules under Reg. §1.661(a)-2(f).

Another area concerns the initial adoption of a taxable year. If a substantial amount of appreciated carryover basis property must be sold to liquidate an estate, adoption of a short taxable year during which only part of the gains would be taxed may mitigate against having "bunched" gains push the estate up to the higher rates under the graduated rate schedule. The taxable year must be adopted in the first return (Reg. §1.441-1(b)(3)) and the income for a short period is not annualized if the taxpayer was not in existence for the entire year (Regs. §1.443-1(a)(2)).

Another area concerns the importance of a request for a discharge of personal liability by the executor or prompt audit. Because of the basis adjustment for death taxes attributable to appreciation may be affected by audit adjustments, consideration of a request for a discharge under section 2204 or 6905 or a prompt assessment under section 6501(d) may be more important than under prior law.

Another planning opportunity may arise with respect to the rules for basis adjustments for property passing to surviving spouse. Because the carryover basis rules prohibit a Federal estate tax basis adjustment for marital deduction property but a comparable restriction does not apply to the new section 691(c) deduction for estate taxes attributable to income in respect of a decedent, it may be advantageous to distribute installment obligations or other items of income in respect of a decedent to a surviving spouse. (See, Wasson, "Estate Planning Benefits for Installment Obligations Increased by 1976 Reform Act" 46 J. of Taxation, 280 (May 1977)).

Similarly, it has been suggested that gifts in anticipation of death to a spouse, which do not qualify for the gift tax marital deduction, may be advantageous since section 1015(d) would permit a gift tax adjustment although the gift taxes are creditable against the estate tax under section 2001(b)(2) and no death tax adjustment would have been allowed if the property had been retained for a death time transfer to the surviving spouse.

In either case, the potential for tax savings depends upon the relative tax brackets of the surviving spouse, other beneficiaries, and the estate. For example, consideration of these planning possibilities would arise where the surviving spouse is expected to be in a very high income tax bracket but another principal beneficiary is expected to be in a low income tax bracket and, therefore, the transfer tax basis adjustment would be worth substantially more to the surviving spouse. I might also catuion that the potential for tax savings may also depend upon positions taken in Treasury regulations.

Recent Revenue Rulings

There have been several interesting revenue rulings issued during 1977 which may be briefly summarized. In Revenue Ruling 77-402, the grantor of a grantor trust renounced the powers held by him shortly before a tax shelter partnership investment started generating income. The ruling holds that the grantor is deemed to have sold his partnership interest for an amount equal to his share of the partnership liabilities reduced or eliminated.

This ruling may have implications for the time of recognition of income upon the death of a taxpayer owning interests in a tax shelter having a negative capital account.[2]

Revenue Ruling 77-322 held that an estate that restores an item previously included by a decedent under a claim of right may utilize the special computation provisions of Code section 1341. A contrary position taken in Revenue Ruling 67-355 was revoked. Generally, the new position would reduce the income tax liability of the estate where the decedent was in a higher bracket, for the year when received, than the estate when the amount is repaid.

Revenue Ruling 77-355 held that, for purposes of computing distributable net income, a simple trust that does not distribute capital gains because local law or the trust requires allocation to corpus may not include capital gains in the formula for allocating indirect expenses to tax-exempt income.

In a Letter Ruling issued on June 1, 1977, the Service held that a loss sustained by the estate upon the sale of *real property* owned by the estate to one of the co-executors (the decedent's son) and his brother was not disallowed by section 267 or 672 of the Code. The ruling makes it clear that a contrary result might be reached if the property involved was stock and the special stock attribution rules of section 267(c) applied. On November 28, 1977, the position taken in the letter ruling was set forth in published Revenue Ruling 77-439. In appropriate circumstances, the ruling may present some planning opportunities. For example, sales to a co-executor could be subject to greater timing control for realization of losses to be used as an offset to gains realized.

Recent Court Decisions

With respect to recent cases, I would like to summarize a Tax Court decision filed on November 3, 1977, in the case of the *Estate of A. Lindsay O'Connor,* 69 T.C. No. 14. In this case, one-half of the decedent's net estate was left in trust for the surviving spouse who was given the trust income, a general power of appointment, and a power to withdraw corpus. About two weeks after the decedent's death, the surviving spouse filed a written election with the executors and trustees to withdraw all of the trust corpus and, at the same time, executed an assignment of all rights in the trust to a charitable foundation. Thereafter, the estate made distributions to the trust and claimed a distribution deduction for them under section 661(a)(2) to the extent of distributable net income. The trust then made distributions to the chari-

[2] See, McGrath and Blattmachr, "Estate Planning for Tax Shelters in View of the Impact of the Carryover Basis Rules," 47 J. Taxation 130 (Sept. 1977).

table foundation. The trust included these amounts in income and claimed a distributions deduction under section 661(a).

With six judges dissenting, the Court set forth three holdings which resulted in taxing the income to the estate. First, the court applied section 678 to treat the surviving spouse and, after the assignment, the charitable foundation as the owner of the trust. Accordingly, the trust was not recognized and the estate was considered to have made the distributions to the charitable foundation with the trust being a mere conduit.

Second, the court held that the exclusive means by which an estate or trust may deduct amounts paid for charitable purposes was under section 642(c) of the Code. Accordingly, no distribution deduction was allowable under section 661 for the distributions considered to have been made to the charitable foundation. In so holding, the court sustained the position taken in section 1.663(a)-2 of the regulations. The court felt that the regulations should be sustained because a literal application of section 661(a)(2) would have permitted the deduction of all distributions to the extent of distributable net income and that would have been inconsistent with the statutory framework and overall legislative objectives of subchapter J of the Code. In addition, the court noted that section 642(c) was a specific provision and section 661(a) was a general provision.

Third, the court held that no charitable deduction was allowable to the estate under section 642(c) of the Code because the distributions to the charitable foundation were not paid pursuant to the terms of the governing instrument as required by the statute but rather were paid to the foundation pursuant to the assignment by the surviving spouse.

In dissenting opinions, three judges disagreed with the holding that the trust should be disregarded by treating the foundation as the owner of the trust under Code section 678. In another dissenting opinion, three judges dissented from the majority's conclusion that no distribution deduction was allowable to the estate under section 661(a)(2) for distributions considered to have been made to the foundation. This dissent points out that the Court of Appeals for the Second Circuit, to which an appeal of this case would lie, had stated in *Statler Trust v. Commissioner*, 361 F.2d 128, 132(2d Cir. 1966), that section 642(c) was enacted "apparently because Congress did not wish charitable gifts by trusts to be subject to the percentage limitations imposed on individuals in section 170(b)." That case also states that Code section 663(a)(2) was enacted to prevent a double deduction if a beneficiary claimed a charitable deduction which was also claimed by the trustee.

In light of the *Statler Trust* case and the significant amount of tax involved, one may reasonably assume that the Tax Court decision in *Estate of O'Connor* will be appealed.

Finally, another issue which might be of interest to you concerns the application of section 302 with respect to the complete termination of an estate's interest in a corporation by redemption of the shares of stock held by the estate. As you know, section 302 generally provides capital gains treatment for the complete redemption of all of the stock owned by the shareholder. For purposes of determining if there has been a termination of interest, the attribution rules of section 318(a)(1) are waived if the distributee does not reacquire stock within 10 years and files an agreement to notify the Service of any such acquisition.

The attribution rules under section 318(a)(1) apply to members of a family. The attribution rules from estates and trusts are prescribed under section 318(a)(2). Accordingly, the Service has ruled (Revenue Rulings 59-233, 68-388, and 72-472) that an estate of trust cannot file the section 302 agreement because, there is no specific reference to the estate and trust attribution rules under section 318(a)(2) for purposes of waiving attribution.

In an unreported case decided on November 16, 1976, *Elizabeth Ann Rickey v. U.S.*, (77-1 U.S.T.C. ¶ 9275), the U.S. District Court for the Western District of Louisiana held that an estate could file the necessary agreement. The court followed a decision of the Tax Court in the case of *Lillian M. Crawford,* 59 T.C. 830 (1973). The *Rickey* case was appealed to the Fifth Circuit on February 25, 1977. Generally, the Tax Court and district court refused to literally apply the provision for waiving the attribution rules. It was thought that a contrary approach would have been illogical and result in a trap when the estate does not distribute the stock and then the distributee's interest is redeemed.