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## SHORT TERM TRUSTS\*

J. W. HORNSBY, JR.\*\*

The section concerning short term trusts was put into statutory law in the Code of 1954. Substantially the same rules and regulations were applicable under the 1939 Code and the so-called "Clifford regulations", from the leading case of *Helvering v. Clifford*. The Code sections involved are §§671-678 and they are titled grantors and others treated as substantial owners. A more appropriate name would be "what not to do" rules, because if the grantor ends up being taxed on the trust income, he has accomplished nothing taxwise. Now, why use short term trusts? Any trust created, as you know, is a separate tax-paying entity. For the individual in the medium to high tax brackets it provides opportunity to shift income to a much lower paying tax unit and thereby to effect an overall tax saving and to get the property back at the end of the trust period. To refresh your recollection on tax rates, an unmarried taxpayer who is not a head of household, hits the 50% bracket at 16-18 thousand dollar taxable income level, after personal exemptions and exemptions for dependents. A head of household hits the 49% bracket with a taxable income of 22-24 thousand. And the married person filing a joint return hits the 50% bracket with taxable income of 32-36 thousand. I am going to use that percentage in my talk, in other words the 50% bracket.

Income tax on a trust, of course, like an individual, starts at the 20% bracket, therefore, the income tax savings would depend on the tax bracket of the particular grantor involved. There are a number of very practical uses for such trusts. For example, savings programs; suppose husband had properties or securities that yield \$3,000 a year but after taxes he has only \$1,500 left. He could put such property in a ten year trust and direct that the income be accumulated for the entire term and

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\*Lecture delivered at Tidewater Tax Conference.

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then paid to his wife. Of course it would be better in my opinion to give the trustee discretion to accumulate or distribute since that income may be needed during the term and tax considerations may become insignificant over that period. The trust, however, having this \$3,000 income, would have a \$100 exemption, and would pay approximately \$600 income taxes instead of \$1,500 paid by husband. Now this is a net savings of \$900 a year or \$9,000 over a period of ten years. Another example would be for educating children. Suppose this same taxpayer had two small children. He set up two ten-year trusts with property yielding \$3,000 a year or \$1,500 to each trust. Now if this income is used in discharge of his support obligations he has accomplished nothing because he will be taxed on it. But suppose the trust provided for distribution to the child of \$599 a year and accumulation of the balance. That figure of course is picked purposely because it is under \$600. The child pays no tax, in fact does not even have to file a return.

You can get a little further break if you want to go to the trouble of filing a return for that child, but for this illustration I am using that amount. The father still gets the dependency exemption as long as he actually supports the child. The remaining \$901 is accumulated, the trust gets the \$100 exemption and pays tax only on the \$801 remainder or \$160 approximate tax. For the two trusts the total tax bill will be \$320. A third example would be for supporting aged relatives. Suppose the taxpayer supports his mother by giving her \$1,000 a year. But to do so he must earn \$2,000. Of course the parent who needs such support is in a low tax bracket and if over 65 years of age gets a double exemption and unlimited deductions for medical expenses. Now the trust term in this case can be set up to be terminated on the death of the mother. It will qualify regardless of the mother's life expectancy, and will return the property to the grantor at the time of her death. Those are some of the possible uses of the short term trust. Let us take a look at some of the rules.

The term or minimum period is ten years with four exceptions. They are sometimes called ten-year trusts. The first exception is where you have the income paid to a charity for two years—to an approved charity I might add. The second

exception is that the trust may be made to terminate on the death of the beneficiary regardless of the life expectancy of the beneficiary; again, the support of the mother situation. It can terminate on the death of the grantor or any other person provided that the grantor or the other person has a life expectancy of at least ten years. And as one writer put it, "If a person suffers from a certain disease that would make that person's life expectancy under ten years." In other words you could have a special situation. You cannot definitely rely on the table for that.

The fourth exception is that it can be made terminable upon the happening of a particular event provided that such event is not reasonably expected to occur within ten years, such as the marriage of a six-year-old child. An illustration that would not qualify of course is where you had a son graduating from high school and the event you selected was his graduation from college. That can reasonably be expected to occur within ten years, and could not be used.

Now let's look at the trustee rules. If the grantor is treated as a substantial owner under the statutes it will happen because he holds certain powers; either he himself or a non adverse party. A non adverse party is one who has no substantial beneficial interest in the trust. For example, a person having a power over the trust corpus does have an adverse interest. But a trustee is not an adverse party merely because he is trustee. Now the grantor may safely have only certain limited powers. First, he can retain the power to apply income to the support of a dependent. The fact that the trust contains this power will not automatically cause the income to be taxed to the grantor. However, the actual use of this power will cause the trust to be taxed to the person who has the duty to support the beneficiary. I think this power should be in a trust instrument as a practical matter; because, as I said, there may be a time when the family security and need may exist and other considerations will be insignificant. Of course if it is used it will be taxed to the father if the beneficiary is the son, or to whomever the person is who has the support or duty. Even if the grandfather sets up the trust and it is used for the support of the grandson, the father will pick it up as his income. The grantor may, however, retain any power to control beneficial enjoyment after the expir-

ation of the ten-year term, or after two years if the beneficiary is an approved charity. There is no further tax benefit after the ten year period but there may be other personal and non tax reasons for continuing the trust.

The grantor may dispose of his reversionary interests in the corpus by listing it in his will. If he should not want to select, in the trust instrument, the irrevocable disposition of the corpus, he could provide that on termination the corpus will revert back to him if living, or if dead, be disposed of as stated in his will.

The power to invade principal: This might become necessary during the trust term, and the grantor has two opportunities to accomplish it without loss of tax advantage. He may retain the right to distribute principal to any current income beneficiary, that is one who receives income currently, provided such distribution is charged against that beneficiary's share. For example, if the trust provides for payment of income to the grantor's two children in equal shares for ten years, and has this power in it, and the grantor actually pays to one child fifty percent of the trust principal, then all income from the remainder must be paid thereafter to the other child. However, if he does not want distribution charged to a beneficiary, he may put in the trust instrument a reasonable standard for such payment, such as one of education, support, or health. I would like to emphasize that if corporate trustees are involved and they are not outnumbered by the controllable trustees, they may be given unlimited power to invade without any standard. For example, you could use brother and trust company, and the trust company would qualify under that rule.

Power to distribute or accumulate income: I think it is advisable to provide for discretion in the trustee to distribute or accumulate income. If the grantor is trustee then the age or legal status of the beneficiary becomes very important. If the beneficiary is under twenty-one or under a legal disability, the grantor may retain the right to pay out or accumulate income until the beneficiary becomes twenty-one or the disability is removed. If that beneficiary is over twenty-one, the grantor may retain the right to pay out or accumulate provided the accumulated income goes to the beneficiary at a specific time

which can be reasonably expected to occur during that beneficiary's life-time. Further provided that should the beneficiary die before receiving these payments, either alternate beneficiaries are named or such beneficiary has a power of appointment over such accumulation. The beneficiary's power need not be a general power. Again, if one-half of the trustees are independent there is no such limitation and they may be given unlimited discretion to accumulate or distribute.

The drafting job on the trust is not complete until an examination of the trust instrument is made to assure that none of the following powers are in the trust. Or, I think better still, that you specifically negate these things in the trust. First is the power to deal with corpus for less than adequate consideration. Second is the power allowing the grantor to borrow trust funds without adequate interest and security. An independent trustee may be authorized a general lending power to make loans to anyone without regard to interest or security. But do not have the power in the grantor to borrow from the trust and not repay with interest before the beginning of the next taxable year, either as trustee or through a controllable trustee. Again, an independent trustee has no such limitations. Do not have the power in the grantor in a nonfiduciary capacity to control voting and investing in controlled stock. In other words, if it is stocks that the grantor will control, do not give him the power other than as trustee to vote this stock. Do not have the power to reacquire the trust corpus by substituting other property of equal value. All of these powers will cause the grantor to be taxed on the trust income.

What about gift and estate taxes? The grantor has made a gift of the right of this beneficiary to receive income for a ten year period. This right must be commuted to a mathematical figure. For example, if the corpus is \$100,000, the regulations state that to compute the gift one must use a 3½% return and multiply by a factor that is given, in this case it is 8.31, so that the value of the gift is approximately \$30,000 or 30% of the corpus. The value of the remainder interest that the grantor owns is \$70,000 as of the beginning of the trust. If the income can be accumulated, you are not allowed to use your annual \$3,000, which I think is a major point in this. If the income is to be distributed currently, as for the support of the aged

mother, then he can use the \$3,000 annual exclusion, or \$6,000 if the wife joins in. Therefore, if there is an accumulation situation, one must use the lifetime exemption of \$30,000 to the extent necessary. Further, the value of the \$70,000 remainder interest increases as the term is used. At the end of five years for example, this value would have gone up to approximately \$84,000; so that if the grantor died at this time he would have \$84,000 of the original \$100,000 in his gross estate. At the end of nine years, it has climbed to \$96,000. Of course if it is a longer trust period than ten years the reversionary values are reduced accordingly.

What is the effect of the five year throw-back rules? The problem arises where trustees are expected to accumulate income and the trust income is accumulated when the beneficiary is in the high tax bracket, and distributed when he is in the low tax bracket. The abuse sought to be corrected here was the tax free distribution of accumulated income in subsequent years in which low taxes have been paid by the trust. If this abuse is found, the Internal Revenue Service agent can spread the distributions back over the preceding five years just as if all the income had been distributed as earned. This of course is limited to the extent that the trust had undistributed net income in the previous years. Now there are certain exceptions to these rules which serve to ease the burden insofar as short term trusts are concerned. If in addition to current income, the distribution of accumulated income does not exceed \$2,000, the rules do not apply. Therefore, accumulated distributions could be paid to a beneficiary in annual installments of \$2,000 and be outside the throw-back rules. I might add that the technique of using multiple trusts to create as many exemptions and exclusions as possible is presently under fire. I do not know that they have found an answer. People have gone so far as to set up a number of trusts for the same beneficiary. I feel that they are going to come up with an answer to that before too long.

Another exception to the throw-back rule is accumulation for the beneficiary until he is twenty-one. Such amounts may be distributed tax-free to the beneficiary when he becomes twenty-one. A third exception is emergency payouts of accumulated income. However, note that here distributions for

education and support do not fit this emergency exemption. The last exemptions from the throw-back rules are final distributions, carrying out the termination of the trust, at least nine years after the last transfer of property to it. Watch out, however, because if any property was transferred to this trust, within this nine year period then the throw-back rules do apply. I think it would be wise to prohibit the trustee from accepting any additional gifts as far as this trust is concerned.

In conclusion, short term trusts can be used to good income tax advantage for the basic reason that the trust income will fall into a lower tax bracket. In my opinion you should avoid letting grantors act as trustees, or retain powers to control income or corpus. There are too many chances that they will fall into the pitfalls of these rules and be taxed on them. Use an independent trustee. Remember that trust income actually used to support a child will be taxed to the father, even if the grandfather set up the trust. Remember that for aged relatives, or for building college funds for children, these trusts are good ways to do it. Remember that you have a gift tax situation where the right to accumulate is involved. You must take part of your lifetime exemption because the annual exclusion will not be available. Lastly, estate taxes are not drastically benefited in the ten year period. Of course if you get into a longer period then you know that the amount that is taxable in the grantor's estate is reduced. But, getting the property back at the end of the beneficiary's life or at the end of a ten year period often means more to your client.