

Chapter 18

p.1057

Investment Income

Fundamental issue: How allocate “unearned income” (i.e., investment income) to the correct taxpayer for federal income tax purposes?

Investment income belongs to the owner of the property – but, how can that ownership be used to deflect that income to a lower bracket taxpayer (within the family unit)?

This includes the utilization of trusts, but the arrangements in this chapter are for allocations of both (1) trust &(2) non-trust income.

Structure of this Chapter

1) Various cases examining (a) constitutional power and (b) the power as authorized under specific statutes to include income as being owned by the original property owner.

2) Various statutory responses in the trust context, including:

(a) Subpart E of Subchapter J (§§671—679);

(b) Taxation of “true” trusts (simple and complex trusts; §§651-652 & 661-662); and,

3) Alimony trusts - §682 (repealed TCJA).

Corliss v. Bowers

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Power under the U.S. Constitution to tax?

Taxpayer (T) transfers into trust with

(1) income to wife for life and (2) remainder to children. T retains power over the trust to either (1) amend or (2) revoke the trust.

Income was actually distributed to wife (pre-joint income tax return era).

Held: T has the power and the income is his for income tax purposes (within U.S. Constitution).

Douglas v. Willcuts

Alimony Trust p.1060

T transfers securities to (irrevocable) trust for wife for specific sum payment; excess to T.

Reversion to T at death of wife. Transfer in a divorce settlement in lieu of alimony or dower.

Held (when alimony was not income to wife):

(1) T's obligation was discharged by the trust income transferred to wife, (2) income is attributed to T for FIT, and, (3) constitutional power exists to attribute the income to him.

Cf., Old Colony Trust Co. decision.

Subsequent statutory response - §682

§ 682 provides a tax structure for an “alimony trust” – When income in trust is used to satisfy his obligation to former spouse (the recipient).

Result: Income is attributable to the former spouse (the recipient ex-spouse) for federal income tax purposes; and, is not includible in income of the transferor ex-spouse.

This treatment occurs after the enactment of Code §§71 and 215; but, TCJA repeal of §§ 71 and 682.

Questions – Problem 2

p.1062

a) **Transfer of securities in trust by A for minor daughter but (1) first use income to pay transferor's gift tax liability, (2) then accumulate income during minority, and, (3) distribute income at majority.**

Note: Income to A to the extent used to pay the gift tax (A's liability is being eliminated).

Planning option: Trust borrows funds to pay the gift tax; grantor then has no interest in the trust. Future trust income liquidates debt.

Questions – Problem 2

p.1063

b) Rental property is owned, placed in trust, expenses are paid by trust, excess income to child. If B remains liable on mortgage - \$5,000 income to B. If any interest payment is allocated as income then an offsetting interest expense deduction is available.

c) Trust is created for minor children and the trustee has power to use the trust income to pay tuition for the children. See Code §677(b).

Burnet v. Wells (5-4)

p.1063

Constitutional case: Grantor created an irrevocable trust and transferred securities and income to be used to pay premiums on an insurance policy on life of trust grantor.

Excess income to daughter for her life and then as directed under a power of appointment.

Held: Income to the grantor. Legislative power exists to authorize this gross income inclusion.

Dissent: No continuing power of Grantor over assets in trust. Income should be taxed to trust.

Sequel to Burnet v. Wells p. 1068

- 1) Enactment of §677(a)(3) providing that income of the trust which funds insurance premium is attributable to the trust grantor.**
- 2) See Part 1(c) – trust with directions to accumulate income (assuming better return than for insurance policy & actuarial gain).**
- 3) Part 1(d) - Assets are transferred by parent to child and the income from assets is then used to acquire insurance on the life of the parent.**

Burnet v. Wells & Issue of Retroactivity p. 1068

Problem 2: In Burnet v. Wells –

- a) Trusts created in 1922
- b) Tax legislation in 1924/1926.

How get back trust funds to pay the income tax when the trust is irrevocable when created?

Enact legislation only on a prospective basis (e.g. 2017 legislation).

How far back without causing constitutional limitations? To beginning of the current year?

Blair v. Commissioner p.1069

Blair was owner of (only) a life interest under a testamentary trust; the remainder interest was for the benefit of his children. (See next slide).

Blair transferred percentage interests in his trust life interest to his children. These assignments were held valid under state law (rejecting earlier “spendthrift” trust treatment).

Held: Assignment was valid and the income was attributable to the children/donees & not to the donor/assignor father. Vertical slice transferred?

Blair Testamentary Trust Structure

1) Grandfather – Last Will, with assets into trust at his death.

2) Life Interest –
to a) Spouse, & b) Next
Generation (i.e., Taxpayer-
Father)

3) Remainder interest –
to grandchildren

Procedural Effects in Tax Context

p.1073

- 1) What is the relevance of the doctrines of (a) res judicata and (b) collateral estoppel?
- 2) What is the governing impact of state court judgments as to the relevant facts in a federal tax dispute? See Estate of Bosch (& Erie).
- 3) Should the IRS be required to appear in state court proceedings when decisions on facts are relevant to (& perhaps governing) for federal tax applicability purposes?

Helvering v. Clifford

p.1074

Facts: Trust grantor was trustee; trust for five years (or earlier death); income distributed to wife in the discretion of the trustee; retained power of the grantor to vote shares, etc.

Held: Under predecessor to §61 the Grantor continued as owner of the trust corpus. Totality of all facts suggest grantor held the equivalent of full ownership. Fact finder not in error when determining grantor was owner of trust assets.

Dissent: No explicit statute covering this.

Helvering v. Horst

“Fruit & Tree” Rule p.1080

Delivery (by gift) of bond interest coupons to a child shortly before an interest income due date.

What is a “coupon bond”? Or, a detached “interest coupon”?

Sup. Ct: “The power to dispose of income is equivalent to the ownership of the income.”

This anticipatory assignment of (this) income is not permitted for income tax purposes.

Cf., registered bonds vs. coupon bonds. How mechanically accomplish a reg. bond transfer?

Helvering v. Eubank

p. 1085

The rights of an insurance agent to renewal commissions arising in the future were transferred to a trust. IRS asserts these commissions paid were includible by the transferor when paid. Relying on Horst - the Sup. Ct. holds that the commissions are taxable to the assignor.

Dissent: Property rights were transferred – represented by the contract rights and no “assignment of income” occurred.

Problem 8, p. 1087

**a) Farmer's contribution of wheat to charity –
Deduction for the full FMV of wheat?**

Note the Haverly case & §170(e)(1)(A).

**b) Transfer of corporate stock to children
immediately prior to sale. Or, to charity?**

**Apply a “step-transaction doctrine” analysis
and the attribute the sale to the transferor
parent?**

Problem 8, p. 1087

c) Landlord leases farm to tenant sharecropper. Rents and crop shares as the assignment of income. But, crop shares (item 2) as an item of property which can be transferred without retained income recognition.

Alternative: then give farm to child.

d) Assignment of book royalties in advance to author's children. Maximize the status as a copyright owner. See front of FIT casebook.

Problem 8, p. 1088 continued

e) **Transfer of next five year's income to be received from life interest under a trust.**

Yes, E remains taxable.

f) **Assignment of last three years of trust income to be received under a twelve year term interest held under a trust. Does F have a remainder interest – and, therefore, child has a carved out interest? A short term income interest which can not be transferred for §61 purposes?**

Problem 8, p. 1088 continued

g) Real estate owner leases for five year term and then assigns interest in lease to another.

1) G is taxed on rent paid to X.

2) Impute a higher rent?

3) Avoid G's participation in lease transaction.

h) Parent gives appreciated stock to child who then sells stock to pay tuition. No support obligation which would be satisfied – therefore, gross income inclusion by son.

TRUSTS & Income Tax

Rules

p.1089

What is a “trust”? A property law concept where (1) legal and (2) equitable ownership are separated (between the equitable owner(s)/beneficiaries and the trustee).

Distributions (income and/or corpus) are payable to one or more beneficiaries.

The tax question (considering the “assignment of income” principle) is: Who is deemed in receipt of the trust income for FIT purposes - (1) trust grantor? (2) trust itself? or, (3) one or more beneficiaries? Not the trustee (an agent).

Irrevocable Trusts and Income Taxation p.1089

Assume (1) an irrevocable or “true” trust with
(2) no retention of controls by the trust grantor
(including, e.g., at the time of death).

Result: Subject to federal tax rules for dividing
income (for income tax purposes) between (1)
the trust, and (2) the beneficiaries.

See Subchapter J, §§641-668 (Subpart A-D).

I.e., “statutory” rules re assignment of income.

Cf., trust income allocation rules for local/trust
law purposes (e.g., P&I rules) *(next slide)*

Income Tax vs. Trust Income Accounting

State trust law provides for differentiating between income & corpus for trust law purposes: e.g., life interest to A, remainder to B.

Examples re allocation:

- a) Capital gains realized by trust (§643(a)(3))
- b) Code §103 tax exempt income (§643(a)(5))
- c) Trustee expenses

Credited/debited to income or principal?

Cf., Uniform P&I Act, as enacted in Texas.

Simple Trusts – True Conduit Treatment p.1089

Assume: Trust is required to distribute all its income currently, and no corpus distributions.

See §§651-652: all “income” is taxed to beneficiary & a distribution deduction to trust.

No income is taxed to (1) the trust (i.e., flow-through treatment) or (2) the trust grantor.

A conduit analysis determines the attribution of trust income to the beneficiary.

§652(b): Pass-through of the tax character (e.g., capital gains or tax-exempt) of trust income.

Complex Trusts

§§661-662

p.1090

A trust may be subject to income tax (at a steeply progressive rate) on its taxable income.

A deduction is permitted to the trust for current income distributions to the beneficiaries.

The beneficiaries are subject to income tax on the distributed amount, as limited to the “distributable net income” or “DNI.” §643(a).

See, throwback rules (p.1091); but, note, the functional repeal of the throwback rules in §665(c) & high tax rate structure for trusts.

Cf., “Grantor” Trust Rules Income to Grantor p.1092

Cf., trusts where the grantor has retained certain significant powers, i.e., “grantor trusts.”

Relevant during the lifetime of the grantor but not after death of the grantor.

Grantor is treated as the owner of income (and deductions) for income tax purposes. I.e., an “assignment of income” has not been completed.

Taxation of the income of the trust is to the grantor/owner. §§671-677 (Subpart E).

Grantor Trust Rules

p.1092

Under what circumstances is the income of a trust allocable to the trust grantor (and not the trust or trust beneficiaries)? I.e., the trust is treated as the equivalent of an “agency.”

See §671 re income attribution made to the grantor.

1) Trust is revocable. §676 requires attribution of a revocable trust’s income to the grantor of the trust.

Grantor Trusts, cont.

2) Reversions – income attribution to the grantor where grantor’s reversionary interest is greater than 5 percent of the value of the trust.

§673. (casebook, p. 1092). Exceptions when a reversion after the death of minor descendant.

3) Powers of control – grantor as owner where holding a “power of disposition.” §674. Certain exceptions for retained powers, §674(b), (c) & (d) &, also, dependent upon who is the trustee.

E.g., §674(c) permits a “spray or sprinkle” power granted to an independent trustee.

Grantor Trusts, cont.

4) Certain unusual “administrative powers” can cause grantor trust treatment. §675.

E.g., power of grantor (a) to buy property from the trust, §675(1); (b) to borrow from trust without adequate security, §675(2); (c) certain borrowing by the grantor and no repayment at year-end, §675(2); or, (d) significant voting powers re stock held by the trust, §675(4) .

Cf., trustee’s capacity to tilt the trust investment policy to (1) bonds or (2) stock.

Grantor Trusts, cont.

5) §677 Income for the benefit of grantor.

§677(a) – distribution to grantor or spouse – presently or delayed;

Or, §677(a)(3) - the payment of insurance premiums on the life of the grantor.

§677(b). Satisfaction of a support obligation.

What is a support obligation? College tuition?

Definition of “support” is a state law matter.

§678 – Power to Demand a Trust Distribution

§678 provides that a person other than the grantor treated as owner if holding authority to demand income or corpus from a trust.

Example: Income to A for life, remainder to B, but C has power to withdraw all assets for C.

Rule: Must have the power to vest the income or corpus of the trust in oneself. However, power can not be subject to a limitation, e.g., can not be a “support” trust (unless exercised).

Problems, p. 1093

Capital Gains Inclusion?

1) D transfers into trust to:

(a) pay income in equal shares to children during D's life, and

(b) then distribute property as D may appoint.

Escape from tax on ordinary income under §674(b)(3)?

But: Continued inclusion for the grantor for capital gains (corpus) realized by the trust (since retained power over the capital gains).

Problems, p. 1093

Sufficient Standard?

2) E transfers property in trust with all trust income to be paid to children in equal shares. E retains power to distribute corpus to wife for her comfort and support.

See §674(b)(5)(A) – this standard is sufficient.

But, the wife is not a beneficiary. Reg. §1.674(b)-1(b)(5)(iii), Example (1).

Problems, p. 1093

Power to Redistribute

3) F transfers property in trust to pay income to children in equal shares during lifetime. F retains power to withhold income from any child; if so, that amount is added to corpus. On F's death, the corpus is distributed in equal shares to F's surviving children.

This constitutes a power to redistribute income. However: This power is excepted from causing grantor's income inclusion by §674(b)(6)(B)

Problems, p. 1093

Trustee Status

4) G transfers property in trust for life to pay current income to G's children in such shares as trustees may determine. Trustees are employee and attorney. Retained power to replace either or both trustees.

a) Attorney is acceptable (§674(c) since attorney is not subordinate. §672(c).

b) But, the power to replace trustee is not sufficiently limited (e.g., could include the grantor?). Reg. §1.674(d)-2(a).

Problems, p. 1093

Trust Loan to Grantor?

5) H borrows 100x from Bank on 12% unsecured demand note. H then created trust to pay income to daughter and contributes 100x to trust. Trustees are H's brother and Bank and have broad investment discretion. Trustees purchase H's note for the trust (from Bank). Under §675(2) or (3) has the grantor borrowed indirectly? Has adequate security been obtained? Does this constitute an assignment of income arrangement?

What Other Choices for an Investment Entity?

- 1) **Partnership (including an “LLC”) – conduit treatment for FIT purposes, including a “family partnership” or “family limited partnership” or an “FLP.”**
- 2) **S corporation – modified conduit treatment. See §1366 re reasonable compensation required.**
- 3) **Qualified retirement plans.**
- 4) **Other techniques? E.g., gift-leaseback or sale-leaseback.**

Interest-free Loans

P.1094

Use an interest-free loan with a child to avoid the applicability of the Subpart E/grantor trust rules?

See Code §7872 (previously discussed), relevant in following context:

- 1) family**
- 2) employer/employee**
- 3) corporation/shareholder**

Problems

p.1098

**1) Employer loans employee 100x to enable:
(a) purchase of home, (b) payment of college tuition, or (c) purchase of tax-exempt bonds.**

Result to employer: (a) (Additional) salary payment and (b) receipt of interest income.

Result to employee: (a) Compensation income and (b) interest expense deduction (for mortgage interest only). Not for college tuition or muni-bond purchase.

Problems p.1098

Section 7872(d)(1)

2) Mother lends child 100x interest free to buy residence.

(a) Interest income to and gift by Mother?

(b) Non-includible gift and deductible interest to child (mortgage interest)?

Would qualify for 100x exception under §7872(d)(1) (investment income limitation).

Problems p.1098

Demand v. Term Loan

3) Assume employer 15 year fixed term loan, but acceleration in event of earlier termination of employment.

Code §7872(f)(5) specifies that term loan accelerated upon employment termination is treated as a demand loan. Therefore, results measured for tax purposes on an annual basis.

Problems

p.1098

4) Other situations where below-market interest loan is a disguise for another transaction: seller financed property disposition transactions where ordinary income might be transformed into capital gain. See Code §483.

Problems

p. 1098

5)(a) Interest free loan would be within §7872(d) special rule when parents have limited investment income.

Interest and taxes would not be deductible by daughter.

Problems

p. 1098

5)(b) Child borrows 160x funds and then lends 200x to parents with no interest.

No qualification for exemption under §7872(d).

Daughter would have annual interest income.

Parents have interest expense deduction if loan is secured by the residence.

Problems

p. 1098

5)(c) Child as owner gets deduction for mortgage interest and taxes.

Qualification as second residence - §163(h)(4).

Parents: Imputed income to the extent of the FMV rent? But, exclusion for gifts under §102.

Treated as a gift for gift tax purposes. Dickman case (U.S. Sup. Ct.).

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