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Short-Term Trusts

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One of the areas of possible tax saving that is frequently overlooked is the field of short-term trusts.

In the typical short-term trust, the grantor gives the income from the property placed in trust to a designated beneficiary for a period of years. At the end of the period, the property reverts to the grantor. The objective is to remove the income from the grantor's usually high brackets and transfer it to the beneficiary's lower brackets.

We recognize at the outset that this type of trust will be includible in valuing the grantor's estate because of the retained reversionary interest. For this reason it is not often a suitable vehicle for the major shifts of interest that are frequently a part of a well integrated estate plan. However, we should not overlook important benefits just because they may not be quite as dramatic as other benefits that can also be obtained.

Another reason for the comparatively infrequent past use of the short-term trust is the uncertainty that surrounded them. In the famous Clifford case the grantor of a five-year trust was held taxable on income payable to his wife under the broad provisions relating to "income derived from any source whatever." In finding the grantor as the owner of the corpus in substance, the Court relied on no one fact but rather on "all considerations and circumstances." Obviously, this type of holding makes intelligent tax planning very difficult.

The situation was clarified somewhat by the issuance of Treasury Regulations on the subject, but their validity has been questionable and there were at least a few published cases where the Treasury seemed to attack trusts that met the regulation requirements. Nevertheless, a number of trusts have been established in reliance on the regulations.

Now, however, the Code itself sets out the circumstances under which trust income will be taxed to the grantor, and appears to close the door on the contention that such income is to be taxed under general principles rather than under the specific provisions. It is to be understood that the new provisions do not deal with matters such as the as-

signment of future income nor is it to be expected that all problems will be clearly and unmistakably solved.

In order to avoid having the trust income taxed to the grantor, it is necessary that certain rights and powers should be absent. One of the rights that, if retained, will subject the grantor to tax, is a reversion to take place within a period of ten years. However, it is permissible to have a reversion at the death of the income beneficiary. This rule makes it possible to create a trust for an elderly beneficiary whose life expectancy might be less than ten years and yet recover the corpus at the beneficiary's death.

Another exception to the ten-year rule is in cases where the income beneficiary is a charity. In this situation a reversion can take place after two years. The advantage of a charitable trust with reversion to the grantor as compared with periodic gifts to the charity is principally to an individual who desires to make gifts beyond the percentage limitations. If he received income which he then donated to charity, he would be taxable to the extent part of the deduction was disallowed. If the income is funneled directly to the charity, he can avoid this problem.

The next broad power which must not be retained if the grantor is to avoid tax is power to control the beneficial enjoyment of the trust. However, there are several exceptions; that is, powers which it is permissible for the grantor to retain. One of these is a power in another person, the trustee, or the grantor as trustee to use income for the support of a beneficiary whom the grantor is obligated to support provided the income is not actually so used. What persons the grantor is obligated to support is a matter of local law, and the client's attorney should consider the problem before he prepares the trust instrument.

Obviously, the rule against use of trust income for support of grantor's dependents limits the usefulness of the short-term trust device where the proposed beneficiaries are the grantor's minor children. But even here, a trust with an accumulation feature might have advantages under some circumstances.

Another power which can be retained is a power to control beneficial enjoyment if the power can only be exercised after the expiration of a ten-year period. However, the grantor will be taxed when the period elapses unless the power is relinquished.

Other powers over the beneficial ènjoyment which the grantor can retain include certain powers exercisable only by will, the power to al-

locate among charitable beneficiaries, the power to make limited distributions of corpus, the power to withhold income temporarily under certain circumstances, and the power to allocate between corpus and income.

Generally, the powers we have been discussing will result in tax to the grantor, not only if they are retained by him, but if they are exercisable by anyone not having a substantial adverse interest in the trust. However, an independent trustee can be given certain discretion over the distribution, apportionment, or accumulation of income with respect to the beneficiary or a class of beneficiaries. Similar discretion can be given to a trustee other than the grantor or his spouse if the discretion is limited by a definite standard.

Ordinarily, the various powers over beneficial enjoyment are not considered as necessary to retain in the short-term type of trust as in trusts of longer duration. Nevertheless, when retention of any particular power may defeat the purpose of the trust, the matter is not one to be ignored.

Another broad class of powers to be avoided has been grouped under the heading of "administrative powers." This includes any power of the grantor or a non-adverse party to obtain the corpus or income without giving full consideration. It also includes a power to make loans to the grantor without adequate security or interest.

Regardless of the provisions of the trust instrument the grantor will be taxed on the income if he has actually borrowed from the trust and has not completely repaid his borrowing unless the loan was made by an independent trustee for adequate interest and with adequate security.

Except where certain discretionary powers as to income distribuions are desired to be retained, it is permissible for the grantor to serve as trustee. In that capacity, the grantor-trustee would normally have the right to vote any securities held and direct the trust's investments including possible investments in closely held corporations in which the grantor might have an important interest. These powers are permissible if the grantor is the trustee, but if held by any person in a non-fiduciary capacity they will result in tax to the grantor.

The grantor is also taxable on the trust income if he, or any nonadverse party, has the right to revoke the trust. An exception is made where the right to revoke only becomes effective after the expiration of a ten-year period. In such cases the grantor only becomes taxable after

the expiration of the period and this can be avoided if the power is relinquished.

If trust income can be distributed to the grantor, accumulated for him, or used to pay insurance premiums on policies on the grantor's life, the trust income will ordinarily be taxable to him.

Assuming that the various powers that could make the grantor taxable are to be avoided, let us consider some of the situations where a short-term trust might be used.

Perhaps the simplest case is one in which the grantor wishes to render assistance to an adult person who is not a former employee and whom he is not obligated to support. A short-term trust could clearly be created that would eliminate income from the grantor's tax return and transfer it to the beneficiary's.

In setting up such a trust it would seem desirable to use fixed income securities or properties or at least securities or properties the income from which would not fluctuate too widely. The reason is that the normal objective is to provide a reasonable allowance to the beneficiary.

If very speculative assets were made the trust corpus and little or no income resulted, the objective would be defeated. On the other hand, if the speculation proved successful, more income might result than the grantor would wish to have irrevocably transferred.

The grantor will be considered to have made a gift of the income interest. If the beneficiary is entitled to the income each year, the gift should be considered to represent a present interest eligible for the $3,000 annual exclusion which can be $6,000 in the case of a married individual. As in the case of any gift this one is also eligible for the specific lifetime exemptions of $30,000 for the donor and $30,000 for his wife to the extent these exemptions have not been used.

If the beneficiary is a former employee, for example a retired servant, there is some thought that the creation of an irrevocable trust might possibly result in his being taxed on the present value of all the income in the year the trust is created. Even if this is the result, it may not be unfavorable depending upon the amounts involved and the respective tax brackets of the grantor and the beneficiary. In this case, the beneficiary would have acquired a basis for income received in subsequent years with a reduction in tax for those years, and also the grantor should not have to pay any gift tax because his payments are considered in the nature of compensation.

Generally, the difference between compensation and a gift is a matter of intent. If the grantor has no obligation to compensate his retired servant and treats the creation of the trust as a gift, this should be strongly indicative of intent to make a gift. However, it might be well to consider the other possibility in this type of situation.

If the grantor was under contractual obligation to make the payments to the servant, it would appear that the creation of a trust would be ineffective as far as relieving him of taxable income.

A special problem arises where the beneficiary is a minor, even though the grantor is not obligated to support him. This results because it may be difficult or thought unwise to give a present interest to a minor, particularly one who is quite young. The 1954 Code makes it possible to make a gift in trust to a minor with a possibility of accumulation and still have the gift treated as a gift of a present interest. To qualify, it is necessary that the property and income therefrom may be expended for the benefit of the beneficiary before he attains the age of twenty-one and that any amount not so expended pass to him when he becomes twenty-one. In the event of the beneficiary's death before he reaches the age of twenty-one the property must be payable to his estate or to anyone he appoints under a general power of appointment.

It will be seen that this provision does not apply to the specific type of short-term trusts we have been discussing because it requires that the property pass to the beneficiary, whereas the short-term trust ordinarily contemplates that the property will revert to the grantor. Nevertheless, the new provision with regard to gifts in trust to minors may be expected to have wide application.

In summary, the term short-term trust must be understood to mean a trust which will not revert to the grantor until after the expiration of a ten-year period or the death of the beneficiary unless the beneficiary is a charity. In general, the grantor or any non-adverse party must not have power to control the beneficial enjoyment of the corpus or income, although certain specified powers may be retained. The power of the grantor to deal with the trust must be limited. The trust must be irrevocable for at least ten years, and the trust's income must not be for the benefit of the grantor.

The income interest placed in trust will normally be subject to gift tax. However, the income tax savings available in suitable cases as a result of eliminating income from the high rates applicable to the grantor may well be substantial, and the possibilities should be considered in a great many tax plans.