

SPECIAL ADMINISTRATIVE CLAUSES FOR TRUSTS

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The emphasis of this topic will be upon the "long pull" tax factors involved in the utilization of a trust to achieve the best tax results as between beneficiaries and the trust. Factors applicable to both testamentary and inter vivos trusts will be discussed. Perhaps the first question to be posed is: "Under what circumstances should one be concerned with such clauses?"

While it is neither possible nor practical to lay down any set rules for determining the proper case for the use of such clauses, it may be observed that tax planning will be important in those cases where (a) the trust income will be substantial and (b) there are a number of beneficiaries. If either of these elements is lacking, the clauses may be used but they will be relatively unimportant.

The basic theory with which we shall be concerned is that income tax economies can be effected by spreading income among a number of taxpayers, with particular attention to those who would otherwise be in low income tax brackets. An effort should be made at the same time to make the plan sufficiently flexible so as to be able to shift that income from one beneficiary to another (and with it, the income tax) as the income patterns of the beneficiaries and their families may change in future years. Assuming this is to be the objective, how is it achieved?

Consider, first, the possibilities where it is desired to hold all the trust assets in a single fund. Such a case may well arise where the fund itself is not too large and where all of it (or a large part) might be required for one or more of the beneficiaries. For example, if the beneficiaries are infants it is altogether possible that any one of them might, through the impact of lengthy illness, need far more than his proportionate share of the trust. We know that if the client were living when this happened he would surely pay all the bills out of his pocket without in any way considering or charging those medical expenses as an advancement against that child's share of his estate. Much the same principle is applicable to the matter of education of the children. The eldest will have an advantage over those who are younger in that he will have had his education and living expenses paid for him for more years during the settlor's life than the others. This inequity may be avoided by holding the trust assets in a single fund and not making any division into shares for the children until they are at least past the age of dependency and education expenses have been paid for all.

As to the clause itself, you will probably find as many varieties of language as you will practitioners who prepare them. Consequently

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the following is offered more for the ideas contained than for precise language:

The Trustee shall pay and distribute such part or all the net income of the trust estate to and among my said wife, my children and/or their spouses and issue, as in the sole discretion of the trustee, shall be to the best interests of the trust estate and said group of beneficiaries. It is not my intention that such payments of income be made equally or to all such beneficiaries but may, in the sole discretion of the trustee, be made in such proportions and to such of said beneficiaries as it deems best.

It will be observed, first, that the payments under this language are in the unrestricted judgment of the fiduciary with no suggestion whatever as to any standards to be applied by the trustee in making its determination. Clearly, in determining what is to the "best interests" of the parties, the trustee may weigh income tax factors to the end that those taxes will be kept to a reasonable minimum within the whole of the family group. Presumably, also, the trustee might allocate tax-free income to a beneficiary in a high bracket and taxable dividends or interest to one in a lower bracket. This must be specifically authorized in the instrument since under Sections 652(b) and 662(b) of the code each beneficiary will be considered to have received a proportionate part of each class of income unless the governing instrument specifically provides otherwise.

While all this is fine theory, it must be appreciated that such an unrestricted power of allocation can give the trustee not only the ultimate in flexibility for minimizing taxes, but also some very difficult problems in its relationship to the beneficiaries. A simple illustration may show what I mean by this. Assume that the trust has two beneficiaries who are brothers. Brother A is an eminently successful lawyer whose top income is in a sixty per cent bracket. In contrast, brother B, who never had the mental agility of A, is a department store clerk—a very charming fellow with a large family, and his top tax bracket is twenty per cent. If the trustee distributes a much larger proportion of the trust income to B merely because of the tax differential, A is very likely to object bitterly. He may very well be just selfish enough that he would prefer to get forty cent dollars of income rather than have the trustee give his brother eighty cent dollars. As a result, I am not at all sure how practical it may be to count much on the tax advantages of this arrangement since they may well be outweighed, in practice, by the personal elements of the case.

All this suggests that in lieu of giving the trustee uncontrolled and absolute discretion, it may be preferable to set up certain objective standards to use as a guide in making distributions. If this is deemed best, consider the following clause:

The Trustee shall pay and distribute such part or all the net income of the trust estate to and among my said wife, my

children and/or their spouses and issue, as in the sole discretion of the trustee shall be necessary to provide for the care, support, maintenance and liberal education of said beneficiaries. It is not my intention that the payments of income hereinabove provided for such beneficiaries be made equally or to all of them, but may, in the sole discretion of the trustee, be made in such proportions and to such of said beneficiaries as it deems necessary to provide for such care, support, maintenance and liberal education.

If you desire to make this even more definite, you may wish to add words to the effect that the trustor intends that the beneficiaries maintain the same standard of living which he has provided for them.

One question may arise in connection with the use of standards. Is the trustee to consider or not to consider what other income the beneficiaries may have available to them to provide for that care and support? For example, suppose that beneficiary A can show clearly that he requires \$5000 per year to provide for his care and maintenance. He presently has an income of \$4000. Does our illustrative clause, above, mean that the trustee is to give him the *full* amount needed for his support, or only the *difference* between the amount necessary to support and that which his own personal income provides? Since the clause itself does not specify, this may result in litigation, which can be avoided by the addition of words indicating whether the settlor wishes it to be one way or the other. You will probably find that most of your clients prefer that the beneficiaries are to receive only if they will not otherwise have sufficient income. For them, you should add to the clause the words:

In making its determination, the Trustee shall take into consideration any other income or means of support available to any beneficiary and which is known to the Trustee.

Because it is entirely possible under combinations of all the foregoing clauses that not all the income may be needed or paid out in any year (observe that there is no provision requiring distribution of *all* the income) we shall need to add one further direction to the trustee, namely:

Any income not so paid out under the foregoing provisions shall be accumulated and added annually to the principal of the trust.

What are the tax results of these clauses? Fundamentally, the income will be taxed to the person who received it since, to the extent that the trust has taxable income and distributes it to beneficiaries, the trust is regarded merely as a conduit for the transfer of the income.¹ And the character of that income is the same in the hands of the beneficiary as in the trustee which received it. This avoids the double tax present in the corporation picture where the corporation pays tax on its income and then the shareholders who receive dividends pay a second tax. The mere fact

¹ INT. REV. CODE OF 1954, §§ 661, 662.

that the beneficiary may be a minor makes no difference since minors are taxpayers just as adults. This is the basis for the oft-suggested idea of paying a minor \$599 either directly or for his benefit. He, having his own personal exemption, will neither file a return nor pay income tax on that amount of income, and yet, if his parent still supplies over half the amount of funds necessary to provide for his living expenses, the parent may still claim him as a dependent.

This is not to suggest that you must limit the amount paid to the minor to that \$599. Under Internal Revenue Code Section 151(e), if the child is under nineteen or a student he may receive *any* amount of income without depriving his parent of the dependency exemption as long as the parent actually furnishes over half of his support. Of course, if the income paid to the child runs \$600 or over, then the child will have to file his own tax return and possibly pay tax—but that may still afford economies since the tax will presumably be still in low brackets. This idea has often been suggested as a good way for a parent to help provide for college funds for his children. He creates a trust to pay each of his children \$599 per year. When the income is paid to them it is deposited in their individual bank accounts and allowed to accumulate until they attend college, when they (under banking law) can withdraw it on their own signatures.

Any income which is not actually paid out or credited to a beneficiary (*i.e.* it is accumulated by the trust) is taxed to the trustee. Such a trust is known as a "Complex Trust" which has an exemption of \$100,² and—the important fact—its tax rates start from twenty per cent just as with an individual taxpayer. One word of warning, however, is appropriate here. Most such trusts, in addition to having provisions like those above relating to the distribution of income, will also provide as a matter of greater flexibility that the trustee, if necessary, may invade the principal of the trust if the income is insufficient to provide adequately for the beneficiaries. If this is done, and if the trust has been accumulating income in the past, then the so-called "Throwback Rule" may apply with the net result that this distribution which, for trust purposes is regarded as principal, may be taxed as income.³ This rule should not be overlooked in considering the tax results of trust distributions.

So far we have discussed situations in which the *trustee* alone is given the final decision as to the payment of income to beneficiaries. Many times, however, the draftsman finds that his client strenuously objects to such an unrestricted grant of power, particularly to a corporate trustee. He, frankly, may not trust the judgment of any trust officer to that degree. In such cases the use of a "Trust Advisor" is usually suggested for the purpose of controlling the distribution. The trust advisor may be a friend of the family or, more usually, a member of the family.

² INT. REV. CODE OF 1954, § 642(b).

³ INT. REV. CODE OF 1954, §§ 665, 666.

We handle this arrangement by revising the above clauses to eliminate the provision giving the trustee the sole discretion and in lieu thereof stipulate that:

The Trustee shall pay to or for the benefit of (the class of beneficiaries) such amounts of the income as shall be directed in writing by my son, John. In the event my said son, John, be not living, available or capable to act, then the trustee shall make such payments as may be so directed by my daughter, Mary; and, if she also be not living, available or capable of acting, then in the sole discretion of the Trustee.

We should immediately observe that in any such case the trust advisor should not himself be in the class of beneficiaries to whom the income may be distributed. If he is, then he *could*, under this power, elect to give it all to himself, with the result that he would be taxable on the *entire* income even though he might actually direct that it all be paid out to others. Next, we should note that such a directional power may be either limited or without standards, just as in the case of the trustee.

A final note of caution in connection with the use of the trust advisor is that when the beneficiary group includes those whom the advisor is legally obligated to support, if he directs that distributions be made to them and if the income is used to discharge his legal obligation of support, then he (the advisor) will be taxed with the income so used.⁴ This statement will immediately raise the question of what sort of expenditures constitute the "discharge of his legal obligation to support," which is indeed a troublesome point. However, without attempting to go into the ramifications, reference should be made to the regulations which clarify the situation at least in part.⁵

Up to this point we have considered the use of the single trust with multiple beneficiaries; now we shift our attention to the second major method of achieving good tax results between trust and beneficiaries, which is that of separate or multiple trusts. These may sometimes be designated as "shares" of a trust rather than "trusts", but as long as they are actually separate units the term does not matter. We noted that the single trust idea is most useful where the amount involved is not too large and where any one or more of the beneficiaries might some time need the whole fund. Conversely, when the fund at the outset is large (*i.e.* large enough that no beneficiary could possibly need it all) or, alternatively, when the period of dependency of the beneficiaries has passed, then the trust may well be split up into separate parts for the various family units which are to participate.

This arrangement makes each family unit quite independent of the needs or demands of any other unit. It is a more flexible device when benefits are to run for different lengths of time; and it will also be

⁴ INT. REV. CODE OF 1954, § 678(c).

⁵ Rev. Reg. § 1.678(c).

found useful where investment objectives may vary for different families. These are at least some of the logical motives that may indicate the use of separate shares. Depending upon the particular time when you prefer to create the separate shares, the following offers an idea as to the clause which can set them up:

Upon the death of my wife, or upon our youngest child from time to time surviving me and my wife attaining the age of twenty-two (22) years, the Trustee shall divide the then trust estate into as many equal shares as there shall be children of mine either then surviving or then deceased but leaving issue then surviving, and one such share shall be set apart for and held for the benefit of each such then living child of mine and one such share shall be set apart for and held for the benefit of the then living issue, on a *per stirpes* basis, of each deceased child of mine.

You will note that this clause is tailored to fit in with a single trust which can precede it pending the youngest child's getting through college (age twenty-two). If, on the other hand, it is deemed preferable not to wait until that time, then the preliminary clause may be limited to the death of the wife alone, or the trust divided or created even at the death of the trustor. The choice is more often than not a result of the personal preference of the client.

From this point on in the drafting of wording respecting the individual shares, you will proceed on the same basis as outlined above with respect to the single share. In other words, you may have the same "sprinkling" of the income among a group consisting of the child, his spouse and his lineal descendants. Also, the same theory with reference to accumulation within each share is applicable here. Thus, by way of illustration, if the total trust had income of \$36,000, divided into three shares for children, each of whom was married and had three children, you could split up this gross income into eighteen payments of \$2000 each (three children plus their spouses plus nine grandchildren plus three trusts). The resulting income tax savings are obvious.

Apart from the above income-sprinkling devices, another very useful concept which you can use relates to estate planning for owners of closely held businesses. More often than not we find that more than half of the owner's net estate (after payment of all cash requirements including taxes) will be represented by shares of stock of the corporation in which he wants his family to retain control. In order to get the maximum marital deduction you will usually have to figure on some part of that stock going into the marital trust. The client, however, is often concerned lest his wife remarry and her spouse in some fashion come into possession of some of this stock. If the corporation may be expected to pay substantial dividends in the future (and if it does not then perhaps it should not be retained at all) there is a method of approach which can at least minimize some of the client's worries and pick

up some income tax savings in the process. The gist of the idea is that we authorize the "B" (non-marital) trust to accumulate its dividend income and use the cash to *purchase* close corporation stock from the "A" (marital) trust.

An illustration will show how this could function. Assume that the close corporation stock pays dividends to the trustee in the amount of \$30,000, of which half is allocated to the A trust and half to the B trust. Let us also assume that the widow will need \$20,000 after-tax income to maintain her standard of living. If we utilized the standard procedure of having all the income from both trusts payable to the widow, she will have only \$16,800 net after taxes (assuming that she has other income in an amount equal to her deductions and personal exemption). If, however, we utilize the suggested procedure, we would have her getting \$15,000 dividends from the marital trust (she must, of course, get these in order to qualify a power of appointment type marital trust) and out of that she will have \$10,300 net left after taxes. As to the other \$15,000 however, we have the B trust accumulate it. The trustee pays the income tax of \$4700, leaving a net after tax of \$10,300, which it then uses to purchase some of the close corporation stock from the trustee of the A trust. Assuming no capital gain is involved, this \$10,300 will then be held by the A trust as *corpus* and may be distributed to the widow as such (under a proper provision of the A trust, of course). This comes to her tax free so that she will thus have *after taxes* a total of \$20,600. As a result, in this operation we have increased her spendable cash by some \$3800 per year which is worthwhile in itself. In addition, however, we have achieved some other good results. We are gradually depleting the marital trust which will be subject to tax at her death, and notably we are getting out of that trust the corporation stock which is most likely to be increasing in value. Then, too, we are decreasing the chances that she might exercise her general power of appointment to give the stock to a new husband, and at the same time shifting the stock over to the trusts for the children where the estate owner wanted it to go.

Another special type of arrangement which may be included in the trust in those cases where it is anticipated that some of the investments may be tax free municipal bonds, is a specific authorization to the trustee to allocate such bond interest to and among such of the beneficiaries as it may deem best. In this fashion, the beneficiary in the high tax bracket may be given all or a large portion of the income of such bonds, which will give him a far greater net benefit than a much larger amount of ordinary dividends. In the absence of specific authorization to the trustee to make such an allocation, it is likely that the tax free income will have to be apportioned among all the income beneficiaries.

In conclusion, we would suggest that the multiple trust—multiple beneficiary—accumulation concept is the most commonly used device to get the best tax advantages between beneficiaries; and perhaps what is

more important, it generally does a better job for the family than the trust forms formerly in vogue. To get the maximum good out of it, however, will take a certain amount of selling on the part of the attorney because few clients are familiar with the idea and many are suspicious of trusts for any purpose. We believe, however, that most clients, once they are shown the possible results, are not at all unhappy about the prospect of giving their families more income at the expense of the Treasury.