Federal Income Taxation of Trusts and Estates (Book Review)

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BOOK REVIEWS

FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES. By Lloyd W. Kennedy. Chicago: Little, Brown and Company, 1948. Pp. 769.

After thirty-five years of experience with the law of income taxation the lawyer may begin to expect notable legal contributions to many phases of this troublesome branch of the law. Until Lloyd W. Kennedy gave us this excellent volume only one branch of income taxation had been given extensive treatment, namely, Corporate Reorganizations.

These provisions in the law were highly technical and the necessity for understanding them so important to business men that it was almost a necessity to devote attention to the reorganization provisions in the tax law even before the courts could adjudicate the many fine points in the law.

In the law of income taxation there are at least three major questions: What is income, who is taxable on the income and when is the income taxable? All three questions recur in the case of estates and trusts. The tax consultant often comes squarely up against the question of what is income under trust law in determining the principal and income of a trust. On the question of who is taxable on the income the issue is complicated by the fact that a trust is a taxable entity and one that can easily be created by an individual. Furthermore the creation of a trust entity sets up three possible taxpayers, the grantor, the trust itself and the beneficiary. On the question of when the income is taxable the complication arises out of the fact that the income may or may not be distributable currently, etc. Similarly, in the case of estates, a separate taxable entity is created and all three questions again arise to plague the tax practitioner and the taxpayer. No other phase of income taxation is so tied up with other branches of the law, and as a result, the treatment of income taxation of estates and trusts can be handled only by one well grounded in trust and decedent's estate law.

In this volume the author quite naturally devotes the first chapter to the general law of trusts and estates. The second chapter deals with problems common to trusts and estates. Three chapters are devoted to problems specially applicable to trusts and these include one chapter on revocable and controlled trusts and one on charitable trusts. A sixth chapter is devoted to problems applicable especially to estates.

The law of income taxation with respect to estates and trusts has only just begun to crystallize. One is struck by the fact that the present state of the law is based upon the decisions of the past five to ten years. The author has done a research job that is thorough and intelligent and the presentation is quite readable. Touches of humor sprinkle the pages and notes and one gets the impression that the author enjoyed writing the book. Take this delightful touch in commenting on the confused taxpayer who is trying to follow the court's gyrations in determining who is to be taxed on distributable income and when. Says the author, "Inability to predict the application of the income tax statutes to a concrete situation is an increasingly common event, and it often entails hardships on the taxpayer who has guessed wrongly, but it is merely one of the hazards of life in a complex society. It is not only the income taxation of trusts and estates which a taxpayer must know, but the whole field of income taxation." And in a footnote the author slyly remarks, "Since this is asking more than human minds can at the moment master, society can be preserved only by a frank acknowledgment of the truth, namely, that income taxation is an *n*-dimensional chess game, some of the rules being created as the play is in progress. Hardships through inability to predict the rules will then appear not as personal affronts or bandit raids on the taxpayer's pocket-book, but as merely a payment of the stakes which make the game fascinating. After all it is only money, not life or liberty, which is involved."

The impact of trust law in determining taxable income reached an extreme though perhaps logical conclusion in *Johnston v. Helvering*.[1] In this case a trustee held a mortgage on some real estate upon which he foreclosed. After acquiring the real estate it was sold at a loss, the trustee receiving a bond and mortgage for the major portion of the selling price. Under New York law the entire operation came under the classification of a salvaging operation and hence a portion of the sales price was allocable as income to the lite beneficiaries. The court held that the income that was allocated to the life beneficiaries under trust law was taxable income under the income tax law, even though the transaction as a whole resulted in a loss and the fictional income created by trust law was not available to the life beneficiaries, since it was incorporated in a single bond and mortgage which was not susceptible to actual distribution. The author's comment on this case is that it properly belongs in a work on magic. His own opinion is that a fiat of state law should not control federal income taxation.

The author provokes some stimulating thought on the proper entity to be taxed where a trust has capital gains in the year that accumulation of income ends. Under trust law capital gain is not income whereas it is income under tax law. State law controls the determination of income as distinguished from corpus. If trust law is to govern, the tax on the capital gain in the year that the trust terminates should be on the trust. If the tax law is to govern, the tax should be upon the beneficiary. The author tells us that there are no decisions answering this question nor do the regulations make any clear cut provision relating to this situation. It is the author's opinion that there is a serious question as to whether a capital gain retains its identity as a capital gain when received by a beneficiary. Prior to 1934 the courts had held that such gains did retain their identity in the hands of the beneficiary and in the only case that has been decided after the 1934 change in Section 117 the earlier decisions were referred to as valid precedents. However, Schedule "A" Form 1041 provides for no segregation of capital gains and ordinary income so that the identity of a net capital gain is lost in the total income reported as Item 10 of the 1946 form.

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[1] 141 F. 2d 208 (C. C. A. 2d 1944), *cert. denied*, 323 U. S. 715 (1944).

Until 1942 amounts distributable to a beneficiary out of income or corpus were treated as annuity payments not taxable to the beneficiary. This was established in *Burnet v. Whitehouse* [2] and in *Helvering v. Pardee*.[3] The courts held that such annuity payments could not be deducted by the trust in determining trust income subject to tax. This situation created tax saving possibilities which were closed by the Revenue Act of 1942. A new concept of distributable income was introduced.[4] The author says that it is difficult to state this concept in concise language and then quotes the statute to prove the difficulty. The reader is urged to read this section in order to agree with the author's comment that "the first three (sentences) . . . are about as distressing to the understanding as any three sentences ever sponsored by such a presumably august body as the Congress of the United States. It is hoped that the following attempt to unravel its meaning will not be wholly futile." Many pages are devoted to an explanation of this section of the law. The difficulty lies in the fact that the term income is being used in two senses, the trust sense and the tax sense.

The net operating loss deduction [5] is available to estates and trusts but these must meet the test of regularly carrying on a trade or business. Beneficiaries do not have the benefit of this deduction, although they may indirectly get a tax benefit for the reason that the carry back may wipe out the income of the trust and the amounts received by the beneficiaries in the earlier years retroactively become payments out of corpus. It is the opinion of the author that the manner of using the net operating loss deduction is in a nebulous state. However, the author indicates that he is indulging in pure speculation since there are no direct authorities on the subject. The regulations need amplification.

The thorough treatment of the Clifford doctrine in the chapter on Revocable and Controlled Trusts is well worth reading. It is the author's opinion that "the development of the Clifford doctrine by a long series of highly individualized decisions has been unsatisfactory . . . it has been impossible to predict with reasonable accuracy what the final decision would be in any particular case."

There have already been published two pamphlets supplementing the text material to March 31, 1948.

This book should have a prominent place in the library of any tax practitioner.

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[2] 283 U. S. 148, 75 L. ed. 916 (1931).
[3] 290 U. S. 365, 78 L. ed. 365 (1933).
[4] INT. REV. CODE § 162(d) (1).
[5] INT. REV. CODE § 122(d).
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