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Federal Gift Tax Implications of Allocating Capital Gains to the Beneficiary of a Short-Term Trust

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FEDERAL GIFT TAX IMPLICATIONS OF ALLOCATING CAPITAL GAINS TO THE BENEFICIARY OF A SHORT-TERM TRUST

The federal gift tax is a consideration often overlooked by grantors in the creation of short-term trusts.[1] Yet the gift tax may be a substantial factor in taxation of the trust.[2] It becomes of particular significance when, by the terms of the instrument, capital gains realized on trust assets while the trust is in effect are to be distributed to the income beneficiary.

When only current income from the assets of a trust is allocated to the beneficiary, the value of the gift is based on a presumed return of 3½ percent per annum.[3] It is apparently possible to allocate realized capital gains, as well as income, to the trust beneficiary without incurring additional gift tax liability. When a grantor also appoints himself trustee, however, the view of the Internal Revenue Service as to the effect of the capital gains provision adds a new dimension to the calculation of the gift tax. This note will analyze the additional gift tax liability incurred as a result of these provisions and the various means by which it may be reduced or avoided.

Gift Taxation

In order to determine the gift tax consequences of such provisions, the relevant legislation and regulations must first be examined. Section 2511(a) of the Internal Revenue Code of 1954 states that the gift tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible . . . ." However, the Code offers enlightenment neither as to what constitutes a "transfer" nor as to what constitutes the necessary completion of a transfer.[4] As will be seen, the time at which a transfer is deemed complete is a key factor in capital gains taxation.

The Treasury Regulations give the position of the Service on the general question of when a gift is completed.[5] Treasury Regulations section 25.2511-2(b) (1954) states:

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[1] 5 J. Lasser, Income Tax Techniques § 31.09(1) (1965).

[2] *See* Treas. Reg. § 25.2512-5 (1954), which sets forth the gift tax imposed on such trusts.

[3] Treas. Reg. § 25.2512-5(e) (1954); Treas. Reg. § 25.2512-5(s) (1954) (Tables I and II). Since 3½ percent is well below current interest rates, the value of the taxable gift of income from the trust assets almost always is underestimated.

[4] Estate of Holtz v. Commissioner, 38 T.C. 37, 41 (1962).

[5] Section 7805 of the Internal Revenue Code authorizes the Treasury Department to issue rules and regulations. Interpretive regulations of the Treasury Department are entitled to substantial weight, especially when

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. . . .

Treasury Regulations section 25.2511-2(c) (1954) elaborates by providing that "[a] gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself."

The Service's Approach to Gift Taxation When the Grantor Is Trustee

No court has yet considered the applicability of the federal gift tax to realized capital gains allocated to income by a grantor-trustee.[6] However, the Service has stated its opinion concerning such gifts in three private letter rulings[7] which have come to the attention of the writer.[8]

The earliest of these rulings was with regard to the proposed Isaac Mirkin Trust.[9] This 1960 ruling may be the first to have con-

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Congress thereafter amends the Internal Revenue Code without revising the administrative interpretation. Lykes v. United States, 343 U.S. 118, 127 (1952); 2 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION—CODE COMMENTARY § 7805 (1964).

[6] No such cases were cited by the Service in rendering the private letter rulings discussed herein. See note 7 *infra*. Nor has the writer's research disclosed any cases directly in point.

[7] Ruling Letter from the Commissioner of Internal Revenue to Edward S. Schlesinger, Esq., counsel to the prospective grantor, March 28, 1960 (Isaac Mirkin Trust) [hereinafter cited as Mirkin Ruling Letter], *cited in* Bush, *Short-Term Trusts: Advantages and Dangers*, N.Y.U. 24TH INST. ON FED. TAX. 317, 326 (1966); Ruling Letter from the Commissioner of Internal Revenue to the Trustee of the Ermina Dunn Dykstra Trust, March 23, 1964 [hereinafter cited as 1964 Dykstra Ruling Letter]; Ruling Letter from the Commissioner of Internal Revenue to the Trustee of the Ermina Dunn Dykstra Trust, June 7, 1968 (confirming the 1964 Dykstra Ruling Letter) [hereinafter cited as 1968 Dykstra Ruling Letter] [copies of the 1964 and the 1968 Dykstra Ruling Letters on file in the Hastings Law Library].

[8] The effect of such rulings should be noted. Statement of Procedural Rules, 26 C.F.R. § 601.201(*l*)(1) (rev. ed. 1968) provides that a "ruling . . . may be revoked or modified at any time in the wise administration of the taxing statutes. . . . If a ruling is revoked or modified, the revocation or modification applies to all open years under the statutes, unless the Commissioner or his delegate exercises the discretionary power under section 7805(b) of the Code to limit the retroactive effect of the ruling." Revocation or modification of a ruling is rarely applied retroactively with respect to the party whose tax liability was considered in said ruling. However, it may apply retroactively to any taxpayer not directly involved in the ruling issued. Statement of Procedural Rules, 26 C.F.R. § 601.201(*l*)(5) (1968).

[9] Mirkin Ruling Letter.

sidered the problem.[10] The second and third rulings concern the Ermina Dunn Dykstra Trust. A ruling on the Dykstra Trust was first given in 1964,[11] and was confirmed in a ruling letter dated June 7, 1968.

In each of the trust instruments, the grantor has appointed himself trustee and has specifically allocated realized capital gains to the income beneficiary.[12] Both are short term trusts with reversions in the grantor. Article Five of the Ermina Dunn Dykstra Trust provides:

> The Trustee shall allocate receipts and charges of the trust between income and corpus in accordance with the California Principal and Income Law, except that gains and losses from the sale of trust assets shall be attributed to income and not principal.

After considering the provisions of the Dykstra Trust, the Commissioner of Internal Revenue concluded that ". . . any profits realized from the sale of trust assets will result in a *further gift in the calendar year in which such profits are realized.*"[13] The same conclusion was reached by the Service in the private letter ruling on the Isaac Mirkin Trust.[14]

The Rationale of the Service's Rulings

Burnet v. Guggenheim[15] and *Sanford v. Commissioner*[16] were cited by the Service in support of its position.[17] Although the cases did not involve gifts of realized capital gains, they do indicate the reason for the rulings. In the *Burnet* case, the grantor of a gift in trust reserved the power of revocation.[18] Later he surrendered that power.[19] The Supreme Court held that the gift was completed in the year in which the power to revoke was disclaimed.[20] Therefore, a gift tax was incurred in the year of the disclaimer.[21]

In the *Sanford* case, the grantor of a gift in trust had retained the power to designate new beneficiaries other than himself.[22] The

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10 The position in the 1964 and 1968 Dykstra Ruling Letters was first taken by the Service in 1960. Telephone conversation from the Internal Revenue Service, Washington, D.C., to Trustee, Dykstra Trust, San Francisco, July 31, 1968.

11 1964 Dykstra Ruling Letter.

12 *Id.*; Mirkin Ruling Letter.

13 1964 Dykstra Ruling Letter (emphasis added).

14 Mirkin Ruling Letter.

15 288 U.S. 280 (1933).

16 308 U.S. 39 (1939).

17 The *Burnet* case was cited only in the Mirkin Ruling Letter. The *Sanford* case was cited in both the Mirkin Ruling Letter and in the 1964 Dykstra Ruling Letter.

18 Burnet v. Guggenheim, 288 U.S. 280, 281 (1933).

19 *Id.*

20 *Id.* at 290.

21 *Id.*

22 Sanford v. Commissioner, 308 U.S. 39, 40-41 (1939).

Court held that this gift was completed by a subsequent relinquishment of the power.[23] As a result, the gift was subject to a tax in the year in which the power was relinquished.[24]

When the cases cited by the Service are considered in conjunction with the regulations on completion of gifts, the reasoning behind the Service's position becomes clear. By appointing himself trustee, the grantor has retained the discretion to decide whether or not capital gains will be realized during the term of the trust.[25] Therefore, in reality he is determining whether the gains will go to the beneficiary or remain part of the principal and revert to the grantor. The Service has taken the view that this power retained by the grantor-trustee renders the gift of capital gains incomplete at the time the trust is created.[26] If capital gains are later realized by sale during the term of the trust, this exercise of discretion completes the gift.[27] Thus, the gains are subject to a gift tax in the year in which they are realized.

Valuation of the Gift

The 1964 Dykstra Ruling Letter also stated that "[t]he value of the gift in such calendar year will be represented by the actuarial computed value of [the grantor's] reversionary interest in such amount of gain."[28] However, inasmuch as the Dykstra Trust provides that any realized capital gains belong to the income beneficiary, the grantor has no reversionary interest in such gains. As a result, if the ruling is taken literally each additional gift is deemed to have no value.[29]

But it is doubtful that the Service intended this literal meaning. A more rational construction of the statement is that the gift tax would be based on the value of the reversionary interest in the capital gain at the instant before it was realized.[30]

Even under this latter construction, the value of the gift would

[23] *Id.* at 54.

[24] *Id.*

[25] For example, the Ermina Dunn Dykstra Trust, Article Two, provides that the trustee shall have the power to "retain as an investment, for such periods of time as he shall deem advisable, any property received by him under this instrument or at any time held or acquired by him subject to this trust; to grant, bargain, sell, exchange . . . or otherwise deal with any or all of the property or any interest therein at any time held by him as Trustee . . . ."

[26] See text accompanying note 13 *supra*.

[27] *Cf.* Commissioner v. Estate of Holme, 326 U.S. 480 (1945).

[28] 1964 Dykstra Ruling Letter.

[29] However, when there is a gift of a reversionary interest, Treas. Reg. § 25.2512-5(d) (1954) sets forth the method for determining the gift's value.

[30] This now appears to be the Service's position. Telephone conversation from the Internal Revenue Service, Washington, D.C., to Trustee, Dykstra Trust, San Francisco, July 31, 1968.

not be the full value of the realized gain. In such a case there has already been a completed gift of the income from the trust. That gift included the right to receive the income from the capital gains for the unexpired term of the trust. Therefore, the value of that right must be deducted from the realized capital gains in order to determine the value of the present gift on which an additional tax must be paid by the grantor.[31]

Avoidance of the Gift Tax

Significance of Early Completion of the Gift

The Service's view that the gift of capital gains is incomplete until the gains are realized is predicated upon the high degree of control retained by the grantor-trustee. Therefore, if this control is eliminated from the terms of the trust, the gift of future capital gains will be complete at the creation of the trust.[32]

Internal Revenue Code section 2512(a) reveals the significance of the time at which a gift is completed. This section states that "[i]f the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." In other words, the value of the gift is determined as of the date at which the transfer is complete.[33] The rule is not altered by the fact that the gift consists of the right to future, speculative returns.[34]

Because of section 2512(a), a gift of future capital gains can be taxed only on its value at the time the gift is completed. This raises the problem of evaluation of potential gains when the gift is completed before any appreciation in the value of the assets has occurred. Section 25.2512-1 of the Treasury Regulations states that the "value of . . . property is the price at which such property would change hands between a willing buyer and a willing seller . . . ."

It is doubtful that any buyer would be willing to purchase the trust beneficiary's right to future capital gains. In addition to normal market uncertainties, whether or not any gains would materialize must depend on the expertise of the trustee who makes the investments. This alone might detract greatly from the market

[31] "If the donor assigns or relinquishes . . . [a] reversion which he holds by virtue of a transfer previously made by him . . . , the value of the gift is the value of the interest transferred." Treas. Reg. § 25.2512-5(a)(1) (1954). Table II, col. 3 of Treas. Reg. § 25.2512-5(f) may be used to calculate the present value of the right to income previously transferred to the beneficiary. This value should then be deducted from the capital gains realized in order to determine the worth of the additional transfer. The same calculation may be made by multiplying the amount of capital gains by the appropriate figure in col. 4.

[32] *See* Treas. Reg. § 25.2511-2 (1954).

[33] Hamm v. Commissioner, 325 F.2d 934, 937 (8th Cir. 1963), *cert. denied*, 377 U.S. 993 (1963).

[34] Galt v. Commissioner, 216 F.2d 41, 50 (7th Cir. 1954), *cert. denied*, 348 U.S. 951 (1954).

value of the right. Furthermore, when only those capital gains which are realized are allocated to income, the value of the right to capital gains also depends on the inclination of the trustee to realize such gains. Therefore, this right would seem to have no "fair market value."[35] Consequently, its transfer should not be taxable as a gift.

This conclusion is supported by the practice of the Service in taxing the gift of a reversionary interest. In determining the value of a reversion, the possibility of future appreciation of trust assets is not taken into account.[36] To ignore this possibility when calculating the value of a reversion, but to account for it by adding to the value of the gift when the right to the same capital gains is given to the beneficiary for a term of years would be highly inconsistent.

Procuring the Advantages of an Early Evaluation of the Gift

Since the gift tax burden on capital gains can be alleviated or even eliminated by early completion of the gift, the transfer should be completed at the inception of the trust or as soon thereafter as possible. One method for completing the gift is to appoint a trustee other than the grantor. The Dykstra ruling contained the following statement:

> [I]f you should resign as trustee, a further gift will be made of the full fair market value of the trust, at the time of such resignation, less the present worth of the right to receive the income from such amount of property for the unexpired term of the trust.[37]

This statement is apparently based on the fact that if another trustee is appointed, the grantor no longer makes the decision as to what capital gains will be realized during the term of the trust. Since he therefore no longer determines whether there is to be a distribution of these gains to the beneficiary, this release of control completes the gift of capital gains.[38]

Since the gift tax is based only upon the fair market value of the trust at the time the gift is completed[39] (*i.e.*, by appointment of another trustee), *a priori* the right to future appreciation of the

[35] *Cf.* Geller v. Commissioner, 9 T.C. 484, 494, 495 (1947). *See also* Central Trust Co. v. United States, 305 F.2d 393, 402 (Ct. Cl. 1962); Treas. Reg. § 25.2512-1 (1965); Rev. Rul. 33, 1967-1 CUM. BULL. 62; Rev. Rul. 60, 1960-2 CUM. BULL. 77.

[36] Treas. Reg. § 25.2512-5(d) (1954) states that the value of a reversionary interest is obtained by "multiplying the value of the property *at the date of the gift*" (emphasis added) by the appropriate figure from the accompanying tables. The resulting figure represents the present value of the right to receive said amount of property at a future date. Note that the present market value of the trust plus the present market value of the reversion (both based on a presumed income of 3½ percent) equals the present market value of the trust corpus.

[37] 1964 Dykstra Ruling Letter.

[38] Higgins v. Commissioner, 129 F.2d 237 (1st Cir. 1942), *cert. denied*, 317 U.S. 658 (1942).

[39] See text accompanying note 37 *supra*.

assets is not taxed.[40] The same method of evaluation apparently would be used if a non-grantor had been appointed trustee in the first instance. Therefore, if a trustee other than the grantor was appointed before any increase in the value of the trust assets occurred, the tax on capital gains would be avoided entirely.

The grantor, however, may not wish to appoint a trustee other than himself. He may not want to rely on the judgment of another in the complex and comparatively risky area of growth-oriented investments. In addition, a trustee willing to administer the short-term trust may be difficult to find.[41] Under these circumstances, there does appear to be another way by which the gift can be completed before any gains occur. The grantor may appoint himself trustee and provide that any increase in the market value of the trust assets, *whether realized by sale or not*, will be distributed to the income beneficiary. Distribution could be made either at the termination of the trust or sooner, in the discretion of the trustee.[42]

With these provisions, there would be no doubt that at the time the trust becomes effective, the grantor has transferred his right to any capital gains. Even if the grantor appoints himself trustee, the only control retained by him is the discretion as to when the beneficiary will receive the gains. This control is analogous to the power to accumulate income, which the Service concedes does not prevent completion of a gift in trust.[43]

A provision allocating unrealized appreciation of the assets to the income beneficiary does eliminate some of the uncertainty as to whether or not the beneficiary will receive any capital gains. It could be argued therefore that the gift does have some marketable value. However, the amount of gain is still dependent upon the acumen of the trustee managing the investments. Investors might be willing to place some value on the beneficiary's right to the gains if a corporate fiduciary was appointed. But the alternative provision is necessary to complete the gift only if the grantor is appointed trustee. Under these circumstances, the gift of future capital gains would still have little or no market value. Therefore, the gift tax consequences of such a provision are negligible. As a result, the only gift tax imposed would be that based on the market value of the right to receive income for the duration of the trust.[44]

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40 See text accompanying note 35 *supra*.

41 Informal surveys have indicated that large trust companies are not handling short-term trusts. Bush, *Short-Term Trusts: Advantages and Dangers*, N.Y.U. 24TH INST. ON FED. TAX. 317, 318 (1966).

42 Treas. Reg. § 25.2511-2(d) (1954) states that "[a] gift is not considered incomplete . . . merely because the donor reserves the power to change the manner or time of enjoyment."

43 *Id.*

44 *Id.* § 25.2512-5(e). Tables I and II are used to calculate the value of the gift of income at a presumed return of 3½ percent per annum.

Unresolved Problems

If the grantor of a short-term trust were aware of the gift tax implications here discussed, he probably would use either an independent trustee or the alternative provision when creating the trust. But he may not learn of the undesirable gift tax consequences until he has created a trust appointing himself as trustee and allocating realized capital gains to the income beneficiary. Once aware of the taxes that he will incur, however, the grantor may be able to complete the gift by one of the methods discussed above.[45] He will thus avoid the tax on any future capital gains.

However, the grantor-trustee may realize capital gains before he becomes aware of the additional gift tax. He will thus be required to pay a tax based on the amount by which assets have appreciated before completion of the gift.[46] In such a case it still may be possible to lessen the gift tax consequences by decreasing the amount of the gift which is taxable.

Offsetting Realized Capital Gains with Realized Capital Losses

Can capital gains and losses on trust assets realized in the same year be offset against each other for the purpose of gift tax evaluation? The Internal Revenue Code allows this practice for income tax calculation.[47] As a result, a capital gains tax is paid only on the net gain.[48] However, practices followed for gift taxation are not necessarily consistent with those followed for income taxation.[49]

Each realization of capital gains would appear to be a separate gift. Consequently, if the Service allows a loss to be offset against a gain, in essence it will be permitting a negative "gift" of capital loss to be deducted from a distinct, positive gift of capital gains. It certainly is not likely that the Service would recognize a negative

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45 But the grantor should note that such completion of the gift may constitute a transfer into the trust within the meaning of section 665(b)(4) of the Internal Revenue Code, and thereby start the running of the 9-year period during which the throwback provisions of sections 665-69 are applicable. Thus, any distribution of accumulated income made during the 9-year period following completion of the gift would be subject to the throwback provisions (relating to income taxation) of those sections unless the distribution falls within one of the three minor exceptions in section 665(b)(1)-(3). However, the completion of the gift of capital gains might be regarded as a "gift . . . of a specific sum of money or property" within the meaning of section 663(a)(1), and thus not be subject to the throwback rule. Treas. Reg. § 1.665(b)-3 (1956).

46 This conclusion follows from the rule that the value of the gift is based on its fair market value at the time it is completed. See text accompanying notes 32-33 *supra*.

47 INT. REV. CODE OF 1954, § 1211; Treas. Reg. § 1.1211-1(b) (1954).

48 INT. REV. CODE OF 1954, § 1211; Treas. Reg. § 1.1211-1(b) (1954).

49 Commissioner v. Beck's Estate, 129 F.2d 243 (2d Cir. 1942); Talge v. United States, 229 F. Supp. 836 (W.D. Mo. 1964).

"gift" for such a purpose.

However, there does appear to be one manner in which the capital loss can be used to offset the gift of capital gains. It may be possible to construe the trust instrument to mean that only net capital gains are to be attributed to the income beneficiary.[50] In such a case only the net gain would constitute a taxable gift.

Capital Loss Carryover

A related problem is whether or not a realized capital loss can be carried forward from one year to the next to offset a gift of realized capital gains in a subsequent year. For income tax purposes, a loss may be carried forward by a noncorporate taxpayer until it is completely absorbed by capital gains.[51] However, since the practice would involve offsetting positive and negative "gifts" made in different years, it seems extremely unlikely that the Service would allow a capital loss to be carried forward for gift tax purposes.

On the other hand, a favorable construction of the trust instrument may permit the same reduction in the taxable gift. If the trust provides for accumulation of trust income, it can be argued that only the net capital gain at final distribution was intended as a gift to the income beneficiary. Thus, only such net gains at that time would constitute a completed, taxable gift.

Conclusion

In spite of the intricate gift tax problems involved, excellent reasons exist for making investments oriented toward capital gains and for allocating these gains to the beneficiary of a short-term trust. Capital gains-oriented investments enjoy many advantages over holdings producing only ordinary income. First, capital gains are taxed at a lower rate than is ordinary income.[52] Secondly, the types of assets from which capital gains can be expected act as a hedge against inflation.[53] Finally, such investments quite often are more productive than holdings chosen primarily for their current income.[54]

If, however, the trust instrument is silent with regard to capital gains, such profits are generally added to the principal.[55] As a re-

[50] For example, Article Five of the Ermina Dunn Dykstra Trust provides that "gains and losses from the sale of trust assets shall be attributed to income . . . ." The Service apparently has construed this as a gift of net realized capital gains, since the 1964 Dykstra Ruling Letter stated that "profits realized from the sale of trust assets will result in *a further gift* in the calendar year in which such profits are realized."

[51] INT. REV. CODE OF 1954, § 1212(b).

[52] INT. REV. CODE OF 1954, § 1201.

[53] Common stocks are a good example of this advantage. F. AMLING, INVESTMENTS: AN INTRODUCTION TO ANALYSIS AND MANAGEMENT 147 (1965).

[54] *Id.* at 604. *See generally* P. FISHER, COMMON STOCKS AND UNCOMMON PROFITS (1958).

[55] *E.g.*, UNIFORM PRINCIPAL AND INCOME ACT § 3(b)(8) (revised 1962), 9B UNIFORM LAWS ANN. 574 (1966).

sult, the beneficiary gets none of the advantages of the growth investments. In addition, the grantor pays the capital gains tax in his presumably higher bracket.[56] Therefore, if the advantages of capital gains are to be combined successfully with the short-term trust, the trust must allocate capital gains to income.

As has been pointed out, if the grantor appoints himself trustee when capital gains are so allocated, he is subject to an additional gift tax each time capital gains are realized. This tax is incurred because the gift is not complete until the gains are realized. However, the grantor can avoid this tax by careful drafting of his trust instrument. He should either appoint another trustee or provide that all capital gains, whether realized by sale or not, will be distributed to the beneficiary before the termination of the trust. With either provision, the gift will be complete at the time the trust goes into effect. Since the gift of future capital gains has no market value at that time, it appears that the careful grantor may transfer the benefits of capital gains to the income beneficiary of a short-term trust without incurring additional gift tax liability.

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[56] INT. REV. CODE OF 1954, § 677(a)(2).

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