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Taxation of Income of a Short-Term Trust

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Such a rule of exclusion as set forth in the present decision represents a judicial determination that policies under the due process clause outweigh the policy underlying the rules of evidence in criminal cases. There is serious doubt as to the wisdom of such evaluation.

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TAXATION OF INCOME OF A SHORT-TERM TRUST

The petitioner, beneficiary under a testamentary trust established by his father, Sam Farkas,[1] on January 8, 1943, set up an inter-vivos trust, transferring to his brother, Mark Farkas, as trustee, all petitioner's right, title, and interest to the profits, dividends, or income from the Estate of Sam Farkas, such income to be used by the trustee to educate petitioner's nieces and nephews, and for their other needs. The trustee was given absolute discretion in determining to whom and in what amounts the income was to be paid, with authority to dispose of all or any part of it, provided no portion was to go to petitioner. The trust was to terminate in ten years or upon the death of the trustee. The trustee, at the termination of the trust, was to dispose of the balance in any manner he saw fit, except that none was to go to petitioner. Petitioner retained no control whatever over the corpus, income, or trustee. In 1943 he filed a gift tax return, reporting a gift of his interest in the testamentary trust; during the same year he reported on his individual income tax return the income paid to him from this trust before he set up the inter-vivos trust, while the trustee of the latter reported as trust income the amount received during the balance of the fiscal year. The Commissioner of Internal Revenue determined that the full amount of income distributed by the testamentary trustee as petitioner's share was taxable to petitioner,[2] and therefore imposed additional taxes. The Tax Court sustained the Commissioner; petitioner asks for a review. *Held,* that the petitioner is not taxable on the whole amount. (a) The interest transferred was an equitable interest in the testamentary trust estate; (b) there was a complete renunciation by petitioner of any benefits or control of the property; (c) the trust was for a large portion of the petitioner's life expectancy; (d) the transfer was a substantial disposition of property and not merely the anticipatory assignment of future income. *Farkas v. Commissioner of Internal Revenue,* 170 F. (2d) 201 (C. A. 5th 1948).

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1. See Farkas v. Farkas, 200 Ga. 886, 38 S. E. (2d) 924 (1946), on determination of a friendly suit brought by present petitioner against the trustee to determine the validity of this inter-vivos transfer. Also, 166 A. L. R. 1312.
2. 52 Stat. 457 (1938), as amended, 26 U. S. C. A. sec. 22(a) (1948). "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . ., of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried in for gain or profit, or gains or profits and income derived from any source whatever. . . ."

The ruling of the leading case[3] in the field of taxation of income of short-term trusts was not directly applied by the court in the present case, as the elements[4] which were the basis of the decision in that case did not predominate here. Rather, it was a matter of applying general principles of taxation of short-term trusts to the question of whether the transfer was substantial or merely colorable, once the conclusion was reached that the transfer was of an equitable interest in the trust estate[5] and not just an assignment of future income.[6] In deciding the main issue, two closely connected factors had to be considered: (1) the control retained by the settlor over the res and over the trustee, (2) the length of the term of the trust.

Where the trust will revert to the settlor within a short period the trust income has been held taxable to him.[7] "... the control factor is sufficiently present when the trust is of short duration, ... (because the grantor will soon reacquire complete dominion), even if there are no express reservations of control. . . ."[8] The original concept of a short-term trust was one that terminated at the end of five years or less; this period was extended until now the question of the settlor's legal control has become vital when the term is longer than six or seven years, as, for example, ten years.[9] If the settlor is in possession of substantially the same rights and property after the transfer as he was before, the income is taxable to him.[10] This taxable control has taken a variety of forms: the settlor names himself or a friend or relative as trustee, or reserves the right to direct the trustee's investment, his management of the trust estate, or his discretion in making payments to beneficiaries;[11] he reserves the power to change trustees or beneficiaries

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3. Helvering v. Clifford, 309 U. S. 331, 60 Sup. Ct. 554, 84 L. Ed. 788 (1940).
   "The Clifford rule is that income from a trust is taxable to the grantor under Sec. 22(a) IRC when the grantor has retained sufficiently broad powers or control with respect to the trust principal or income." P-H Law Students Tax Serv., March 10, 1948, Report Number 25, p. 1. In the present case the court did not discuss the Clifford case itself as the fact situations are different. From the Clifford case have come the Clifford rule and regulations, U. S. Treas. Reg. 111, sec. 29.22(a)-21 (1945). These regulations are not applicable to taxable years prior to January 1, 1946, hence were not binding on the court in the present case.
4. (a) Trust for a short term (5 years); (b) settlor retained control and management of the trust property; (c) income stayed within the settlor's "intimate family group". "Each of these elements involves a matter of degree, and the absence of any one of them might possibly render the principles established in the Clifford case inapplicable." Note, 132 A. L. R. 844, 847.
5. Blair v. Commissioner, 300 U. S. 5, 57 Sup. Ct. 330, 81 L. Ed. 465 (1937).
6. Helvering v. Horst, 311 U. S. 112, 61 Sup. Ct. 144, 85 L. Ed. 75, 131 A. L. R. 655, 671 (1940); Helvering v. Eubank, 311 U. S. 122, 61 Sup. Ct. 149, 85 L. Ed. 81 (1940); note, 83 A. L. R. 88.
   McCord, J., dissenting in instant case, held that there was only an anticipatory assignment of future income and therefore within the rule of Harrison v. Schaffner, 312 U. S. 579, 61 Sup. Ct. 759, 85 L. Ed. 1055 (1941). The majority of this court chose to follow the Blair case, the Tax Court and counsel for the Commissioner in deciding that the transfer was of an equitable interest in the (testamentary) trust estate.
7. Penn v. Comm., 109 F. (2d) 954 (C. C. A. 8th 1940); First Nat'l Bank v. Comm., 110 F. (2d) 448 (C. C. A. 7th 1940); Reuter v. Comm., 118 F. (2d) 698 (C. C. A. 5th 1941); Bush v. Comm., 123 F. (2d) 242 (C. C. A. 8th 1941); McNight v. Comm., 123 F. (2d) 240 (C. C. A. 8th 1941); Price v. Comm., 132 F. (2d) 95 (C. C. A. 6th 1942); Comm. v. Goulder, 123 F. (2d) 686 (C. C. A. 6th 1941).
8. Comm. v. Buck, 120 F. (2d) 775 (C. C. A. 2d 1941).
9. Helvering v. Elias, 122 F. (2d) 171 (C. C. A. 2d 1941).
10. Braunfeld, Taxability of Assigned Income After Transfer of the Property, 26 Tax Magazine 30 (1948); Helvering v. Horst, supra note 6; note, 166 A. L. R. 1308, 1314; 2 P-H Fed. Tax Serv. par. 15, 321-B (1948).
11. 2 P-H Fed. Tax Serv. par. 15, 321-E (1948), and cases cited therein.

or to terminate the trust altogether;[12] or where the settlor is found to be using the device of a trust to continue operations in substantially the same manner as before, the trust being only a sham to reduce the settlor's tax liability.[13]

The term of the present trust was ten years, or less if the trustee died before the term expired; the right to receive the income at the end of ten years would revert to petitioner. "Giving up the right to the income of a trust for a relatively short term while retaining a reversionary interest is not a cession of rights of ownership sufficient to avoid taxation. * * * It is the very fact of reversion, coupled with a relatively short term, that permits the conclusion that the grantor has not divested himself of income for tax purposes."[14] Just how long a term must be to make the settlor not liable for income taxes when he has retained no control has not been conclusively decided.[15] Where a settlor had parted with both title and control and was not under an obligation to support the beneficiary, the court refused to extend the concept of a short term trust to a trust of ten years at the expiration of which or upon the prior death of the benefiiciary the principal with any accumulated income was to revert to the settlor.[16]

As the Farkas trust was for a goodly part of the life expectancy of the petitioner, was irrevocable by him, prohibited him from obtaining any of the income, gave the trustee absolute discretion and control of the disposition of the income among the beneficiaries, was not used to relieve petitioner of any duty of support of members of his family, and retained in him no characteristics of ownership, the transfer was a substantial disposition of property. "The fact that the thing assigned could revert to the settlor upon the death of the trustee, standing alone, would not . . . render the income from the trust taxable to the settlor."[17]

The decision reached by the court here recognizes the fact that, though a case involves taxation of income of a short-term trust, and the *Clifford* case involved the same question, the two are not necessarily congruent; the *Clifford* rule is not one that can be indiscriminately imposed on all cases bearing the label of short-term trust. Instead, each trust must be examined individually to determine whether its resemblance or dissimilarity to a *Clifford* trust is predominate.

J. E. MacInnis

Occupation Taxes and The Employee

The Board of Aldermen of Louisville, Kentucky, passed an ordinance imposing an annual tax or license fee for the privilege of engaging in any business, occupation, calling, profession or labor within the city. The ordinance contained

12. Ibid, par. 15,321-D.
13. Ibid, pars. 15-321-C, 15,322; Magill, What Shall Be Done With the Clifford Case, 45 Col. L. Rev. 111 (1944).
14. Note, The Treasury Interpretation of the Clifford Rule, 46 Col. L. Rev. 602, 606 (1946).
15. Ibid, 606.
16. Comm. v. Jonas, 122 F. (2d) 169 (C. C. A. 2d 1941).
17. Farkas v. Comm., instant case.