

# INCOME TAXATION OF TRUSTS AND ESTATES

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## FINAL EXAMINATION

This examination consists of three questions. The first question counts for 40% of the grade on the examination. The second and third questions each count for 30% of the grade on the examination.

The examination lasts for three hours. Allocate your time as you wish.

The examination is "open-book, open-notes." You may consult any written materials that you have carried into the room.

Please discuss each answer fully. Show your work on computations. Use a calculator if you like. (Errors solely in arithmetic will not count against you, if I still can discern the correct legal theory.)

For each question, apply the Internal Revenue Code as in force as of the dates indicated. You may disregard, however, any provisions of the Omnibus Reconciliation Act of 1990 (including the Revenue Reconciliation Act of 1990), approved on November 5.

## GOOD LUCK

I. On January 1, 1990, I established the No. 1 Trust, for the exclusive benefit of my three minor children. The No. 1 Trust is irrevocable, precludes any reversion, and has an independent trustee. It provides for current distribution of income or corpus, or accumulation of income toward distribution of income or corpus in future years, all in the trustee's sole discretion.

I funded the No. 1 Trust with 3000 shares of stock. I had bought the 3000 shares at 20, or for \$60,000 in total, several years ago. I funded the No. 1 Trust also with ten 5%, tax-exempt municipal bonds, which I purchased at par or for \$10,000 in total, also several years ago. (I paid no commission on either purchase, each time by way of a bona fide, genuine gift.)

The No. 1 Trust has completed all of its transactions for this year. Specifically, the trustee performed what I count as eight transactions, as follows:

I.) Received \$15,000 in cash dividends on the stock.

II.) Accepted my cash contribution of \$2199.

III.) Received a two-for-one stock split, pro rata to all shareholders, of 3000 shares. Before the split, the 3000 shares of stock had doubled, to 40, or \$120,000. Thus, the 3000-share dividend had a fair market value, upon receipt, of \$60,000.

IV.) Two months after receiving the cash and stock dividends, sold half of the stock, or 3000 shares, at  $25 \frac{1}{2}$ , or for \$76,500, for a gain of \$46,500 ( $= (3000 \times 25.5) - (3000 \times 20)/2$ ). However, commissions on the sale, paid separately, amounted to \$1500.

V.) Then reinvested the net proceeds of the sale of stock, \$45,000, by buying another corporation's stock, and paying commissions of \$999, for a total cost of \$45,999.

VI.) Paid to his own account his annual, fixed trustee is fee, in consideration of all services without itemization, of \$1200.

VII.) Received \$5000 in interest on the tax-exempt bonds.

VIII.) Distributed equivalently, among the three beneficiaries, the \$15,000 in dividends; the remaining 3000 shares of stock, then having an actual fair market value of  $\$8.33 \frac{1}{3}$  a share, or \$25,000 ( $= 3000 \times 8 \frac{1}{3}$ ) (the market's euphoria having cooled); and, the \$5000 in tax-exempt bond interest.

Please discuss, with respect to matters dealt with in the course, the various income tax consequences that arise from these events, a) for me; b) for the No. I Trust (i. e., for the trustee as liable for the income tax on the trust, under Code Section 641(b)); and, c) for the beneficiaries, all for the taxable year 1990.

Please state and explain any assumptions you choose to make.

You may disregard any gift tax consequences. Please disregard also the "kiddie tax," under Code Section 1 (1) , as well as the computation of the actual amount of tax liability of the trust, under Code Section 1(e)(2).

II. Decedent, D, died on January 1, 1980, survived by spouse, S. D had executed a will, but the will expressly excluded S:

The governing local law permits a surviving spouse to elect dower against a decedent's estate. That is, for the present case, the surviving spouse may elect against the will, and take instead a one-third interest in the personal property owned by the decedent at time of death. The local law further provides that any judgment of dower shall include "mesne profits", the income or gains from or with respect to the dower interest, measured from the date of the decedent's death to the date of the judgment.

S duly elected dower. S therefore obtained a judgment in state court, on December 31, 1987, awarding property representing a one-third interest in D's estate and having a fair market value of \$100,000, along with \$25,000 in mesne profits earned each year (compounding notwithstanding), for a total of \$300,000 (= 100,000 + (25,000 x 8)). The mesne profits of the estate consisted entirely of taxable interest. The estate paid the judgment that same day, and then duly terminated under local law.

Local law remains unsettled on the vesting of the surviving spouses' one-third interest under dower. One view, considers dower to vest as of the date of a final judgment, awarding it. The opposing view considers dower to vest at the decedent's death, by operation of law.

The executor of D's estate elected a taxable year beginning February 1 and ending January 31. No estate or inheritance taxes applied. The estate incurred no expenses of administration.

D's estate received \$50,000 each year, above and beyond the \$25,000 representing mesne profits. This \$50,000 represented the interest, all taxable, from the other two-thirds part of the estate's various investments. D's executor distributed this \$50,000, each year, to certain beneficiaries, pursuant to D's testamentary trust.

The estate omitted from gross income, for 1980 through 1987, the \$200,000 in mesne profits paid to S in 1987. The executor appreciated that D's estate always had been obligated to disburse the mesne profits to S, sooner or later. From this he concluded that D's estate never had taken the mesne profits under claim of right. S also omitted the \$200,000 in mesne profits from gross

income, from 1980 through 1986, and included the \$200,000 in mesne profits in gross income in 1987.

Please discuss fully the correct treatment for D's estate (i.e., D as executor) and for S, in these facts, and with respect to matters dealt with in the course. Please identify and explain any assumptions you might make.

III. I have two valued clients, John and Christina. They have six children, from twenty-three to fourteen years of age. The three younger children still are minors, under age eighteen. Where John and Christina live, a parent bears the legal obligation to support children through their undergraduate education. The three older children now are working on their bachelor's degrees. John and Christina called me yesterday to "find a loophole."

Here is what I have in mind. John will establish a trust. Christina will serve as sole trustee. She will possess the power to make any distributions of income or corpus, in her sole discretion, excepting any power to make any distribution that would satisfy any obligation of John to support the recipient. The trust will run for ten years and a day, after which it will terminate, with the remainder to Christina.

John's S corporation (100% held by himself) will borrow \$200,000, due in one year, from a local bank. It can borrow that amount, in the present circumstances, at 9 1/2 per cent. It will lend the \$200,000 to the trust, interest-free, and take back the trust's demand note for \$200,000. John and Christina will end up deducting the annual interest to the bank, \$19,000, at their high marginal tax rate (over 40%, including state tax, next year). The trust will use the \$200,000 loan to purchase a one-year certificate of deposit at John's bank, which will pay interest at 8 per cent, or \$16,000. But, the trust will distribute all of this income, such that it will be includible only to the beneficiaries at their very low average marginal rate (close to zero).

This will enable John and Christina, and the trust and the children as beneficiaries and distributees, to work a nice, potentially recurrent tax-rate arbitrage. It will well more than offset the \$3000 shortfall (16,000 - 19,000) in the economics.

I would appreciate your remarks on this, too. Be sure to identify any and every problem you may see (with respect to matters considered in the course). Answer in depth insofar as possible.

But, please be sure for this memorandum not to sacrifice breadth.  
(I might pursue, on my own and in depth, whatever you spot.)