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THE SHORT TERM ACCUMULATION TRUST AND
THE NEW THROWBACK RULE

INTRODUCTION

The scope of this paper will include the history of the throwback rule and the reasons for it. The discussion herein will be limited to domestic short-term accumulation trusts. This comment will point out the effective changes of the 1969 Tax Reform Act, more specifically sections 665-69, by comparing and contrasting the present with the prior law, and thus guide the reader through the myriad changes and complex calculations necessitated when dealing with distributions from a trust of accumulated net income and accumulated capital gains.

HISTORY

In 1934 one Clifford established a trust, with himself as trustee, the corpus of which was certain of his securities. The trust was to terminate after five years or upon the death of Clifford and his wife, whichever first occurred. The trust provided that the net income from the securities in trust was to be paid to, or held for the benefit of, his wife. At the termination of the trust, the securities were to revert to Clifford, and all accrued and undistributed net income or proceeds from the investment of such net income were to be treated as the property of the beneficiary, Clifford’s wife. Trustee, Clifford, had the power of absolute discretion over the proceeds of the trust. In addition, Clifford expressly reserved the power:

(a) to exercise all voting powers incident to the trusteed shares of stock; (b) to ‘sell, exchange, mortgage, or pledge’ any of the securities under the declaration of trust ‘whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration’ as respondent in his ‘absolute discretion may deem fitting’; (c) to invest ‘any cash or money in the trust estate or any income therefrom’ by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property ‘without restriction’ because of their ‘speculative character’ or ‘rate of return’ or any ‘laws pertaining to the investment of trust funds’; (d) to collect all income; (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of ‘other persons or in my own name as an individual’ except as otherwise provided.

The Commissioner determined that the transfer of trust income to the beneficiary was ineffective to transfer tax liability

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1 Helvering v. Clifford, 309 U.S. 331, 332 (1940).
2 Id. at 332-33.
from the trustor to such beneficiary and consequently Clifford’s tax return for 1934 was found deficient. He was subsequently taxed on the full value of such income.

Because of this and similar problems resulting from attempts to use the short-term trust as an effective tool in reducing income tax liability, the Supreme Court granted certiorari to the court.

The Supreme Court upheld the Commissioner’s contention that the income during the life of the trust was taxable to the trustee. The Court based its decision on the theory that Clifford retained the substantial ownership of the property throughout the duration of the trust. In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of §22(a) . . .

In substance his control over the corpus was in all essential respects the same after the trust was created, as before . . . [A]s a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property . . . [w]hen the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive §22(a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax wise) where portions of that income are routed . . .

Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, . . . the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error . . . To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.\(^3\)

\(^3\) Id. at 335.

\(^4\) Id. at 335-37. See Paul, The Background of the Revenue Act of 1937, 5 U. Chi. L. Rev. 41 (1938). The majority opinion of the Court was delivered by Justice Douglas, and a dissent was written by Justice Roberts with Justice McReynolds joining in that dissent. The basic ground of the dissent was that the establishment of guidelines to determine whether or not a trust is irrevocable is a legislative rather than a judicial function. Id. at 338.
The Court stressed three main factors: first, the short duration of the trust; second, the interspousal relationship; and third, the retention of administrative control over the trust by the settlor.\(^5\) But because of the undefined boundaries concerning such trusts, the courts were deluged with cases dealing with Clifford-type trusts, and the end result of the Clifford decision was confusion rather than clarification.\(^6\) Such cases raised various issues as to: (1) the duration of the trust — the minimal time limit; (2) the degree of similarity of interests between settlor and beneficiary — the problem of family beneficiaries; (3) the identity of the trustee — was the trustee an adverse party; (4) the extent of the settlor’s control.

In response to this mass confusion, the Treasury Department issued what was termed the “Clifford Regulations,”\(^7\) which isolated, analyzed and discussed the implications of each principal ground of the Clifford decision. It then stated that any one of these factors in itself would be sufficient to charge the trustor with the income derived from such a trust.\(^8\)

**CODIFICATION**

The Clifford Regulations with some modifications were incorporated in the 1954 Internal Revenue Code.\(^9\) Under the Code provisions the following factors are determinative as to whether or not the settlor of such a trust will be taxed on the income accruing therefrom.

“1. **Can the income or principal of the trust return to the settlor?**”\(^10\)

Section 673(a) of the Code covers reversionary interests. The trustor is taxed where he has a reversionary interest in either the corpus or the income of the trust, if through such an interest he could reasonably expect to regain the possession and the enjoyment of such property within ten years. Thus, to escape taxation under this section, the trust must be created for a period longer than ten years or an interest in the corpus or income must not reasonably be expected to revert to the grantor.

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\(^5\) Id.

\(^6\) Kohnstamm v. Pedrick, 153 F.2d 506 (2d Cir. 1945).

\(^7\) Treas. Reg. §29.22(a)-21-22 (1945). The original regulations were issued as T.D. 5468 in 1945, then these were modified in 1947 by T.D. 5567. But see M. Shattuck & J. Farr, An Estate Planner’s Handbook, 213 n.29 (2d ed. 1953), where Commissioner v. Clark, 17 T.C. 1357 (1952), aff’d 202 F.2d 94 (7th Cir. 1953), is cited to show that the ten year rule in the regulations is unconstitutional, because arbitrary and unreasonable. Thus since the case is good law today it would seem that the Clifford Regulations’ applicability would be severely limited.

\(^8\) See text at notes 5 and 6 for examples.


\(^10\) The following seven questions are posed in A. Casner, Estate Planning, 167-68 (3rd ed. 1961) (emphasis added).
within ten years. There is, however, an exception to this general rule under section 673(c). If the trust is created for the duration of the beneficiary's life, and the beneficiary dies within the ten year period, section 673(a) will not apply and the grantor will not incur tax liability. If the life in being by which the duration of the trust is measured is not that of the beneficiary, and that "life in being's" actuarial life expectancy is less than ten years at the creation of the trust, then the grantor would have to account for the taxes due from the trust.  

"2. Can the income or principal of the trust be used to discharge the settlor's legal obligations, including his obligation to support or maintain some person?"  

Section 677(a) (1-2) of the Code states that the settlor will be treated as the owner of any part of the trust if the income from such portion of the trust can be distributed at the discretion of the grantor or a non-adverse party, and if such income is distributed to the grantor or held for future distribution to  

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11 INT. REV. CODE of 1954, §673 (prior to 1969 amendment) Reversionary Interests  
   (a) General rule. — The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.  
   (b) Exception where income is payable to charitable beneficiaries. — Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170 (b) (A) (i), (ii), or (iii).  
   (c) Reversionary interest taking effect at death of income beneficiary. — The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.  
   (d) Postponement of date specified for reacquisition. — Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.  

12 See note 10 supra.  

13 The terms adverse and nonadverse party are important when considering sections 677(a) and (b). Section 672 defines adverse and nonadverse party; §672(a) defines adverse party as: [Any] person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust. See also Carkhuff v. Commissioner, 83 F.2d 626 (6th Cir. 1936) where the court stated that a trustee is not an adverse party and that a beneficiary does qualify as such only to the extent to which he shares in the income or corpus of the trust. Section 672(b) defines nonadverse party as any person "who is not an adverse party."
him. As to the obligation to support, the Federal Tax Regulations of 1970 are self explanatory.

"3. Can the income or principal of the trust be used to pay

\[\text{14 Id. §677 (prior to 1969 amendment). Income for Benefit of Grantor}\]

(a) General rule. — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be —

(1) distributed to the grantor or the grantor’s spouse,

(2) held or accumulated for future distribution to the grantor or the grantor’s spouse.

\[\text{15 Treas. Reg., §1.677(b)-1. Trusts for Support}\]

(a) Section 677(b) provides in effect that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person except the grantor not acting as trustee or cotrustee be applied or distributed for the support or maintenance of a beneficiary, such as the wife or child of the grantor, whom the grantor is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes.

(b) If any amount applied or distributed for the support of a beneficiary whom the grantor is legally obligated to support is paid out of corpus or out of other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a) (2), taxable to the grantor under section 662. . . . [T]he grantor may be taxed on an accumulation distribution under subpart D (section 665 and following) of such part I. Those provisions including the exception in section 665, are applied on the basis that the grantor is the beneficiary.

. . .

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor’s legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor’s obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor’s debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

See also Int. Rev. Code of 1954, §677(b):

Obligations of support. — Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where applied or distributed are paid out of corpus or out of other income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.
insurance premiums on policies of insurance on the life of the settlor?"\(^{16}\)

Section 677 (a) (3) in covering this question states that if such payments are made at the discretion of the grantor or a non-adverse party, the amount of those payments will be treated as income to the grantor, and will be taxable to him.\(^{17}\)

"4. If there is a power to control beneficial enjoyment, though no benefit may be conferred on the settlor, is the power in the settlor, in the settlor's wife, in a subordinate party, in an independent party or an adverse party?"\(^{18}\)

The settlor shall be treated as the owner of any portion of a trust over which he, or a non-adverse party, has the power to control the beneficial enjoyment. This general rule is qualified to the extent that if an adverse party\(^{19}\) must consent to the exercise of the power, or agree with determinations concerning enjoyment of the trust, then the settlor is not considered the owner thereof, and will not be taxed.\(^{20}\)

"5. If there is a power to control beneficial enjoyment, though no benefit may be conferred on the settlor, does the power relate to income only, or to principal only, or to both income and principal?"\(^{21}\)

This power may relate to either income or principal without the settlor becoming liable, so long as his powers are exclusively limited to one or more of the below variations:

1) the power is limited to the application of the income to the support of one of settlor's dependents; 2) the power only affects the beneficial enjoyment after the required ten-year time period; 3) such power is exercisable only testamentarily; 4) such power is limited to allocation of the trust corpus between chari-
table beneficiaries; the settlor has the power to distribute corpus between named beneficiaries; the power is one by which the settlor can withhold income from a named beneficiary if such is done only temporarily; the power can be exercised to withhold income during the period of disability of any named beneficiary; or the power is one where the settlor has the right to allocate the receipts to the beneficiaries out of either the corpus or the income of the trust or both.

"6. If there is a power to control beneficial enjoyment,

22 INT. REV. CODE of 1954, §170(c) (prior to 1969 amendment): Charitable contribution defined. — For purposes of this section, the term 'charitable contribution' means a contribution or gift to or for the use of —

(1) A State, a Territory, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

(2) A corporation, trust, or community chest, fund, or foundation —

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization —

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual. See 1969 changes.

23 This power shall not relieve the settlor from taxation if he maintains a power to add beneficiaries to a class of beneficiaries except where provisions are made for after-born children. Id. §674(b) (5).

24 Id.: §674(b) (prior to 1969 amendment).

Exceptions for certain powers. — (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent. — A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after expiration of 10-year period. — A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the
though no benefit may be conferred on the settlor, is the power extensive or limited as to the variations in beneficial enjoyment which may be made?"25

These powers enumerated above are not exclusive. Code section 674(d) allows a further extension of the settlors power either:

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income of corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporary. — A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable:

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary. — A power exercisable only during:

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income. — A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

25 See note 10 supra.
if such power is limited by an ascertainable standard provided such standard is exercisable by a trustee other than the settlor or the settlor's spouse.\textsuperscript{26}

"7. Do certain administrative powers exist?"\textsuperscript{27}

The settlor will be considered the owner of a portion of a trust if he maintains the power to borrow from the corpus of the trust for less than adequate interest or security, or if the settlor retains the power to control the voting of any securities held in such a trust or the power to regulate the investment, or where he retains the power to substitute property for the corpus of the trust.\textsuperscript{28}

**BENEFITS OF THE SHORT-TERM TRUST**

Because of high income tax rates, many people have sought

\textsuperscript{26} INT. REV. CODE of 1954, §674(d) (prior to 1969 amendment): Power to allocate income if limited by a standard. — Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

\textsuperscript{27} See note 10 supra, and see generally, Casner, *Taxation of Income under T.D. 5488, 84 TRUSTS AND ESTATES 233 (1947); Casner, The Amended Clifford Regulations, 85 TRUSTS AND ESTATES 249 (1947); Alexander, A Case Method Restatement of the New Clifford Regulations, 3 TAX L. REV. 189 (1947); Kennedy, Short-Term Trusts Today, 30 TAXES 1006 (1952).

\textsuperscript{28} INT. REV. CODE of 1954, §675 (prior to 1969 amendment). Administrative Powers —

The grantor shall be treated as the owner of any portion of a trust in respect of which —

(1) Power to deal for less than adequate and full consideration. — A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security. — A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds. — The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) General powers of administration. — A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means
New Throwback Rule
to find a haven in the short-term trust. Such trusts are an effective tool for transferring high income producing property to dependents and others with the end result being the reduction of the grantor's high income tax rate.

Short-term trusts are practical to only a limited class of taxpayers: those who have no real interest in estate taxes, and who do not wish to part from their capital in toto, i.e., through gifts or lengthy life estates. Thus it is the relatively young taxpayer with a high salary who can reap the most benefit from such a transaction: he can set up several trusts for each of his children to pay income to them. The term of the trust should be for more than ten years and if retirement of the taxpayer is more than ten years from the date of the creation of such interest, then the date of his retirement would be the most advantageous time for the termination of the trust. In this manner such a taxpayer could reduce his income tax considerably and have to pay only a minimum of Federal gift tax due to his and his spouse's joint life time exclusion of $60,000.29

Although tax savings may be the primary motivation behind the utilization of such a trust, there are others. For example, a settlor may protect himself from his own indiscretions by severing his ties to certain property for a period of ten years or more; a settlor may wish to make one of his dependents fi-

any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

29 Id. §2503 (prior to 1969 amendment). Taxable Gifts

(a) General definition. — The term "taxable gifts" means the total amount of gifts made during the calendar year, less deductions provided in subsection C (sec. 2521 and following).

(b) Exclusions from gifts. — In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1955 and subsequent calendar years, the first $3,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year... .

(c) Transfer for the benefit of minor. — No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom —

(1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and

(2) will to the extent not so expended —

(A) pass to the donee on his attaining the age of 21 years, and

(B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c). Note also, that married taxpayers are eligible for a joint life time exclusion of $60,000 for gifts made throughout the husband's and his spouse's life-time. (Id. §2521).
nancially independent, or he may use the short-term trust as an effective device to protect his family from the effects of any hazardous business adventures into which the settlor may enter.

For these and other reasons, many taxpayers choose the irrevocable inter-vivos trust rather than the revocable trust.

**THE OLD THROWBACK RULE AND ITS EFFECT ON THE SHORT-TERM ACCUMULATION TRUST**

The "throwback rule" made its debut in the 1954 Code. The rule was enacted to close a tax avoidance loophole in accumulation trusts. However, this rule was not applied to estates since the defect in the area of estate taxes did not appear to be an overwhelming problem to Congress when it enacted the rule. It was thus possible for estates to accumulate income for a number of years, resulting in taxation of the estate, rather than the beneficiary when such accumulations were finally distributed.

Note, however, that the throwback rule does not apply to simple trusts. The Code makes a marked distinction between the simple trust and the complex trust. A simple trust is one in which all the income accumulated from such a trust in any one year will be currently distributed to the beneficiary. A complex trust is one in which either it is not required under the provisions of the instrument to distribute income currently, or one which makes a distribution of corpus in any taxable year. A simple trust may, in any one year, be classified as a complex trust if in that particular year the trust accumulates income or distributes a portion of the trust corpus.

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30 There would be a great income tax advantage if a trust could time its distributions to years in which its beneficiary had little or no income and thus received trust distributions at low tax rates during those years. Note also, that in spite of the '65-day and 12-month rules' of existing law, it is still possible to shift the tax burden in part from a beneficiary to a trust. For example, if the distribution of trust income for one year is deferred to a date more than 65 days after the beginning of the following year, and the trust income for the following year is distributed within the first 65 days after the end of that year, the beneficiary is taxable to the extent of the trust income for the second year only, even though he received all the income for both years. The purpose of the 'throwback rule' is to close this tax avoidance loophole in the existing law.


31 The pertinent sections of the Code dealing with a simple trust appear in Subpart B of Subchapter J. The complex trusts are regulated by Subpart C of Subchapter 5.

Note also, that the designations of "simple" and "complex" trusts appeared in the committee reports. See H. REP. No. 133, 83rd Cong., 2d Sess. at 83-84 (1954). This terminology is not found in the subsequent statutory provisions but such designations do appear in the Regulations.

32 INT. REV. CODE of 1954, §661(a) (1).

33 Id. §661(a) (2).

34 Id. §661(a).

35 Id. §661(a).
The Five-Year Throwback Rule

Where a complex trust\textsuperscript{37} distributes to a beneficiary an amount in excess of its distributable net income for a particular year, the five-year throwback rule comes into play, unless such distribution qualifies under an exception to the throwback rule.\textsuperscript{38} When such a distribution is made the excess of that amount over the distributable net income earned in the year of distribution will be thrown back to the most recent year or years (depending on the amount of such excess) of a preceding five-year period during which an accumulation of net income was made in lieu of distributing such sum or sums to the beneficiary. That excess is then considered for tax purposes to have been distributed in that prior year or those prior years of accumulation.

The throwback rule is merely a legal fiction, for the income tax in the year to which the accumulation is thrown back is not recomputed. The computation for such accumulated income operates in the following manner:\textsuperscript{39}

1) the excess distribution or accumulation is computed in accordance with IRC section 665(b),\textsuperscript{40} which states that any amounts which are properly paid out of the trust either:

a) according to specific requirements of the trust (IRC section 661(a)(1)) or

\textsuperscript{36} Under the 1954 INT. REV. CODE §§665 through 669 provided for a five-year throwback rule, and was in effect until 1969 when the Tax Reform Act of that year made substantial changes and eliminated the five-year rule and replaced it with an unlimited throwback rule. \textit{Id.} §§665-669 (amended 1969).

\textsuperscript{37} See note 31 supra.

\textsuperscript{38} INT. REV. CODE of 1954, §663 (exclusions).

\textsuperscript{39} For example, if in 1966 an accumulation trust had distributed $15,000 of which current distributable net income was $10,000, $5,000 of such distribution would be thrown back to the most recent of a preceding five-year period in which an accumulation was made. Thus, if in 1965 the trust had $5,000 of undistributed net income for that particular year, the $5,000 would be thrown back to the 1965 tax year, but if in 1965 such undistributed net income was only $2,000 the remaining $3,000 of the 1966 distribution would have to be thrown back to the next earlier year in the five-year period in which there was undistributed net income for the year. Thus the process would continue until either the five-year period or the excessive distribution was consumed.

In addition, the accumulation distribution will be thrown back only to a "preceding taxable year" — §666(a). Thus a taxable year beginning before January 1, 1954 is excluded by definition from the term "preceding taxable year" set out in §665(e). Therefore if the particular carry-back period would extend to periods preceding 1954 such periods will not be included, and the five-year period will be curtailed. Any amount of excess distributable net income which falls outside the bounds of the throwback rule will be considered a distribution of corpus — §666(a). For once the allocation process to "preceding taxable years" has been achieved no part of the accumulation distribution is income to the beneficiary. Thus such a situation leaves the beneficiary with no taxable income, (because such is considered corpus) and the trust is not allowed a deduction for such distribution.

\textsuperscript{40} \textit{Id.} §665(b) (prior to 1969 amendment); see note 66 infra.
b) at the trustee's discretion (IRC section 661(a)(2));

2) this distribution or accumulation is reduced in value by an amount equal to the value of the distributable net income earned by the trust in the year of distribution;

3) the remainder is then considered an accumulated distribution and this amount is thrown back to a preceding taxable year.

4) However, before this can be effectuated, the taxes paid by the trust in the preceding year in which an accumulation of net income was made must be determined by following IRC section 665(d).

This section determines . . . the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includable in distributable net income . . . .

(Treas. Reg. §1.665(d)-1.)

5) Finally, this figure is added to the amount of income distributed (in the year of distribution); the total of these two figures is then deducted from the distributable net income earned by the trust in the year of distribution, and this leaves the net accumulated distribution.

For tax purposes, however, the beneficiary is deemed to have received in the year of distribution not only the excess of the distributable net income, but also, an amount equal to the proportion of income tax paid by the trust in the year of accumulation. The taxes paid by the beneficiary on the accumulated distribution and the portion of the taxes deemed distributed to him will not be greater than the aggregate tax that he would have had to pay in the year of accumulation — if such had been included in his gross income.

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41 See note 39 supra and also Id. §666(a) (prior to 1969 amendment).
42 Id. §665 (prior to 1969 amendment):
(a) Undistributed net income. — For purposes of this subpart, the term “undistributed net income” for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum or —
(1) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661(a); and (2) the amount of taxes imposed on the trust.
43 Id. §665(d) (prior to 1969 amendment); see note 66 infra.
44 There is an exception to this where items of gross income do not qualify for distributable net income, the taxes on the trust do not equal the income tax paid by the trust. For computing the taxes for the trust in such cases see Treas. Reg. §1.665d-1(a) (1969).
45 INT. REV. CODE of 1954, §666(a)-(b) (prior to 1969 amendment).
46 Id. §666(c) (prior to 1969 amendment); see text at note 74.
47 Id. §668(a) (prior to 1969 amendment):
In addition the beneficiary is allowed a credit against his taxes payable in the year of distribution. This credit is a pro rata portion of the taxes paid by the trust on the undistributed net income in the year of accumulation. Such credit is the amount of tax the trust would have saved had the income been distributed in that prior year instead of being accumulated.44

Clarification of the above explanation by a concrete example seems appropriate: Facts — The terms of a trust instrument vest the trustee with discretionary power to pay out income and corpus to A. In 1955 the distributable net income (DNI) of the trust is $10,000. In 1955 the trustee pays out $5,000 of DNI to A. The trust will be subject to a tax of approximately $1,100 on the undistributed portion of the income earned in 1955. The undistributed net income for 1955 would be $3,900: DNI ($10,000) minus $6,100 (distributed net income ($5,000) plus taxes paid by the trust ($1,100)). In 1956 the DNI of the trust is $10,000. The trustee in that year pays out $12,500 pursuant to his power to pay out both income and capital. Thus, the trustee has made an accumulation distribution of $2,500. (Distribution of $12,500 minus DNI $10,000 equals accumulation distribution of $2,500). The $2,500 is taxable income to A in 1956, but is deemed to be paid out of the undistributed net income of a preceding year.49

The beneficiary is considered to have received not only the accumulation distribution but also a portion of the amount of the taxes paid by the trust on such accumulation. A is therefore considered to have received additional income of $705.13 (the tax

(a) Amounts treated as received in prior taxable years. — The total of the amounts which are treated under section 668 as having been distributed by the trust in a preceding taxable year shall be included in the income of a beneficiary or beneficiaries of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary or beneficiaries under section 662(a)(2) and (b) if such total had been paid to such beneficiary or beneficiaries on the last day of such preceding taxable year. The portion of such total included under the preceding sentence in the income of any beneficiary shall be based upon the same ratio as determined under the second sentence of section 662(a)(2) for the taxable year in respect of which the accumulation distribution is determined, except that proper adjustment of such ratio shall be made, in accordance with regulations prescribed by the Secretary or his delegate, for amounts which fall within paragraphs (1) through (4) of section 665(b). The tax of the beneficiaries attributable to the amounts treated as having been received on the last day of such preceding taxable year of the trust shall not be greater than the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiaries on such day in accordance with section 662(a)(2) and (b). Except as provided in section 669, in the case of a foreign trust created by a United States person the preceding sentence shall not apply to any beneficiary who is a United States person. (Emphasis added.)

44 Id. §668(b) (prior to 1969 amendment); See note 78 infra.
49 Id. §665(b) (prior to 1969 amendment) the term accumulation distribution means an amount in excess of $2,000.
paid by the trust in the preceding year ($1,100) multiplied by
the ratio of the accumulation distribution to the undistributed
net income ($3,900).\footnote{See note 47 supra. See also 1 A. Casner, Estate Planning, 743 (3rd
ed. 1961).}

After the accumulation distribution and the credits are de-

erived, one final step is necessary; that being a recomputation of
the undistributed net income of 1955 (the year of accumulation).
In 1955 the distributed net income has been recomputed to
$8,205.13 ($5,000 actually distributed in 1956 and the remaining
$3,205.13 deemed to have been distributed through the conduit of
the throwback rule). This figure is then deducted from the DNI
in 1955 ($10,000) leaving $1,794.87.\footnote{See note 47 supra. See also 1 A. Casner, Estate Planning, 743 (3rd
ed. 1961).} Next the amount of taxes paid on this $1,794.87 must be deducted from it. The original
amount of taxes paid by the trust in 1955, $1,100, will be reduced
by the credit which was allowed the beneficiary in off-setting the
accumulation distribution in 1956 or $761.03 ($1,100 minus
$761.03). The taxes imposed on the trust will be $338.97 for
1955. This amount is then deducted from the remaining undis-
tributed net income in 1955 ($1,794.87 minus $338.97) leaving a
total of $1,455.90 which is the net undistributed net income for
1955.\footnote{Id. §663(c). See 1 A. Casner, Estate Planning, 75 (3rd ed. 1961).}

There is a further qualification of the throwback rule when
a complex trust has more than one beneficiary. When such is
the case, the Code permits one trust to be treated as consisting of
separate trusts for determining the amount of DNI to each of
the beneficiaries.\footnote{Id. §663(c). See 1 A. Casner, Estate Planning, 75 (3rd ed. 1961).}

Under the previous five-year throwback rule there were
many exceptions which exempted certain distributions from the
rule, but which are no longer effective: first, any distributions
not in excess of $2,000;\textsuperscript{44} second, distributions of income accumulated before the birth of the beneficiary, or before the beneficiary attained the age of 21;\textsuperscript{45} third, distributions made to meet the beneficiary’s emergency needs;\textsuperscript{46} fourth, a final distribution made more than nine years after the date of the last transfer to the trust;\textsuperscript{47} and fifth, certain required distributions made upon the beneficiary reaching a specified age from trusts created before 1954.\textsuperscript{48}

THE NEW “UNLIMITED THROWBACK RULE”

The throwback rule was completely renovated by the Tax Reform Act of 1969. This was necessary to achieve the ends of Congress in passing the original five-year rule\textsuperscript{49} because, substantially all of the benefits (e.g. shifting of income tax from a high bracketed taxpayer to a taxpayer in a much lower bracket), that existed before the rule, could be effected merely through proper estate planning. Because of the limitation of the five-year period in which the income could be thrownback, and various exceptions to the rule, a great many loopholes had been bored into the barrier which the Congress had intended to erect.\textsuperscript{50}

\textsuperscript{44}Treas. Reg. (1970) §1.665(b)-(a). If any amount properly paid out by the trust does not exceed the DNI for the taxable year reduced by the total amounts required to be distributed currently by $2,000 such amount will not be considered an accumulation distribution and will not require the use of the throwback rule. Thus there is an annual exclusion of $2,000 in each taxable year as far as the five year throwback rule is concerned.

\textsuperscript{45}Such distributions are excluded only to the extent that there was not any undistributed net income from prior years, other than income accumulated while the beneficiary was under 21 Id. §1.665(b)-2(b) (1). And if a distribution could have been made out of income accumulated before or after the beneficiary attains 21, such is considered to have been made from the most recently accumulated income. Id. §1.665(b)-2(b) (1). Apparently the exception applies also to accumulated income distributed before the beneficiary attains 21. Further note that a distribution to a beneficiary of income accumulated before he attained 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. Id. §1.665(b)-2(b) (1); see also TAX COORDINATOR C.6003 and 1 A. CASNER, ESTATE PLANNING 748 (3rd ed. 1961).

\textsuperscript{46}Such distributions are excluded from accumulation distribution if the beneficiary has no other resources sufficient to meet his needs. Treas. Reg. §1.665(b)-2(b) (2) (1970).

\textsuperscript{47}This exception was enacted to prevent the setting up of trusts for the purpose of accumulating income and then having such trust make a final distribution in a relatively short period of time and thus effectuate an avoidance of the five-year throwback rule. S. REP. No. 1622, 83rd Cong., 2d Sess. 358 (1954). INT. REV. CODE of 1954, §665(b) (4) (prior to 1969 amendment) provides that: “amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than 9 years after the date of the last transfer to such trust” will not be subject to the five-year rule. Thus this rule will apply to a discretionary complex trust that does not permit distribution of corpus or accumulated income until the final distribution, or as mandatory accumulation trust.

\textsuperscript{48}Id. §§665(b) (3). See note 66 infra.

\textsuperscript{49}See text at note 30; S. REP. NO. 1622, 83rd Cong., 2d Sess. 85 (1954); and Treas. Reg. §1.665-1.

\textsuperscript{50}See Boyle v. United States, 190 F. Supp. 950 (D.C. La. 1961), and Sence v. United States, 394 F.2d 842 (Ct. Cl. 1968), and for multiple
Realizing the shortcomings of the prior law, Congress enacted the 1969 Tax Reform Act plugging the loopholes in the former rule. The new rule replaced the five-year throwback period with an unlimited period in which accumulated income will be thrown back. The new act has eliminated all the exceptions to the old throwback rule. However, this process of elimination is coordinated through a phase out process between the years beginning with 1969 and continuing through 1973, with the exception of the $2,000 exemption which was curtailed immediately.

Further, the 1969 Act incorporated undistributed capital gains within the scope of the throwback rule. The computation for undistributed net income has not been affected by the new changes. The new rule, in actuality, creates a new throwback rule as to capital gains, for such throwback rule is applied separately from the rule dealing with income.

The Tax Coordinator — "69 Tax Reform Law" (1970) gives a brief summary of the changes effected by the new act.

The 5-year throwback rule has been converted into an unlimited throwback. The accumulation distribution is thrown back to the earliest years first, instead of to preceding years in inverse order. All the exceptions to the old 5-year throwback rule have been eliminated. A shortcut method is provided for computing the tax on accumulated income. There is a new unlimited throwback rule for capital gains allocated to the corpus of complex trusts. The credit allowed to a beneficiary for taxes paid by the trust in preceding years is the same as the amount of taxes deemed distributed. Under prior law the credit was the amount of taxes the trust would not have paid if the total amount deemed distributed had actually been distributed in the preceding year. A beneficiary is specifically allowed a refund for overpayment of taxes by the trust.

The effective changes of the 1969 Tax Reform Act are as follows:

Sec. 665. Definitions Applicable to Subpart D
(a) Undistributed Net Income. — For purposes of this subpart, the term 'undistributed net income' for any taxable year means the amount by which the distributable net income of the trust for such taxable year exceeds the sum of — (1) the amounts for such taxable year specified in paragraphs (1) and (2) of sec-

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61 §331 of Tax Reform Act of 1969. Note also that the unlimited throwback rules are applicable only to trusts, thus exempting estates from such rules. INT. REV. CODE of 1954, §§666-69.

62 See text at notes 54-58.

63 The throwback rule as to capital gain distribution does not apply as long as the complex trust actually distributes all its income in the year earned. INT. REV. CODE of 1954 §§666(a) and 669(a).


65 Pub. L. No. 91-172 12/30/70.
tion §661(a), and (2) the amount of taxes imposed on the trust attributable to such distributable net income.

(b) Accumulation Distribution.—For purposes of this subpart, the term ‘accumulation distribution’ means, for any taxable year of the trust, the amount by which — (1) the amounts specified in paragraph (2) of section 661(a) for such taxable year, exceed (2) distributable net income for such year reduced (but not below zero) by the amounts specified in paragraph (1) of section 661(a) . . . .

(d) Taxes imposed on the Trust.—For purposes of this subpart, the term ‘taxes imposed on the trust’ means the amount of the taxes which are imposed for any taxable year of the trust under this chapter (without regard to this subpart) and which, under regulations prescribed by the Secretary or his delegate, are properly allocable to the undistributed portions of distributable net income and gains in excess or losses from sales or exchanges of capital assets. The amount determined in the preceding sentence shall be reduced by any amount of such taxes deemed distributed under section 666(b) and (c) or 669(d) and (e) to any beneficiary.

(e) Preceding Taxable Year.—For purposes of this subpart (1) in the case of a trust . . . the term ‘preceding taxable year’ does not include any taxable year of the trust —

(A) which precedes by more than 5 years the taxable year of the trust in which an accumulation distribution is made, if it is made in a taxable year beginning before January 1, 1974,

(B) which begins before January 1, 1969 in the case of an accumulation distribution made during a taxable year beginning after December 31, 1973, or

(C) which begins before January 1, 1969, in the case of a capital gain distribution made during a taxable year beginning after December 31, 1968 . . . .

(f) Undistributed Capital Gain.—For purposes of this subpart, the term ‘undistributed capital gain’ means, for any taxable year of the trust beginning after December 31, 1968, the amount by which —

(1) gains in excess of losses from the sale or exchange of capital assets, to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during such taxable year, or (B) paid, permanently set aside, or used for the purposes specified in section 642(c), exceed (2) the amount of taxes imposed on the trust attributable to such gains.

(g) Capital Gain Distribution.—For purposes of this subpart, the term ‘capital gain distribution’ for any taxable year of the trust means, to the extent of undistributed capital gain for such taxable year, that portion of —

(1) the excess of the amounts specified in paragraph (2) of section 661(a) for such taxable year over distributable net income for such year reduced (but not below zero) by the amounts specified in paragraph (1) of section 661(a), over (2) the undis-
tributed net income of the trust for all preceding taxable years.\textsuperscript{66}

The amended section 665\textsuperscript{67} effectuated a deletion of the foreign trust exception and the $2,000 exclusion of section 665(b). The new amendment makes it clear that the DNI in a year in which an accumulation distribution is made cannot be reduced below zero by the amount of income \textit{required} to be distributed currently by the trust. For example, if a trust had DNI of $40,000 (current income plus any accumulated undistributed net income) and had currently distributable net income of $30,000 (note that a current distributable net income \textit{required} to be paid

\textsuperscript{66} (Old Law) \textit{Id}, §665.

(b) Accumulation distribution of trusts other than certain foreign trusts. — For purposes of this subpart, in the case of a trust (other than a foreign trust created by a United States person), the term 'accumulation distribution' for any taxable year of the trust means the amount (if in excess of $2,000) by which the amounts specified in paragraph (2) of section 661(a) for such taxable years exceed distributable net income reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666 and shall not include —

1. amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21;
2. amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary;
3. amounts properly paid or credited to a beneficiary upon such beneficiary attaining a specified age or ages if —
   A. the total number of such distributions cannot exceed 4 with respect to such beneficiary,
   B. the period between each such distribution to such beneficiary is 4 years or more, and
   C. as of January 1, 1954, such distributions are required by the specific terms of the governing instrument; and
4. amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than 9 years after the date of the last transfer to such trust.

(c) Accumulation distribution of certain foreign trusts. — For purposes of this subpart, in the case of a foreign trust created by a United States person, the term 'accumulation distribution' for any taxable year of the trust means the amount by which the amounts specified in paragraph (2) of section 661(a) for such taxable year exceed distributable net income, reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666 and shall not include —

(d) Taxes imposed on the trust. — For purposes of this subpart, the term 'taxes imposed on the trust' means the amount of the taxes which are imposed for any taxable year on the trust under this chapter (without regard to this subpart) and which . . . are properly allocable to the undistributed portion of the distributable net income. The amount determined in the preceding sentence shall be reduced by any amount of such taxes allowed, under sections 667 and 668, as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year.

(e) Preceding taxable year. — For purposes of this subpart, the term 'preceding taxable year' does not include any taxable year of the trust to which this part does not apply. In the case of a preceding taxable year with respect to which a trust qualifies (without regard to this subpart) under the provisions of subpart B . . . .

\textsuperscript{67} Note, subsection (a) of §665 was unaffected by the new act. \textit{See generally} 4 CCH 1971 STAND. FED. TAX REP. ¶8674.
of $50,000 could not leave a minus DNI of $10,000) which would leave $10,000, and made a further discretionary distribution of income and any other non-current distribution, such amount would have deducted from it the remaining $10,000 of DNI and leave the remainder as an accumulation distribution.

The new act further excluded all the exceptions in section 665(b) dealing with amounts paid a beneficiary accumulated before his birth or his attainment of 21 years of age, amounts paid out in emergencies, amounts paid when a beneficiary attains a specified age or ages, and amounts paid out on final distribution.68

Subsection (d)69 of section 665 adds a new tax imposed on the trust. The new addition to section 665(d) extends the reach of the throwback rule to capital gains which are accumulated by the trust. Subsection (d) also makes the same rules which apply to undistributed net income applicable to undistributed capital gains, by substituting section 666(b) and (c) for section 669(d) and (e) for sections 667 and 668 under the old law, as far as making the determination as to what amounts shall reduce the taxes imposed on the trust in the year of accumulation.

Subsection (e) of section 665 has been amended to include parts (e)(1)-(A)(B)(C) and (2). This change alters the term "preceding taxable year" by not including within its scope the exceptions under (A)(B)(C) of the old section 665(e)(1). Thus section 665(e)(1)(A) excludes from the term "preceding taxable year" an accumulation distribution made in a taxable year which begins before January 1, 1974 and which precedes the year of distribution by more than five years. Distribution made in taxable years beginning before 1974 can, therefore, be thrown back only five years. Section 665(e)(1)(B) states that a preceding taxable year will not include a taxable year of the trust beginning January 1, 1969 if the accumulation distribution is made in a taxable year beginning after December 31, 1973. Thus a distribution made after 1973 can be thrown back any number of years but not beyond 1969. Section 665(e)(1)(C) deals with the throwback of capital gain, and excludes from "preceding taxable year" the time period before January 1, 1969. Thus section 665(e) as amended phases out the old 5-year rule as to income and limits the new rule as to capital gains throwback to periods beginning after December 31, 1968.70

68 These exceptions were discussed at notes 53-58 supra under the five-year throwback rule.

69 Subsection (c) of $665 deals with "certain foreign trusts" which are not within the scope of this comment. For a discussion of Foreign Trusts and the new unlimited throwback rule see, TAX COORDINATOR C-6000.2 at 16, 127.

70 Id. C-6000.4 provides an excellent "checklist" for the new throwback rule and its transitional period.
Subparts (f) and (g) of section 665 are new additions to the old rule and deal exclusively with capital gains. Subpart (f)

C-6000.4. Year by Year Checklist of Throwback Transitional Rules.

The unlimited throwback rule for accumulated ordinary income other than capital gains generally applies to distributions made in taxable years beginning after '68, while the capital gains throwback generally applies to distributions made in taxable years beginning after '69. But there are certain transitional rules which limit application of these throwback rules, depending on when the distribution was made. Here is a year by year summary of these transitional rules:

CALENDAR '69 (OR TAXABLE YEAR BEGINNING IN '69).
Accumulation distribution —
... preceding years to which distribution can be thrown back — '64, '65, '66, '67, '68, '69.
... order in which thrown back — inverse order.
... exceptions (2) through (5) listed at §C-6000.23 apply.
Capital gain distribution — not applicable.

CALENDAR '70 (OR TAXABLE YEAR BEGINNING IN '70).
Accumulation distribution —
... preceding years to which distribution can be thrown back — '65, '66, '67, '68 and '69.
... order in which thrown back — earliest year first.
... exceptions (2) through (5) listed at §C-6000.23 apply to income accumulated in '65, '66, '67 and '68 (or taxable years beginning in '65, '66, '67 and '68).
Capital gain distribution —
... preceding years to which distribution can be thrown back — '69.
... order in which thrown back — earliest year first.
... exception for distribution from one pre-'70 trust.

CALENDAR '71 (OR TAXABLE YEAR BEGINNING IN '71).
Accumulation distribution —
... preceding years to which distribution can be thrown back — '66, '67, '68, '69 and '70.
... order in which thrown back — earliest year first.
... exceptions (2) through (5) listed at §C-6000.23 apply to income accumulated in '66, '67 and '68.
Capital gain distribution —
... preceding years to which distribution can be thrown back — '69 and '70.
... order in which thrown back — earliest year first.
... exception for distribution before Jan. 1, 1972 from one pre-'70 trust.

CALENDAR '72 (OR TAXABLE YEAR BEGINNING IN '72).
Accumulation distribution —
... preceding years to which distribution can be thrown back — '67, '68, '69, '70 and '71.
... order in which thrown back — earliest year first.
... exceptions (2) through (5) listed at §C-6000.23 apply to income accumulated in '67 and '68 (or taxable years beginning in '67 and '68).
Capital gain distribution —
... preceding years to which distribution can be thrown back — '69, '70 and '71.
... order in which thrown back — earliest year first.
... exception — none.

CALENDAR '73 (OR TAXABLE YEAR BEGINNING IN '73).
Accumulation distribution —
... preceding years to which distribution can be thrown back — '68, '69, '70, '71 and '72.
... order in which thrown back — earliest year first.
... exceptions (2) through (5) listed at §C-6000.23 apply to income accumulated in '68 (or taxable years beginning in '68).
Capital gain distribution —
... preceding year to which distribution can be thrown back — '69, '70, '71, and '72.
... order in which thrown back — earliest year first.
... exceptions — none.
deals with computation of undistributed capital gain. First, as noted before, the capital gain rule does not affect any year before January 1, 1969. To determine the undistributed capital gain, the excess of gains over losses from the sale of capital assets must first be determined: Such gains only qualify if they are not distributed during the taxable year, or if they are not permanently set aside for charitable purposes. The next step is to determine the amount of taxes imposed on the trust attributable to these gains. The excess, subpart (g), of the gains over the taxes is considered undistributed capital gain for that taxable year.

Sec. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO PREcedING YEARS

(a) AMOUNT ALLOCATED. — In the case of a trust which is subject to subpart C, the amount of the accumulation distribution of such trust for a taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of each of the preceding taxable years, commencing with the earliest of such years, to the extent that such amount exceeds the total of any undistributed net income for all earlier preceding taxable years. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income for such preceding taxable year. For purposes of this subsection, undistributed net income for each of such preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(b) TOTAL TAXES DEEMED DISTRIBUTED. — If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year, and such portion of such distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year attributable to the undistributed net income. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year.
ble year attributable to such undistributed net income shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(c) **Pro Rata Portion of Taxes Deemed Distributed.** — If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year and such portion of the accumulation distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes imposed on the trust for such taxable year attributable to the undistributed net income multiplied by the ratio of the portion of the accumulation distribution to the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income shall be computed without regard to the accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(d) **Rule When Information Is Not Available.** — If adequate records are not available to determine the proper application of this subpart to an amount distributed by a trust, such amount shall be deemed to be an accumulation distribution consisting of undistributed net income earned during the earliest preceding taxable year of the trust in which it can be established that the trust was in existence.74

Under the amended section 666(a) the order in which accumulation distributions are thrown back is reversed. The throwback application now applies to the earliest years of accumulation,

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74 (Old Law) *Id.*

Sec. 666. Accumulation Distribution Allocated to 5 Preceding Years

(a) Amount allocated. In the case of a trust (other than a foreign trust created by a United States person) which for a taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the accumulation distribution of such trust for such taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of each of the 5 preceding taxable years to the extent that such amount exceeds the total of any undistributed net incomes for any taxable years intervening between the taxable year with respect to which the accumulation distribution is determined and such preceding taxable year. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income of such preceding taxable year. For purposes of this subsection, undistributed net income for each of such 5 preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(b) Total taxes deemed distributed. — If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year, and such portion of such accumulation distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be
FIFO (first in, first out) whereas, under the old rule, the rule was applied to the most recent year of accumulation, LIFO (last in, first out).75

Subparts (b) and (c) of section 666 are relatively unchanged by the 1969 Act except for slight deviations in the verbiage. This change is effected by the words “to the undistributed net income” which appear in both subparts (b) and (c) of section 666. This change eliminated a discrepancy that existed between section 666(b) and (c). Under the old law when section 666(c) was applicable, the additional amount of the taxes deemed distributed, due to the tax paid by the trust, was usually less than the tax credit received by the beneficiary under section 667. But when section 666(b) was applicable the additional amount of accumulation distribution allocated to preceding years was always equal to the tax credit allowed the beneficiary under section 667. Thus, where the accumulation distribution allocated to a preceding year was more than the undistributed net income for that preceding year (section 666(b)) the total taxes deemed distributed under 666(b) would have been equal to the total tax credit allowed the beneficiary from that year. But under section 666(c) where the amount thrown back is less than the undistributed net income for that year the pro rata portion of the taxes deemed distributed will not equal the credit received. In addition, by applying section 666(c) it was possible to have leftover undistributed net income because of the fractional computation under this section.76 The new act eliminated this phenomenon and thus does away with leftover undistributed net income. Subpart (d) is a new addition to the Code. This rule makes provision for a trust which does not keep adequate records and throws back any accumulation distribution to the earliest preceding year in which it can be determined that the trust was in existence.

Sec. 667. Denial of Refund to Trusts; Authorization of Credit to Beneficiaries.

...
(a) **DENIAL OF REFUND TO TRUSTS.** — No refund or credit shall be allowed to a trust for any preceding taxable year by reason of a distribution deemed to have been made by such trust in such year under section 666 and 669.

(b) **AUTHORIZATION OF CREDIT TO BENEFICIARY.** — There shall be allowed as a credit (without interest) against the tax imposed by this subtitle on the beneficiary by the trust under sections 666(b) and (c) and 669(d) and (e) during preceding taxable years of the trust on the last day of which the beneficiary was in being, reduced by the amount of the taxes deemed distributed to such beneficiary for such preceding taxable years to the extent that such taxes are taken into account under sections 668(b)(1) and 669(b) in determining the amount of the tax imposed by section 668.77

A trust is taxed on income when earned, and if such is undistributed, and a distribution of either accumulated income or capital gains is made in a preceding year, the trust is not allowed a refund on taxes previously paid, but instead the Code under section 667 allows the beneficiary to whom distribution is made a credit for the taxes paid previously by the trust.

**Sec. 668. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS**

(a) **GENERAL RULE.** — The total of the amounts which are treated under sections 666 and 669 as having been distributed by the trust in a preceding taxable year shall be included in the income of a beneficiary of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary under section 662(a)(2) and (b) if such total had been paid to such beneficiary on the last day of such preceding taxable year. The tax imposed by this subtitle on a beneficiary for a taxable year in which any such amount is included in his income shall be determined only as provided in this section and shall consist of the sum of —

1. a partial tax computed on the taxable income reduced by an amount equal to the total of such amounts, at the rate and in the manner as if this section had not been enacted,
2. a partial tax determined as provided in subsection (b) of this section, and
3. in the case of a beneficiary of a trust which is not re-

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77 (Old Law) **INT. REV. CODE of 1954, §667:**

**Denial of Refund to Trusts.** — The amount of taxes imposed on the trust under this chapter, which would not have been payable by the trust for any preceding taxable year had the trust in fact made distributions at the times and in the amounts deemed under section 666, shall not be [sic] refunded or credited to the trust, but shall be allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions. For purposes of the preceding sentence, the amount of taxes which may not be refunded or credited to the trust shall be an amount equal to the excess of (1) the taxes imposed on the trust for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over (2) the amount of taxes for such preceding taxable year imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of this subpart on account of the accumulation distribution determined for such taxable year.
required to distribute all of its income currently, a partial tax
determined as provided in section 669.

For purposes of this subpart, a trust shall not be considered to be
a trust which is not required to distribute all of its income cur-
cently for any taxable year prior to the first taxable year in which
income is accumulated.

(b) Tax on Distribution —

(1) Alternative Methods. — Except as provided in para-

graph (2), the partial tax imposed by subsection (a) (2) shall
be the lesser of —

(A) the aggregate of the taxes attributable to the
amounts deemed distributed under section 666 had they been
included in the gross income of the beneficiary on the last day
of each respective preceding taxable year, or

(B) the tax determined by multiplying, by the number
of preceding taxable years of the trust, on the last day of
which an amount is deemed under section 666 (a) to have been
distributed, the average of the increase in tax attributable to
recomputing the beneficiary's gross income for each of the
beneficiary's 3 taxable years immediately preceding the year
of the accumulation distribution by adding to the income of
each of such years an amount determined by dividing the
amount deemed distributed under section 666 and required to
be included in income under subsection (a) by such number
of preceding taxable years of the trust,
less an amount equal to the amount of taxes deemed distributed
to the beneficiary under sections 666 (b) and (c).

(2) Special Rules. —

(A) If a beneficiary was not in existence on the last day
of a preceding taxable year of the trust with respect to which
a distribution is deemed made under section 666 (a), the par-
tial tax under either paragraph (1) (A) or (1) (B) shall be
computed as if the beneficiary were in existence on the last
day of such year on the basis that the beneficiary had no gross
income (other than amounts deemed distributed to him under
sections 666 and 669 by the same or other trusts) and no de-
ductions for such year.

(B) The partial tax shall not be computed under the
provisions of subparagraph (B) of paragraph (1) if, in the
same prior taxable year of the beneficiary in which any part
of the accumulation distribution is deemed under section
666 (a) to have been distributed to such beneficiary, some part
of prior accumulation distributions by each of two or more
other trusts is deemed under section 666 (a) to have been dis-
tributed to such beneficiary.

(C) If the partial tax is computed under paragraph
(1) (B), and the amount of the undistributed net income
distributed in any preceding taxable year of the trust
is less than 25 percent of the amount of the accumulation dis-
tribution divided by the number of preceding taxable years to
which the accumulation distribution is allocated under section
666 (a), the number of preceding taxable years of the trust
with respect to which an amount is deemed distributed to a
beneficiary under section 666(a) shall be determined without regard to such year.

(3) Effect of Other Accumulation Distributions and Capital Gain Distributions. — In computing the partial tax under paragraph (1) for any beneficiary, the income of such beneficiary for each of his prior taxable years —

(A) shall include amounts previously deemed distributed to such beneficiary in such year under section 666 or 669 as a result of prior accumulation distributions or capital gain distributions (whether from the same or another trust), and

(B) shall not include amounts deemed distributed to such beneficiary in such year under section 669 as a result of a capital gain distribution from the same trust in the current year.

(4) Multiple Distributions in the Same Taxable Year. — In the case of accumulation distributions made from more than one trust which are includible in the income of a beneficiary in the same taxable year, the distributions shall be deemed to have been made consecutively in whichever order the beneficiary shall determine.

(5) Information Requirements with Respect to Beneficiary. —

(A) Except as provided in subparagraph (B), the partial tax shall not be computed under the provisions of paragraph (1) (A) unless the beneficiary supplies such information with respect to his income, for each taxable year with which or in which ends a taxable year of the trust on the last day of which an amount is deemed distributed under section 666(a), as the Secretary or his delegate prescribes by regulations.

(B) If by reason of paragraph (2) (B) the provisions of paragraph (1) (B) do not apply, the determination of the amount of the beneficiary's income for a taxable year for which the beneficiary has not supplied the information required under subparagraph (A) shall be made by the Secretary or his delegate on the basis of information available to him."

The Tax Reform Act has substantially changed the rules for computing the beneficiary's tax for years beginning after December 31, 1968. These changes will provide a much more arduous task for the tax planner than in prior years. The most significant changes as to these new computations appear in amended section 668. Instead of computing tax due in a year of distribu-

78 (Old Law) Id. See note 47 supra.

(b) Credit for taxes paid by trust. — The tax imposed on beneficiaries under this chapter shall be credited with a pro rata portion of the taxes imposed on the trust under this chapter for such preceding taxable year which would not have been payable by the trust for such preceding taxable year had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666.

79 Under the old law, the beneficiary's tax was the total amount deemed distributed to him:

as the lesser of the tax due therein the year of receipt and the tax which would have been due if the amounts had been distributed to him in the
tion as including amounts thrown back plus the tax deemed distributed in that prior year, the beneficiary must now compute his tax in segments. Section 668(a) describes the method by which a beneficiary will compute his tax liability in the year of receipt of an excess distribution. This liability is computed by totaling three partial taxes. The first partial tax is a tax on the beneficiary's taxable income exclusive of the throwback rules. The second partial tax is a tax resulting from the basic throwback provisions for ordinary income accumulation, and the third is a partial tax resulting from the capital gain throwback provisions.

Subpart (b) of section 668 is a new addition to the Code and sets up two alternative methods for computing the tax, an "exact method," and a "short-cut method." The tax due is the lesser amount produced by either of these two methods. Under the exact method the partial tax on accumulation distribution and/or capital gain distribution is the total of the increase in tax to the beneficiary that would have been obtained if the distribution had actually been made on the last day of each of the preceding taxable years. This particular method requires a recomputation of both trust and beneficiary taxes.

The "short-cut" method involves a three-year averaging device. First, the total accumulation income deemed distributed and required to be included as income and including those taxes deemed distributed is divided by the number of preceding years of the trust from which the distribution was considered to have been made. Second, after this average annual income is determined, this annual amount of income is added to the beneficiary's income for each of the three years prior to the current year of distribution. Third, after this additional amount is added to those three preceding years, the beneficiary's tax for each of those years is recomputed. Fourth, after the taxes in preceding years to which they were thrown back $668(a) prior to the new act. He was then allowed a credit against his tax for the 'taxes imposed on the trust'. This credit, however, was not the same as the amount of tax deemed distributed if less than all of the undistributed income in a given year was deemed distributed. Thus, the credit allowed was equal to the tax which would not have been paid by the trust if the income had been distributed currently $668(a) before the new act. Stienmann and Schlinger, The Trust Throwback Rules of the Tax Reform Act, 5 REAL PROPERTY, PROPERTY AND TRUST JOURNAL 171 (1970).

82 INT. REV. CODE of 1954, $668 (a) (2).
83 Id. $669.
each of these years is determined, the total tax *increases* for those years are added together and then that total is divided by three (three-year income averaging device) and lastly the average annual tax increase, determined in step four is then multiplied by the number of preceding taxable years of the trust from which distribution was deemed to have been made.  

The following is an illustration from President Nixon's Tax Reform Proposals:

Mr. Able creates a trust which is to accumulate its income and pay the income to Able's son when the son reaches 30. The son is now 19. Over the 11 years of the trust, the trust earned $1,200 of income annually and had expenses each year of $100 allocable to the production of income. The trust paid tax of $1,450 on the accumulated income. When the son reaches 30, the $9,550 of accumulated income after taxes and the $1,100 of current net income is distributed to him. Under the throwback rule, the son is treated as having received a distribution of $11,000 (the taxes paid by the trust are considered to have been distributed to the son). The income of the current year is taxed directly to the son. The computation under the short-cut method is as follows: $11,000 (accumulation distribution) divided by 10 (number of years out of which distribution was made) equals $1,100. The $1,100 is added to the three preceding years' taxable income and the increase in tax due to the additional $1,100 in each year are computed. Assume the $1,100 produces increases in tax as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last year</td>
<td>$350</td>
</tr>
<tr>
<td>Two years ago</td>
<td>$300</td>
</tr>
<tr>
<td>Three years ago</td>
<td>$250</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$900</strong></td>
</tr>
</tbody>
</table>

$900 (total additional tax) divided by three equals $300 (average annual increase in tax).

$300 (average annual increase in tax) times 10 equals $3,000.

$3,000 is the tax which Able's son must pay on the distribution as computed under the short-cut method. He is also entitled to a credit for taxes paid by the trust, *i.e.*, $1,450. The amount of tax currently to be paid would thus be $1,550.  

In addition there are certain "Special Rules" which effect the method of tax determination. If a beneficiary was not in existence during the year in which distributed income was accumulated, he will still be entitled to use the exact method. Thus, for such a beneficiary it will be assumed that he had no

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85 INT. REV. CODE of 1954, §668(b) (1) (B). Note also, that, if in computing the tax under the "short-cut" method any preceding taxable year in which less than a minimum amount of income (25% of the average undistributable net income deemed distributed in any year) was accumulated will be disregarded. Further, if such year is disregarded, the average annual taxes increase will be multiplied by the reduced number of preceding years. *Id.* §666(b) (2) (C).

86 TAX COORDINATOR, C-6000.44 at 56.133 (5/4/70).
New Throwback Rule

gross income aside from throwback amounts, and furthermore he will not have any deductions in those prior years.\textsuperscript{87} A specific limitation on the use of the "short-cut" method is placed on a beneficiary who is the beneficiary of more than one trust; in such a case he is not entitled to use this method.\textsuperscript{88} An accumulation distribution is computed first as to the partial tax on income before the partial tax on capital gain distribution is computed if the trust makes a distribution of both in the same taxable year.\textsuperscript{89}

Note also, that in order to use the "exact method," the beneficiary must supply all the information required regarding his income for preceding years. There is, however, an exception to this rule: if in any year the beneficiary receives a distribution from more than one trust, the "exact method" will be used even though the exact information required is not supplied.\textsuperscript{90}

Sec. 669. TREATMENT OF CAPITAL GAIN DEEMED DISTRIBUTED IN PRECEDING YEARS

(a) AMOUNT ALLOCATED. — In the case of a trust which is not required to distribute all of its income currently, the amount of a capital gain distribution of such trust for a taxable year shall be deemed to be an amount properly paid, credited, or required to be distributed on the last day of each of the preceding taxable years, commencing with the earliest of such years, to the extent that such amount exceeds the total of any undistributed capital gain for all earlier preceding taxable years. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed capital gain for such preceding taxable year. For purposes of this subsection, undistributed capital gain for each of such preceding taxable years shall be computed without regard to such capital gain distribution and without regard to any capital gain distribution determined for any succeeding taxable year.

(b) TAX ON DISTRIBUTION. — The partial tax imposed by section 668 (a) (3) shall be the lesser of —

(1) the aggregate of the taxes attributable to the amounts deemed distributed under this section, had such amounts been

\textsuperscript{87} INT. REV. CODE of 1954, §668 (b) (2) (A) and §669 (C), see also S. REP. No. 91-552 91st Cong. 1st Sess., 129 (1969).

\textsuperscript{88} Id. §668 (b) (2) (B) — note that such trusts must both be complex trusts, or ones which will accumulate undistributable net income or capital gain.

\textsuperscript{89} Id. §668 (b) (2) (B).

\textsuperscript{90} Id. §668 (b) (5) (a) and (b). Note also:

In order to use the exact method of computation, the beneficiary has to supply such information as treasury regulations may require regarding his income for each of the years in which an amount is considered distributed. But if the short-cut method can't be used because during any of the years in which an amount is deemed distributed there are also prior accumulation distributions from two or more other trusts (see paragraph C-6000.45), then the exact method is used even though the required information isn't supplied. In this case the determination of the amount of the beneficiary's income for a taxable year is made by Treasury on the basis of available information.

TAX COORDINATOR, C-6000.43 at 16, 132B — (5/14/70).
included in the gross income of the beneficiary on the last day of each respective preceding taxable year, or

(2) the tax determined by multiplying by the number of preceding taxable years of the trust, on the last day of which net gains from the sale or exchange of capital assets are deemed under subsection (a) to have been distributed, the average of the increase in tax attributable to recomputing the beneficiary's gross income for each of the beneficiary's 3 taxable years immediately preceding the year of the capital gain distribution by adding to the income of each of such years an amount determined by dividing the total of the amounts deemed distributed under this section and required to be included in income under section 668(a) by such number of preceding taxable years of the trust, less an amount equal to the amount of taxes deemed distributed to the beneficiary under subsections (d) and (e) which are attributable to the capital gain distribution.

(c) EFFECT OF OTHER DISTRIBUTIONS; SPECIAL RULES, ETC.

In computing the partial tax under subsection (b) for any beneficiary, the income of such beneficiary for each of his prior taxable years —

(1) shall include amounts previously deemed distributed to such beneficiary in such year under section 666 or 669 as a result of prior accumulation distributions or capital gain distributions (whether from the same or another trust), and

(2) shall include amounts deemed distributed to such beneficiary in such year under section 666 as a result of an accumulation distribution from the same trust in the current year.

Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided by paragraphs (2), (4), and (5) of section 668(b) shall be applied for purposes of this section.

(d) TOTAL TAXES DEEMED DISTRIBUTED. — If any portion of a capital gain distribution for any taxable year is deemed under subsection (a) to be an amount properly paid, credited or required to be distributed on the last day of any preceding taxable year, and such portion of such capital gain distribution is not less than the undistributed capital gain for such preceding taxable year, the trust shall be deemed to have properly distributed on the last day of such preceding taxable year an additional amount. Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain. For purposes of this subsection, the undistributed capital gain and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain. For purposes of this subsection, the undistributed capital gain and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain shall be computed without regard to such capital gain distribution and without regard to any capital gain distribution determined for any succeeding taxable year.

(e) PRO RATA PORTIONS OF TAXES DEEMED DISTRIBUTED. — If any portion of a capital gain distribution for any taxable year is deemed under subsection (a) to be an amount properly paid, credited, or required to be distributed on the last day of any preceding taxable year and such portion of the capital gain distribution is less than the undistributed capital gain for such preceding taxable year, the trust shall be deemed to have properly distributed on the last day of such preceding taxable year an additional amount. Such ad-
ditional amount shall be equal to the taxes imposed on the trust for such taxable year attributable to such undistributed capital gain multiplied by the ratio of the portion of the capital gain distribution to the undistributed capital gain of the trust for such year. For purposes of this subsection, the undistributed capital gain and the taxes imposed on the trust for such preceding taxable year attributable to such gain shall be computed without regard to the capital gain distribution and without regard to any capital gain distribution determined for any succeeding taxable year.

(f) CHARACTER OF CAPITAL GAIN. — For purposes of this section, the character of the capital gain of a trust for any taxable year with respect to a beneficiary shall be the same as it was with respect to the trust.91

Section 669 in general provides for the tax computation as to undistributed capital gain.92 Section 669 lays out the formula for the separate capital gains tax which will have to be taken into account separately by the beneficiary. The tax imposed on undistributed capital gain uses somewhat the same type of partial tax method employed for accumulated undistributed net income under section 668. Under the new provisions for a capital gains throwback, two preliminary computations must be made: (A) “capital gain distribution,” and then (B) “undistributed capital gain.”

In ascertaining the former, (A), the amount of the distribution for the current year to be thrown back93 must be determined. There are five steps in the determination of this figure.

1) The DNI for the taxable year is reduced by the total amounts of income required to be distributed currently, but not below zero.

2) Then add up all other amounts properly paid, credited or required to be distributed for the taxable year.

3) The difference between the latter (2) and former (1) amounts must be computed, this total being considered the accumulation distribution for the taxable year.

4) The undistributed net income of the trust must then be totaled for all preceding taxable years.

5) The excess of the accumulation distribution, determined in step three, over the undistributed net income, determined in step four, (to the extent of undistributed capital gain for the taxable year) is the capital gain distribution for the year.94

91 (Old Law) Id. §669.
92 Id. §669 is new to the Code. Its forerunner, the previous §669, prior to the 1969 Tax Reform Act, dealt with taxation of certain foreign trusts.
93 Id. §665(g). See text at notes 70-73 and a capital gains distribution is deemed to have been made only when the undistributed net income has not been absorbed by accumulation distribution.
94 Id. §665(g) see also, TAX COORDINATOR, “1969 Tax Reform Law” at 209 (Jan. 27, 1970) and S. REP., Pub. L. No. 91-172 at 130 (1969).
Thus, the capital gain distribution can only occur when the undistributed income for the preceding taxable years is exhausted. The capital gain distribution is then thrown back to the earliest year in which there was undistributed capital gain.

In ascertaining the latter, step B, ("Undistributed capital gain")95 which is the counterpart to "undistributed net income," three steps are necessary,

1) Determine the total gain in excess of losses from the sale or exchange of capital assets to the extent they are allocated to corpus and are not paid out to the beneficiary in the taxable year or set aside for charitable purposes.96

2) Compute the amount of taxes imposed on the trust which are attributable to these gains.97

3) Determine the excess of the former over the latter. That is the undistributed capital gain for the year.

Having arrived at these two figures, i.e., (A) "capital gain distribution" and then (B) "undistributed capital gain," the beneficiary's tax liability for the year in which he received a distribution of accumulation, is computed either by the short-cut or exact method of computation, whichever is less.98

Under the "exact method," the tax on the amount of capital gain and those taxes deemed distributed in preceding years is the aggregate of the taxes that would have been payable if the distribution had actually been made on the last day of each one of the preceding years.99

Under the "short-cut" method or the three-year income averaging device, the beneficiary's taxes are computed, totaled and then divided by the number of preceding years in which the distribution is deemed to have been made. This has the effect of averaging the taxes on the capital gain distribution over the period in which they were accumulated. This method consists of three steps: 1) The average annual net gain is determined. This is done by dividing the total net gains from the sale or exchange of capital assets deemed distributed and required to be included in income by the number of preceding years of the trust from which the net gains were deemed to have been distributed. 2) The increase in the average annual tax is then determined by adding to the income of the beneficiary for each of three years

95 Id. §665(f) see text at note 71.
96 Id. §642(c).
97 Id. §665(d) (Taxes Imposed on the Trust) see text at notes 79 to 84.
98 Id. §669(b)(1) and (2). Note also, that the exact or "short-cut" method must be utilized to compute the tax on the distribution. The beneficiary will not be able to include the entire distribution in the year he actually receives it. S. REP., Pub. L. No. 91-172 at 131 (1969).
99 Id. §669(b)(1).
immediately prior to the current year (year in which distribution is made) the average annual net gain (computed in step 1). The taxes of the beneficiary are then recomputed for the three year period (including therein the net gains), then the tax increase over that time period are added together, and that total is divided by three. 3) Finally, the average annual tax increase, determined in step two, is multiplied by the number of preceding years during which the net gains are considered to have been made. 100

After the determination is made as to which method will provide for the lower tax, the amount is then decreased by the amount of taxes deemed distributed to the beneficiary under subparts (d) and (e) of section 669 (where a portion of taxes are deemed distributed as a part of a gain distribution). 101

If there has been a prior distribution of capital gain or income, the beneficiary must include these amounts when determining what his income for each of those prior years involved was, whether he is using the “short-cut” method or “exact” method in the current year. 102 The beneficiary must also include such amounts (whether they were products of the present trust making such a distribution or from a different trust) and the accumulated ordinary income (including the taxes deemed distributed in prior years) deriving from an accumulation distribution of capital gain in the current year. 103

Paragraphs (2), (4) and (5) of section 668 (b) also apply to capital gain distribution throwback. These paragraphs deal with the necessity of the existence of a beneficiary at the time of distribution, the effect of a distribution from more than one trust to a particular beneficiary, the inclusion of a preceding taxable year if the amount thrown back to that year is less than 25 percent multiple distributions in the same taxable year, and the information required from the beneficiary as far as the computation of the taxes. 104

Trust taxes on capital gains are considered an additional distribution. Where the trust has paid tax for a preceding year on capital gains, the throwback rule operates to create an additional distribution comprised of such taxes paid on the accumulation of capital gains in that year. The amount is deemed properly paid out on the last day of that preceding year. This additional distribution of taxes paid by the trust is computed as fol-

100 Id. §669 (b) (2).
101 See text accompanying note 104 infra.
102 Id. §669 (c) (1).
103 Id. §669 (c) (2). Note also, that accumulation distributions of income are always determined and thrownback before the throwback rule for capital gain is effectuated. See note 59 supra.
104 Notes 50-53 supra.
flows: Where the amount of capital gain thrown back is equal to or is more than the undistributed capital gain for that year, the amount of tax deemed distributed is equal to all the taxes imposed on the trust as to the undistributed capital gain for that year.\footnote{105}

If, however, the amount of capital gain thrown back to any preceding year is less than the undistributed capital gain for that year, the additional amount of trust tax paid deemed distributed is a pro rata portion of that tax, that pro rata portion being computed by taking the trust's income for the year which is attributable to the undistributed capital gain in that year multiplied by the ratio of the portion of capital gain distributed to the undistributed capital gain for such year (the numerator being the capital gain distributed to the extent such was allocated to that year, the denominator being the undistributed capital gain of the trust for the same year).\footnote{106}

The last subpart of section 669, subpart (f), states that whatever the character of the capital gain of a trust (i.e. either short term or long term) for any taxable year, it shall retain the same character with respect to a beneficiary.\footnote{107}

**FURTHER CHANGES UNDER THE 1969 TAX REFORM ACT**

Section 231(b) of the new act amends section 663(b).\footnote{108} Under the amendment a trustee of a complex trust has the right to elect within the first 65 days of the trust's taxable year to consider such amount distributed in the preceding taxable year, rather than in the year of actual distribution. This decision only effects those tax years beginning after 1968.\footnote{109} This rule will allow a trustee to distribute to a beneficiary undistributed capital gain free of capital gains tax, thereby allowing a trust to treat the current year's capital gain distribution as taking place in the prior year in which there may not have been any undistributed capital gain.\footnote{110}

This section of the new act deals with the effective dates of

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\footnote{105}{Id. §669 (d).}
\footnote{106}{Id. §669 (e).}
\footnote{107}{See generally TAX COORDINATOR, C-6000.49 at 16, 134-16, 134B.}
\footnote{108}{Id. §663 (b) (2) before amendment:
\footnote{109}{§331 (d) (1) of Pub. L. No. 91-172 (1969).}
\footnote{110}{See TAX COORDINATOR, C-6000.33 at 16.130B. See also Temp. Treas. Reg. §13.6 stating that the election must be made by attaching a statement to a timely return for the taxable year for which the election is made.}
these new rules and their transitional phase.\textsuperscript{111} These rules and exceptions where discussed previously,\textsuperscript{112} except for part (2) (C) of 5331 (d). This section exempts trusts that were in existence on December 31, 1969 from the application of the capital gains throwback rule until 1972. A further limitation applied to this rule is that the beneficiary who is involved must be a beneficiary of only one such trust. But when a situation exists where a person is the beneficiary of two complex trusts that meet the requirements of the above rule, then said beneficiary has the option to elect which trust he desires to apply such exemptions to. However, the rule as to multiple trusts does not apply to a trust for a surviving spouse. Thus where trusts meet the requirements of section 2056 (b) (5), all such trusts could be availed of such exemption.

Section 677 (a) was amended to read as follows by the 1969 Tax Reform Act:\textsuperscript{113}

(a) \textbf{GENERAL RULE.} — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be —

(1) distributed to the grantor or the grantor’s spouse;

(2) held or accumulated for future distribution to the grantor or the grantor’s spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contribution).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.\textsuperscript{114}

This amendment destroyed a tax loophole in any trust set up by one spouse for the benefit of the other. Under prior law it was possible for a spouse to create a short-term trust (Clifford Trust),\textsuperscript{115} or other trust in which income could be accumulated for the benefit of a spouse. The trust would pay the taxes on such accumulations and then at the end of the trust term, the

\textsuperscript{111} Pub. L. No. 91-172 (12/30/69).
\textsuperscript{112} See text at note 70 supra.
\textsuperscript{113} §332(a) of the Tax Reform Act effectuated such change Pub. L. No. 91-172 (12/30/69).
\textsuperscript{114} This amendment substituted the words “grantor or grantor’s spouse” for the words “the grantor”. §332 (a) of the Tax Reform Act of 1969.
\textsuperscript{115} See note 7 supra.
beneficiary could receive a tax free distribution of such amounts.\textsuperscript{116}

Under the new law any property transferred in trust after October 9, 1969,\textsuperscript{117} the income of which may\textsuperscript{118} be used by or for the benefit of the beneficiary spouse, is taxed to the grantor spouse as the income is earned by the trust.\textsuperscript{119} Thus the new provision holds the grantor liable for income when accumulated in the trust even when such is not distributed.

**CONCLUSION**

After fifteen years the throwback rule has come of age. It can no longer be sidestepped, through application of one of the numerous exceptions that were available to the estate planner during the pre 1969 maturation period of the rule.

The *Tax Reform Act of 1969* has vastly increased the complexity of trust distributions. Not only has the method of computation of tax under the rule increased in complexity, since the tax advisers must now work their way through the labyrinth of both the "exact" and "short-cut" methods of taxation for both a distribution of accumulated income and accumulated capital gain, but in order to manipulate through this newly constructed maze, the tax advisor must be equipped with exact records of prior taxes paid by the beneficiary and the trust.

For future tax advisement special consideration must be given to Treasury regulations that will deal with: (a) the computation of tax on capital gain distribution when the beneficiary was not in existence in a prior year, (b) multiple distributions in the same year, and (c) situations in which adequate records are unavailable as to the prior tax years.

The short-term accumulation trust will still remain an effective conduit for the deterrence of taxation, as in the case of a low bracketed beneficiary and a high bracketed grantor. And it also provides an efficacious method of accumulating income for beneficiaries who are minors and who would be unable to wisely handle the income from a simple trust.

Thus, the tax incentives for creating an accumulation trust have been somewhat curtailed by the 1969 *Tax Reform Act*, but the non-tax benefits still constitute substantial motivation for the utilization of such a trust.

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\textsuperscript{117} §332(b), Pub. L. No. 91-172 (1969).

\textsuperscript{118} §677(b) *TAX COORDINATOR* at 215. Under prior law it was the grantor of such trust.

\textsuperscript{119} This section will not apply to any trust where the beneficiary is required to include such income in his taxes. Such a situation would arise under a separation or alimony agreement. S. REP., Pub. L. No. 91-172 at 133.