BYU Law Review

Volume 1978 | Issue 3 Article 7

9-1-1978

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The "pure equity" or "family estate" trust, a device widely marketed across the United States, is "guaranteed" by its proponents to alleviate the burdens of income taxation.[1] The trust is best described as an irrevocable, inter vivos, complex trust and is sold as a tax avoidance device[2] to thousands of unsophisticated purchasers, often without full disclosure of its potential for generating litigation. This Comment examines the probable income tax consequences of the family estate trust by contrasting the legal positions of the trust's proponents and Internal Revenue Service.

I. Characteristics of the Family Estate Trust

Although currently marketed in various forms, the distinguishing characteristic of the family estate trust is that the same individual fills four trust capacities: grantor, trust employee, trustee, and beneficiary. As grantor he transfers to the trust in fee simple his general passive assets, businesses, distributorships,

1. Many of the guarantees come in the form of verbal testimonials on the validity and legality of the trusts, but some organizations provide that any challenge to the validity of the trust will be defended in court at no cost to the purchaser.

The history of the family estate trust concept is somewhat obscure, but one account relates the story of Patrick Henry who allegedly set up the first such trust of record in America for Governor Robert Morris of Virginia in 1765. The trusts were apparently little publicized yet commonly used until the passage of the sixteenth amendment in 1913. Following the income tax amendment, the family estate trust went into a period of disuse until resurrected in the 1930's by Harry Morgan Phipps. The current surge of interest in these trusts is attributed to the promotional abilities of James R. Walsh, who in 1972 revitalized Mr. Phipps' National Pure Trust Service format and created two sister organizations—Trust Inc. and Educational Scientific Publishers. *See* Estate Guardian Educational Trust, Historical Development of the Pure Living Trust 1 (1976) (promotional material distributed by E.G.E.T., San Diego, Cal.); Hill, *Tax Cuts for Sale,* Wall St. J., July 13, 1977, at 1, col. 5. In addition to "pure equity" and "family estate," this trust instrument has also been referred to as the "Constitution," "apocalypse," "pure living," "Patrick Henry," "common law," and "family equity" trust. For the sake of convenience this Comment will refer to the trust concept, which encompasses all of the above derivations to one extent or another, as the "family estate trust."

2. Efforts to minimize taxes are neither illegal nor unethical. The classic statement on the subject was made by Judge Learned Hand:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947). *See also* Knetsch v. United States, 364 U.S. 361, 365 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935); Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L.J. 440 (1968).

farms, and family residence, receiving units of beneficial interest in return.[3] As trust employee he contractually relinquishes to the trust all his personal services, which may then be leased or loaned out to third-party employers at the discretion of the trustees. As trustee he, along with other trustees, is responsible for administering the trust and leasing out its employees to employers, patients, or clients who compensate the trust directly.[4] Finally, as beneficiary he shares in the income of the trust to the extent of the units he retains after conveying his other units to his spouse, children, or other trusts.

II. Competing Positions of the IRS and Trust Proponents

Proponents of the family estate trust maintain that the device minimizes income taxation yet remains in total compliance with the letter of state trust law, the Internal Revenue Code, and

3. Units are essentially fractions of the beneficial ownership of the trust. For example, in a 100-unit trust where the grantor conveys away all but fifteen units, he has retained a 15% interest in the trust income and assets.

In a community property jurisdiction, or where the husband and wife own the assets to be conveyed to the trust in joint tenancy, it is necessary that one spouse's interest be granted to the other spouse who then conveys the assets to the trust in fee simple in return for 100 units of beneficial interest. The grantor then transfers to the other spouse one-half (50) of the units in consideration of the prior interest in the community or joint tenancy. Each spouse then has 50 units to retain or convey as he or she desires. The grantor, who is generally the primary wage earner for the family, usually transfers the majority of his units to his children or other trusts in order to further split the trust income. The grantor's spouse likewise conveys away some units, but is advised to retain a sufficient interest to maximize the likelihood of treatment as an adverse party. The units allegedly qualify as a present interest in a security (the trust property), but, because of the discretionary control over the trust by the trustees, the value of the units is considerably less than the value of the underlying trust assets. Gift tax valuation on the units conveyed away is determined on their remainder interest value as discounted according to Treas. Reg. § 25.2512-5 (1970). *See* Educational Scientific Publishers, A Lawyer's Discussion of the Legal Aspects of the Family Equity Trust 5-6 (1978) (promotional pamphlet distributed by E.S. Publishers, Houston, Tex.).

The irrevocability of the conveyance raises serious questions as to potential problems in the event of a divorce. If the departing spouse retains her 50 units, can she then continue to collect half of the trust's income (her ex-husband's wages) for the duration of the trust? Since answers to questions of this nature are so uncertain, this is obviously one area where the potential for litigation is enormous.

4. The board of trustees normally includes the grantor, his spouse, and at least one unrelated party. The trustees are generally paid a substantial amount of compensation by the trust for their services in this capacity.

The integral relationship between family members in various family estate trust capacities presents notorious opportunities for abuse. Some promoters of this type of trust maintain that the family residence, having previously been transferred to the trust, can be lived in without cost to the husband and wife (trustees) because they are protecting and caring for trust assets; further claims include the deductibility of dinner between Mom and Dad because they are really cotrustees discussing trust business. *See* Hill, *Tax Cuts for Sale,* Wall St. J., July 13, 1977 at 1, col. 5.

the applicable Treasury Regulations. The Internal Revenue Service, however, through revenue rulings,[5] news releases,[6] and litigation[7] has launched a vigorous attack against the trust. In its attack the IRS relies primarily on the following two arguments: First, the assignment of services is in fact an assignment of income taxable to the assignor under I.R.C. § 61(a)(1); and second, the retained control over the trust and the lack of an adverse party on the board of trustees make the trust income taxable to the grantor under I.R.C. §§ 671-677.

A. *Assignment of Services or Assignment of Income?*

1. *The position of the IRS*

The primary argument made by the IRS against the family estate trust is that the assignment of services by the grantor to the trust is in economic reality no more than an assignment of income. The abatement of income tax liability through this sort of income assignment has been prohibited by an unbroken string of Supreme Court decisions originating with *Lucas v. Earl.*[8]

In *Lucas* the wage earner and his wife entered into a contract stipulating that any income received by the husband was to be considered joint income to both. Subsequently, the husband filed a tax return claiming only one-half his earnings as income. The IRS responded by assessing a deficiency. The Supreme Court held that such an arrangement, although legal under state law, would not be recognized under the Internal Revenue Code.[9] The Court declared that income would be taxed to the earner without regard to "anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."[10]

In three recent Tax Court cases the IRS has relied on the *Lucas* rationale and has successfully taken the position that family estate trusts are anticipatory arrangements devised to divert income from its earner. Consequently, in these cases trust income has been found to be taxable to the earner personally under I.R.C. § 61(a)(1).[11]

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5. Rev. Rul. 75-258, 1975-2 C.B. 503; Rev. Rul. 75-257, 1975-2 C.B. 251.

6. I.R.S. News Release No. 1878, Aug. 31, 1977.

7. Wesenberg v. Commissioner, 69 T.C. 559 (1978); Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977); Horvat v. Commissioner, 36 T.C.M. (CCH) 476 (1977).

8. 281 U.S. 111 (1930). *See, e.g.,* United States v. Basye, 410 U.S. 441 (1973); Commissioner v. Culbertson, 337 U.S. 733 (1949).

9. 281 U.S. at 114.

10. *Id.* at 115.

11. I.R.C. § 61(a)(1) reads: "Except as otherwise provided in this subtitle, gross

In *Horvat v. Commissioner,*[12] the taxpayer contracted to give to his family estate trust "exclusive use of [his] lifetime services and all resultant earned remuneration."[13] Thereafter, Horvat's employer continued issuing payroll checks to the taxpayer, who then endorsed them over to the trust. Horvat failed to include as personal income any of his salary received subsequent to the creation of the trust, and the IRS claimed a deficiency. The Tax Court held in favor of the Service, primarily relying on the following factors: First, there was no substantial business purpose for the trust; second, there was no privity between the trust and the employer since the services performed and the business activity conducted were those of the petitioner and not of the trust; and third, the petitioner retained control of the earnings.[14]

A similar arrangement was again rejected in *Damm v. Commissioner.*[15] Damm, like Horvat, conveyed his assets and assigned his personal services to his family estate trust and notified his employer of the assignment. Damm sent his employer the Internal Revenue Service Employer Identification Number that had been assigned to the trust and requested that all future payroll checks be made payable to the trust directly. The employer refused to comply with the request and continued to issue the payroll checks to Damm, who then endorsed them over to the trust. The court held in favor of the IRS for three reasons: the trust was not a party to the employment contracts; the disposition of earned income remained with Damm; and Damm, irrespective of the trust, retained control over the manner in which the income was earned.[16]

Most recently, in the case of *Wesenberg v. Commissioner,*[17] a doctor employed as an instructor at the University of Colorado Medical School formed a family estate trust and requested that the school make all future payroll checks payable to the "Richard L. Wesenberg Family Estate (A Trust)." The employer complied

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income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions and similar items . . . . " *See* United States v. Basye, 410 U.S. 441 (1973); Commissioner v. Culbertson, 337 U.S. 733 (1949).

12. 36 T.C.M. (CCH) 476 (1977). In *Horvat* two cases were decided together; both petitioners argued pro se. The factual situation in Rev. Rul. 75-257, 1975-2 C.B. 251, is virtually identical to that of *Horvat.*

13. 36 T.C.M. (CCH) at 477.

14. *Id.* at 478-79.

15. 36 T.C.M. (CCH) 793 (1977).

16. *Id.* at 796.

17. 69 T.C. 559 (1978).

with the request and subsequently sent all paychecks directly to the trust. Nevertheless, the Tax Court found that

> the ultimate direction and control over the earning of the compensation rested in Richard and not in the Trust. While Richard may have conveyed, at least in form, his services to the Trust, in substance he was not a bona fide servant or agent of the Trust with respect to the services he rendered the school.[18]

As in *Horvat* and *Damm*, the Tax Court in *Wesenberg* based its holding on the findings that the trust had no privity of contract with the third-party employer and the ultimate control over earnings was retained by Wesenberg and not the trust.[19]

2. *The position of the trust proponents*

The proponents of the family estate trust have not been discouraged by the results in *Horvat, Damm,* and *Wesenberg.* Although they admit that the mere assignment of income is taxable under I.R.C. § 61(a)(1) and *Lucas v. Earl,* they argue that in a properly constructed family estate trust there is no assignment of income at all. In all three cases cited above, the income earner contracted with his employer in an individual capacity rather than as trustee. The trust, therefore, was not privy to the employment contract but was merely designated to receive the employment income. If, on the other hand, the trust itself is the contracting party and as such effectively leases out the services of the trust employee to a third-party employer, the assignment of income theory should not apply. Trust proponents, asserting that the question of control by the trust over the employee is dispositive, point to the "leased employee" doctrine as authority for their conclusion that the trust employee should only be taxed on the income actually paid him by the trust.[20]

The validity of a taxpayer's leasing his services to a corporate

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18. *Id.* at 562. The court concluded its opinion by stating: "Indeed, considering Richard's education and intellectual ability, we find it difficult to believe that he envisioned the Trust as anything other than a flagrant tax avoidance scheme." *Id.* at 564. In addition to back taxes and interest, Wesenberg was assessed a five percent penalty "due to negligence or intentional disregard of rules and regulations (but without intent to defraud)." I.R.C. § 6653(a).

19. 69 T.C. at 562. In addition to the assignment of income theory, the Tax Court also held that Wesenberg was taxable on the trust income under the grantor trust provisions, I.R.C. §§ 674, 676-677. 69 T.C. at 564.

20. *See* Brief for Petitioner at 20, Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977); EDUCATIONAL SCIENTIFIC PUBLISHERS, AN ANALYSIS OF THE HORVAT TAX COURT DECISION AND THE 1975 REVENUE RULINGS ON FAMILY TRUSTS 2 (1977) (promotional pamphlet distributed by E.S. Publishers, Houston, Tex.).

entity has been firmly established since the early case of *Charles Laughton.*[21] In this case, Laughton, the majority stockholder in a closely held corporation, leased his talents and services to the corporation. The corporation then contracted out the services of its employee to various film studios, which paid the corporation an amount significantly greater than that paid to the employee as salary. The Tax Court held in favor of the taxpayer, who had paid taxes only on the amount of salary paid to him by the corporation. On appeal, the Ninth Circuit upheld Laughton's leased employee argument because two conditions were present: First, the corporation was controlled by a board of directors that could exercise independent management discretion, notwithstanding the fact that the employee was the majority stockholder; and second, the corporation was established for the non-tax-related, independent business purpose of joining efforts "with other employees of the company to create motion pictures."[22]

Trust proponents argue that the same rationale applies to the family estate trust. If the trust has an independent business reason for its existence and is the contracting agent with the third-party employer for the services of the leased employee, the employee should only be liable for the income he receives from the trust regardless of what is actually paid to the trust by the third-party employer.

3. *Analysis of the IRS' and trust proponents' positions*

The IRS is primarily concerned with whether or not the trust is a sham device used to divert income from its earner to lessen tax liability. On the other hand, trust proponents contend the trust itself qualifies as the income earner under the leased employee doctrine.

The Service's position stems from the early case of *Higgins v. Smith,*[23] where the Supreme Court upheld the Treasury Department's right to look beyond the mere form of a corporate entity. The Court stated:

> The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of

21. 40 B.T.A. 101 (1939), *remanded,* 113 F.2d 103 (9th Cir. 1940). *See also* Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); Fontaine Fox, 37 B.T.A. 271 (1938).

22. 113 F.2d 103, 104 (9th Cir. 1940).

23. 308 U.S. 473 (1940).

> the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.[24]

Relying on the *Higgins* rationale, the IRS has challenged the tax status of numerous entities under the general captions of "sham transaction" and "substance over form"; but, as demonstrated in *Laughton,* the Service's determinations have not always been upheld by the courts. The courts appear to hold that if there is a bona fide business purpose for a leased employee relationship other than the reduction of taxes, and if the taxpayer complies with the letter of congressional tax legislation and state incorporation statutes, the IRS will be precluded from resorting to the subjective "common law of taxation"[25] approach inherent in the use of the general captions. Although the IRS clearly has authority to ascertain the economic reality of a trust entity, the leased employee doctrine may shelter the family estate trust as long as the assignment of services by the grantor to the trust is based on a non-tax-related business purpose.

In relying on the leased employee doctrine to support their defense of the family estate trust, however, trust advocates have assumed a heavy burden. Even if the family estate trust complies with the letter of the law, the real issue is whether the assignment of services to the family estate trust has sufficient justification, aside from tax avoidance, to overcome the IRS contention that the device is a sham. Both *Laughton* and the recent family estate trust cases emphasized the importance of finding an independent business purpose to justify the leased employee relationship. For example, the appellate court in *Laughton* carefully considered the *Higgins* admonition and concluded:

> We take the [*Higgins*] opinion to mean that the "tax event" is not an unreal attempt to use a corporation for a sham transaction, procuring an advantageous tax consequence to the taxpayer, if it may be considered as one *primarily for an independent business purpose* and not a transfer of assets (here Laughton's services), with a retention of their control, solely to reduce tax liability.[26]

Similarly, in *Horvat* the court noted:

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24. *Id.* at 477-78.

25. *See* Brown, *The Growing "Common Law" of Taxation,* 34 S. CAL. L. REV. 235 (1961).

26. 113 F.2d at 104 (emphasis added).

> While it is true that *a viable business entity actually engaged in business activity cannot be ignored,* herein the conclusion is inescapable that petitioners' family trusts were nothing more than a vehicle designed to lessen petitioners' tax burden; clearly the "tax laws permit no such easy road to tax avoidance."[27]

The IRS should be required to recognize the validity of the trust entity only if a bona fide business purpose for the trust can be shown. Thus, to withstand IRS attack, the family estate trust must be able to demonstrate a reason for its existence other than reduction of tax liability.

Considering the traditional emphasis by promoters of the family estate trust on the tax-saving aspects of the device, it may be quite difficult to show that any particular trust was established *primarily* for an independent business purpose. There are, however, benefits associated with such a trust arrangement that are not tax related and that might be asserted as legitimate, independent purposes for establishing a family estate trust. For example, the grantor might want to relinquish management responsibilities for his businesses to a professional management firm that would serve as trustee. The trust device also allows a grantor to arrange his affairs so as to avoid the publicity and expense of probate proceedings following his death. Nevertheless, the courts thus far have only considered independent *business* purposes; therefore, the aforementioned trust benefits may not be sufficient to satisfy the test unless the IRS and the courts will extend it to encompass purposes beyond those currently described as business purposes.

Should a true business purpose for a family estate trust be found, yet another dilemma arises to confront an unwary trustor. Although the trust may not then be vulnerable to an assignment of income attack, the establishment of a business purpose will lend credence to an alternative IRS contention that the family estate trust is an association properly taxable as a corporation under I.R.C. § 7701. Section 7701 and its corresponding Treasury regulations provide that if a trust has the function and appearance of a corporation it will be taxed as a corporation.[28]

27. 36 T.C.M. (CCH) at 478-79 (emphasis added) (footnote omitted) (quoting United States v. Basye, 410 U.S. 441, 452 (1973)).

28. *See* Rev. Rul. 75-258, 1975-2 C.B. 503. The contention that a family estate trust is an association taxable as a corporation under I.R.C. § 7701 comes from an expanded reading of Morrissey v. Commissioner, 296 U.S. 344 (1935). *Morrissey* set forth a test to distinguish between a private trust and a business trust taxable as a corporation. This test has been embodied into a Treasury regulation which provides:

In addition to the above difficulties, the grantor/employee may be forced to eschew the position of trustee. A primary factor in the vigorous prosecution of the family estate trust by the IRS is the fact that the same person often fills the four positions of grantor, employee, trustee, and beneficiary. Although a single person may fill all four capacities under state trust law, such blatant control over a taxable entity invites the close scrutiny of IRS auditors.

If conservation of assets for the family, avoidance of probate, and other such nontax considerations are the real purposes of the trust, then these purposes can be served through an arrangement whereby outsiders serve as trustees. The grantor/employee can remove the taint of sham from the assignment of his services by having noncontrolled trustees negotiate with the third-party employers instead of doing it himself while wearing his trustee hat. But removing the appearance of sham by divesting the grantor of all power and control over the trust results in an untenable loss of the grantor's personal and economic freedom. First, by allowing an unrelated trustee to negotiate the third-party employment contracts, the employee is obligated to labor where, when, and for whatever wages the trustee dictates. Depending on the trust instrument, this condition of near servitude could continue for the twenty-five year duration of the trust. Second, the use of unrelated trustees in an irrevocable trust instrument removes from the grantor the very control over the family estate that the the trust was designed to provide. Essentially, the grantor would be making the unconscionable exchange of personal freedom for freedom from taxation. The alternative format suggested clearly represents a drastic change from the current family

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> The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. . . . *An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.*

Treas. Reg. § 301.7701-2(a)(1), T.D. 6503, 1960-2 C.B. 409 (emphasis added).

The IRS contends the family estate trust possesses associates, business purposes, and a preponderance of corporate characteristics over noncorporate characteristics and is therefore an association taxable as a corporation. *See* Elmer Irvin Trust, 29 T.C. 846 (1958).

estate trust instrument, yet the fact remains that the greater the apparent control over the trust by the grantor, the greater the likelihood of IRS challenge.

B. *Family Estate Trusts as Grantor Trusts*

In addition to the assignment of income theory, the Internal Revenue Service has attacked family estate trusts under the grantor trust provisions of I.R.C. §§ 671-677.[29] In essence, these sections provide that income placed in trust will remain taxable to the grantor to the extent that he retains a reversionary interest in the trust property, or beneficial enjoyment of income from the trust corpus without the prior approval of an adverse party.[30] An adverse party is defined as any individual "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."[31] Accordingly, a trustee does not qualify as an adverse party unless he also has a substantial beneficial interest in the trust itself.[32]

1. *The position of the IRS*

The Internal Revenue Service's position that family estate trusts are grantor trusts was expressed in *Damm v. Commissioner.*[33] Although the case was ultimately decided on the assignment of income theory, the Service argued alternatively that the family estate trust was subject to the grantor trust provisions of sections 671-677. Counsel for the IRS defined the purpose behind the grantor trust provisions:

> [T]he obvious purpose behind the grantor trust provisions is to ensure that the grantor has not used the trust as a device to escape taxation on the income of the trust property while retaining his effective access to the property and/or income. If such power is retained by the grantor or by an individual not having an interest in the trust adverse to the exercise of such power, then the grantor is deemed to be the owner of that portion over which he has retained such control.[34]

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29. Rev. Rul. 75-257, 1975-2 C.B. 251; *see* Paxton v. Commissioner, 520 F.2d 923 (9th Cir. 1975), Brief for Respondent at 22, Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977).

30. I.R.C. § 674(a).

31. I.R.C. § 672(a).

32. Paxton v. Commissioner, 520 F.2d 923, 928 (9th Cir. 1975); Treas. Reg. § 1.672(a)-1(a) (1956).

33. 36 T.C.M. (CCH) 793 (1977).

34. Brief for Respondent at 22-23, Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977).

In the family estate trust there are no named beneficiaries as such; rather, the grantor receives "units of beneficial interest" in exchange for the assets transferred and personal services assigned to the trust. The grantor can then either retain the units or distribute them to his spouse, children, or other trusts. In *Damm* the IRS not only contended that the grantor was taxable on the units he retained, but argued that he was taxable on the entire trust income. The IRS maintained that there could be no adverse party among trustees whose beneficial interest in the trust was determined by possession of "units."[35] Essentially, the IRS argued that if a trustee's interest is represented by such units, he will receive a fixed proportion of the proceeds of the trust regardless of whether the trust is cancelled or continued. Such a trustee would not be an adverse party because his interests would not be adversely affected by the exercise of his power as trustee.[36] Therefore, the IRS argued, the grantor should be taxed on the entire trust income as he could control its disposition without the consent of any adverse party.[37]

2. *The position of the trust porponents*

Proponents of the family estate trust obviously contend that trust income should not be taxed to the grantor under sections 671-677. While they have distinct rationales for each grantor trust provision in the Code, the basis for their argument is that, in a properly structured family estate trust, the beneficial enjoyment of the trust is controlled by adverse parties and the remainder interests vest in the beneficiaries instead of reverting to the grantor.

Since the assets of a family estate trust are distributed to the holders of the units of beneficial interest upon termination of the trust, the grantor of the trust retains a reversionary interest in the trust corpus only to the extent that he retains units of beneficial interest. Trust proponents assert that section 673, which taxes the grantor's reversionary interests in either trust corpus or income,[38]

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35. *Id.* at 25.

36. *Id.*

37. Section 674(a) indicates that a grantor will be considered the owner of that portion of a trust over which he retains a power of disposition without the approval or consent of an adverse party. The IRS' argument that a trustee in a family estate trust cannot be an adverse party because distributions of trust income and/or corpus would be made in proportion to his holdings of beneficial units, if valid, would result in the grantor being taxable under § 674(a).

38. Section 673(a) states:

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

therefore would not apply to units transferred to other beneficiaries.

As for trust income, trust proponents argue the grantor has not retained sufficient power over the family estate trust to be taxable under section 674. Section 674 taxes trust income to the grantor only to the extent that the grantor can control the beneficial enjoyment of the trust income without the consent of an adverse party.[39] In contrast to the IRS contention that holders of units cannot qualify as adverse parties, the trust proponents argue that such units represent proportionate shares in the equitable ownership of the trust equal to any other beneficial interest in trust property. Accordingly, it is the proponents' position that a trustee who holds units of beneficial interest is an adverse party as defined by section 672(a).[40]

The question of retained beneficial enjoyment also arises under section 675 and regulation 1.675-1,[41] which tax the grantor if he can obtain financial benefits from dealing with the trust that would not be available in an arm's length transaction.[42] In the family estate trust, retained administrative powers over the trust should not raise difficulties if the trust instrument requires all transactions between the grantor and the trust to be on an arm's length basis. This "arm's length," however, may be difficult for the grantor of such a trust to maintain within the embrace of his own family.

Trust proponents argue that the rule of section 676, which provides that a grantor will be personally taxed on trust income if he or a nonadverse party has power to revoke the trust or return the corpus to the grantor, is inapplicable in the family estate trust situation. They point to the fact that the power to terminate the

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> 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.

39. I.R.C. § 674(a).

40. Section 672(a) defines an 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."

41. Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.

Treas. Reg. § 1.675-1(a) (1956).

42. *E.g.*, receiving interest-free loans from the trust, dealing with the trust for less than full and adequate consideration, retaining the power to control the investment of trust funds in a nonfiduciary capacity.

trust is vested in the trustees, the majority of whom are adverse parties, and that upon termination the assets of the trust are to be distributed to the beneficiaries of the trust rather than reverting to the grantor.

Finally, the proponents contend that only if the grantor or a nonadverse party has a power to distribute income to or for the benefit of the grantor or his spouse will he be taxed under the provisions of section 677.[43] This rule should be inapplicable to the family estate trust since such powers are vested in the trustees, the majority of whom are adverse parties. In any event, it can apply only to the extent the grantor retains units of beneficial interest.[44]

3. *Analysis of the IRS' and trust proponents' positions*

From this brief review of the positions of the IRS and trust proponents as to the applicability of the grantor trust sections of the Code, it is apparent that the determinative issue is whether a trustee who holds units of beneficial interest qualifies as an adverse party. Contrary to the position of the IRS, the answer to this question would appear to depend upon the substantiality of the interests held by the trustee, and not upon the nature or form of those interests.

When the IRS argued in *Damm* that a trustee holding units of beneficial interest could never qualify as an adverse party,[45] it took a position that is not supported by the Code, Treasury regulations, or case law. By way of definition, section 672(a) states in part that "the term 'adverse party' means any person having a *substantial* beneficial interest in the trust."[46] The regulations elaborate on the substantiality criterion by stating that "[a]n interest is a substantial interest if its value in relation to the value of the property subject to the power is *not insignificant.*"[47] Thus, the real issue in determining whether a trustee holding units of beneficial interest in a family estate trust qualifies as an adverse party is the substantiality of his interest in relation to the total value of the trust assets. Neither the Code nor the regulations

43. Section 677(a) deals with the treatment of a grantor who retains the right to receive trust income either for himself or his spouse. The section applies even if the income is not received in cash but is used to purchase life insurance policies on the grantor or his spouse.

44. Proponents' grantor trust arguments were primarily derived from EDUCATIONAL SCIENTIFIC PUBLISHERS, *supra* note 4, at 8-9.

45. *See* Brief for Respondent, Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977).

46. I.R.C. § 672(a) (emphasis added).

47. Treas. Reg. § 1.672(a)-1(a) (1956) (emphasis added).

require that the beneficial interest be expressed in terms of an absolute figure or percentage of trust assets rather than as a specified number of units of beneficial interest. The *form* in which the trustee's interest is held should be irrelevant as long as a determination can be made as to its *value* in relation to the total value of all interests in the trust assets.

Recent case law affirms that the courts also consider the substantiality of the interest rather than the form in which the interest is held in determining whether a party is adverse under section 672(a). In *Paxton v. Commissioner*,[48] the Ninth Circuit discussed the adverseness of a trustee who held "Certificates of Interest" representing units in a family estate trust. The trustee in question held 192 of a total of 5,000 units of interest in the trust. The court affirmed the lower court's finding that the 3.84% interest represented by the trustee's 192 units was *not substantial enough* to qualify him as an adverse party in relation to the entire trust corpus and income.[49] In so doing, however, the court noted that the trustee was an adverse party as to his 3.84% interest and indicated that he could have been an adverse party as to the entire trust if the units he held represented a somewhat greater percentage of the total value of the trust assets.[50] Thus, the court concerned itself entirely with the substantiality of the trustee's interest and did not automatically disqualify the trustee because his interest was expressed in "units" rather than more conventionally as a percentage of the trust assets.

Similarly, in *Wesenberg v. Commissioner*[51] the Tax Court considered a case involving units of beneficial interest in a family estate trust situation. After quoting the definition of adverse parties under section 672(a), the court concluded that a beneficiary holding "units" was an adverse party.[52] In this case, however, none of the trustees was a beneficiary and therefore the trust income was found to be taxable to the grantor since he could exercise his powers over the trust income and corpus without the consent or approval of an adverse party.[53]

III. The Future of the Family Estate Trust

It is clear from the foregoing discussion that neither the In-

48. 520 F.2d 923 (9th Cir. 1975).
49. *Id.* at 926-27.
50. *Id.* at 927.
51. 69 T.C. 559 (1978).
52. *Id.* at 563.
53. *Id.*

ternal Revenue Service nor the proponents of the trust are approaching the family estate trust issue from an entirely objective position. The IRS treats this device as a sham and attempts to place on the taxpayer the burden of justifying the trust as a taxable entity.[54] In recent years the IRS has won every Tax Court challenge of the trust,[55] and the United States Courts of Appeal have made it plain that the clearly erroneous doctrine will apply to these Tax Court decisions.[56] Reversal has never been granted in favor of the taxpayer in a family estate trust case.

On the other hand, none of the cases brought to trial by the Service has involved a trust providing for privity of contract between the trust and the third-party employer so as to raise the "leased employee" issue.[57] In addition, none of the trusts challenged in court thus far has provided a substantial beneficial interest to the trustees so as to directly challenge the Service's position on the adverse party issue.

It remains to be seen what the result will be when the IRS finally challenges a family estate trust that meets the letter of the law in both of the above areas. Supporting the Service's position is basic federal tax policy which requires that "the realities of the

54. Bernuth v. Commissioner, 470 F.2d 710 (2d Cir. 1972).

55. Wesenberg v. Commissioner, 69 T.C. 559 (1978); Damm v. Commissioner, 36 T.C.M. (CCH) 793 (1977); Horvat v. Commissioner, 36 T.C.M. (CCH) 476 (1977). The success record of the IRS in litigating family estate trust cases is at least partly due to the fact that it has complete discretion to choose which cases it will prosecute.

56. *E.g.*, Paxton v. Commissioner, 520 F.2d 923, 925 (9th Cir. 1975); Paster v. Commissioner, 245 F.2d 381 (8th Cir. 1957); *see* FED. R. CIV. P. 52(a).

57. In the case of Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970), Judge Friendly again considered the leased employee doctrine:

> "Loaned employee" cases such as this reveal a tension between competing policies on tax law. On one side is the principle of a graduated income tax, which is undercut when individuals are permitted to split their income with others or to spread it over several years. Lucas v. Earl. . . . Opposing this is the policy of recognizing the corporation as a taxable entity distinct from its shareholders in all but extreme cases. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

Id. at 652 (citations omitted). In *Rubin* the court reversed the Tax Court's determination of taxpayer liability based upon the "common law of taxation" and remanded to the Tax Court to make a new determination utilizing the provisions of § 482. Judge Friendly castigated the Tax Court's use of arbitrary and clouded tax terms:

> References to "substance over form" and the "true earner" of income merely restate the issue in cases like this: Who is the "true earner"? What is substance and what is form? Moreover, [the Tax Court does] so in a way which makes it appear that these questions can be answered simply by viewing the facts with appropriate suspicion.

429 F.2d at 653. For an interesting diatribe on the IRS' attacks on the family estate trust, see Tkach, *The Pure Equity Trust—How I Use It to Beat the IRS and Malpractice Lawyers*, PRIVATE PRAC., Dec. 1976, at 15.

taxpayer's economic interest, rather than the niceties of the conveyancer's art, . . . determine the power to tax."[58] Moreover, since *Lucas v. Earl*[59] the Supreme Court has repeatedly taken the position that assignment of income to another will not relieve its earner of tax assessment regardless of compliance with state law.[60] The family estate trust carries an additional burden because it involves the grantor's family members in beneficiary and trustee capacities and accordingly invites the "special scrutiny" which the Supreme Court has declared is necessary "where the parties to a transfer are members of the same family group."[61]

Family estate trusts can conceivably be constructed to conform with the literal requirements of trust law, the leased employee doctrine, and sections 61 and 671-677. However, to construct a trust which will withstand the "sham" caption attack by the IRS, the grantor may be forced to relinquish to noncontrolled trustees such control over his own affairs as to render himself a virtual slave to his family estate trust. The very instrument by which a taxpayer seeks to "free" himself from the burden of taxes may result in the forfeiture of freedoms more substantial than the freedom from taxation. The creation of such a trust is possible but it has yet to be tested in court.

In the meantime, family estate trusts are being vigorously promoted across the nation, and the IRS is challenging them on all fronts. Anyone purchasing such a trust should, for the present, be prepared to either pay back taxes, interest, and penalties when challenged by the Service, or defend his trust in court with little prospect of prevailing.

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58. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 58 n. 1 (1942).
59. 281 U.S. 111 (1930).
60. United States v. Basye, 410 U.S. 441 (1973); Commissioner v. Sunnen, 333 U.S. 591 (1948); Gregory v. Helvering, 293 U.S. 465 (1935).
61. Commissioner v. Sunnen, 333 U.S. 591, 605 (1948).