

THE INTER VIVOS TRUST AS
A PERSONAL FINANCIAL TOOL IN KANSAS

by

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CHAPTER I

INTRODUCTION

In 1972, the value of assets held in personal trusts by insured U.S. commercial banks reached \$154,901,791,000, up 14% from 1971.¹ Clearly, trusts must offer some benefits as a personal financial tool if such a volume of wealth is to be held in trust. At the same time, the trust is probably the least understood and least utilized financial tool of moderate wealth-holders,² even though the trust offers significant benefits to these persons as well as to the very wealthy.³ This report examines some of the economic implications of inter vivos (or living) trust utilization as a personal financial tool. While the trust is a powerful tool for reducing taxable estates, it offers significant economic benefits to the living donor and beneficiaries. This paper does not discuss charitable trusts, but confines itself to inter vivos trusts established for individuals.

The purpose of this paper is to gather, present, and combine information pertaining to Kansas inter vivos trusts, to examine the gift, estate and inheritance, and income tax implications of various trust forms, to mention some non-tax impacts of inter vivos trust, and to illustrate the impact of trust usage on varying income groups.

¹FDIC, Trust Assets of Insured Commercial Banks, 1972, cited by William H. Levy, "Trust Assets Reach 403 Billion in 1972," Trusts and Estates, 113 (Mar., 1974), p. 144-146.

²Elwyn G. Voss, Estate Planning; Its Use and Importance to New York Farmers, Cornell Agr. Econ. Res. 73-15, (Ithaca, N.Y.: Cornell Univ. Agr. Exp. Station, Sept., 1973), pp. 16 & 30.

³Morton Freilicher, Estate Planning Handbook with Forms (Englewood Cliffs, N.J.: Prentice - Hall, Inc., 1970), p. 150.

METHODS USED

The methods used to accomplish these objectives include (1) presentation of a brief definition and description of inter vivos trusts, (2) discussion of non-tax advantages and disadvantages of inter vivos trusts, (3) consideration of income tax implications, (4) examination of the estate, inheritance, and gift tax savings and costs, and (5) a summary.

Because of the constantly changing tax laws and rulings, this report does not include any cases, rulings, or laws created after January 1, 1974. If for no other reason than this, any person considering using an inter vivos trust should consult competent legal experts and the current laws. This report should not be used as an absolute authority on any matter due to possibly changed statutes and the general nature of this report.

DEFINITION AND PARTS OF INTER VIVOS TRUSTS

A trust is a fiduciary relationship in which one person holds legal title to property, subject to an equitable obligation to keep or use the property for the benefit of another.¹ An inter vivos trust is established during the life of the creator, as compared to the after-death creation of the testamentary trust.

All trusts consist of five elements, including the creator, a trustee, a beneficiary, some property, and the terms of the trust.²

¹George G. Bogert, Handbook of the Law of Trusts (4th ed., St. Paul, Minn.: West Publishing Co., 1963), p. 1.

²Gilbert T. Stephenson, Estates and Trusts (4th ed.; New York: Appleton-Century-Crofts, 1965), p. 64.

The creator is the person who intentionally creates or causes the trust to come into existence; the creator is also known as the settlor, the grantor, the trustor, or the donor. While only natural persons may create testamentary trusts, any being, legal or natural, that may hold title to property (governments, corporations, associations, or any group or organization allowed to hold legal title) may create an inter vivos trust. The creator must, of course, hold legal title in the property transferred into trust and the legal power to dispose of the property.¹

The trustee is the person who holds title for the benefit of the beneficiary, and may also be the grantor.² While a trust must have a trustee in order to remain operative, a trust does not fail if the original trustee can not serve. Should a named or appointed trustee refuse or fail to serve, and the trust agreement not specify a trustee selection procedure, the probate court appoints a new trustee and the trust continues. Any person may be a sole or co-trustee, so long as she or he does not have some disability that might prevent proper discharge of the trustee duties. However, a sole beneficiary may not serve as a sole trustee of the same trust. A corporation may serve as trustee or co-trustee if it has been licensed to do business as a trustee.³ In Kansas, banks and trust companies are required to receive legal permission to serve as trustee from the Comptroller of the Currency (if it is a national bank)⁴ or from the State Banking Commissioners (if it is a state bank or a trust company). As of the end of 1973, 113

¹Bogert, p. 14. ²Bogert, p. 4. ³Bogert, p. 64.

⁴Edwin McInnis, Trust Functions and Services (American Institute of Banking Section, The American Bankers Association, 1972), p. 42.

corporations in Kansas were entitled to serve as trustee.¹

A trust must have a beneficiary. A beneficiary may be an individual, a charity, or a group of individuals legally entitled to hold property, plus those persons under a legal disability to hold property, such as infants or incompetents.² In fact, one of the first uses of the trust was to circumvent the English Mortmain Acts, which prevented churches from holding real property.³

The property placed into trust is known as the trust corpus or res. Any kind of property that is capable of being owned may be placed in trust, provided the grantor owns the property when placed in trust. Further, the property placed in trust must be adequately described so that the court may ensure that the property is properly maintained and administered.⁴

The terms of the trust indicate for what purpose the trust was created, the duties and powers of the trustee, and the rights of the beneficiaries, based on the law of trusts or the trust instrument, or both. While trusts may be created orally, trust agreements are generally and should be written, to minimize the chance of misunderstanding or fraud.⁵

¹Trusts and Estates, Directory of Trust Institutions of the United States and Canada (1974) (New York: Trusts and Estates, 1974), p. 69-73.

²Bogert, p. 88. ³McInnis, p. 11. ⁴Bogert, p. 49.

⁵Bogert, p. 3.

CHAPTER II

NON-TAX IMPLICATIONS OF INTER VIVOS TRUSTS

While most literature on trusts tends to emphasize tax-saving features of the inter vivos trust, extensive non-tax benefits, both in monetary and non-monetary form, can accrue to the grantor or the beneficiaries. In some cases, these benefits are of such value as to overcome any tax disadvantages. In fact, McInnis warns:

... the creation of a living trust for the chief purpose of saving taxes (the good of the beneficiaries being an incidental consideration) is not only questionable from a social point of view but may in fact prove to be ineffectual as a tax savings device. The changes in tax laws and regulations are so frequent and so drastic that a person who creates a living trust has no assurance that a tax-saving plan that is clearly within the law today will still be so tomorrow.¹

Essentially, most non-tax benefits of trusts can be summarized into four main factors. The remainder of this chapter will discuss these factors, which are as follows:

- (1) avoidance of probate and its attendant publicity,
- (2) provision of competent and continuous management,
- (3) shielding the grantor or the beneficiaries from creditors, profligates, or spendthrifts, and
- (4) assuring stable incomes for dependents.

Of course, not all trusts have the same provisions and intents, so that not all trusts have these benefits.

AVOIDANCE OF PROBATE AND ATTENDANT PUBLICITY

In general, all property owned by a decedent must go through a

¹Edwin McInnis, Trust Functions and Services (American Institute of Banking Section, The American Bankers Association, 1972), p. 154.

legal process called probate to insure that the decedent's debts are satisfied, to collect, determine, and protect the estate property, to pass good title to real estate, and to insure that no rightful heir is unintentionally or wrongfully disinherited.¹ While such purposes are commendable, probating an estate is a time-consuming, cumbersome, and sometimes very expensive public process. Norman Dacey presents a rather alarming account of graft, overcharging, abuses of Probate Court power, and other reasons to avoid probate in his book How to Avoid Probate.²

On the other hand, property in which the decedent's interests end at or before death does not pass through probate (although such property may be included in the decedent's taxable estate). Property that thus does not pass through probate includes property held in joint tenancy, life estates, and continuing inter vivos trusts.³ If the inter vivos trust does not terminate and pass to the decedent's estate, it avoids Probate Court costs and probate lawyer and executor fees.

Economic advantages of probate avoidance may extend further than these savings, however. Probate proceedings, including lists of assets and heirs, are a matter of public record, perhaps allowing competitors to gain information or shysters to relieve heirs of their inheritance.

¹Elinor Anderson, What is Probate?, Kans. Agr., Ext. Serv. Leaflet 210 (Manhattan, Kans.: Kans. Agr. Ext. Serv., Apr., 1974).

²Norman F. Dacey, How to Avoid Probate (New York: Crown Publishers, Inc., 1965).

³John R. Graham, J. Martin Redfern, and Henry J. Meenen, Estate Planning: Problems, Tools, and Case Studies of Arkansas Farm Estates, Ark. Agr. Exp. Sta. Bul. 771 (Fayetteville, Ark: Univ. of Ark. Agr. Exp. Sta., Feb., 1972), p. 65.

Inter vivos trusts are private agreements and their terms, beneficiaries, and assets secret.¹ Additionally, because the notice to probate an estate is a public notice, and all possible heirs must be notified, wills are often contested by disgruntled heirs; inter vivos trusts, enacted in secret without others' knowledge, are rarely if ever successfully challenged.²

The probate mechanism is very slow and cumbersome, and may cause asset management problems during the probate period. Inter vivos trusts may continue with no such time lag. Should the grantor-decedent be serving as trustee at death, a time lag occurs until the Probate Court appoints a successor trustee; this lag is short, especially if contingent trustees are named in the trust agreement.³ A business held in trust with the grantor serving as trustee can survive the death of the grantor more easily than if the grantor had owned the business outright, as the time-consuming probate process and perhaps forced sale by an heir can be avoided. A trustee can keep the business operational and profitable, or can quickly liquidate the business at favorable terms, without the lengthy process of court approvals.⁴ The trustee generally has most of the powers of an owner, and can so conduct the business much as the grantor would.

COMPETENT AND CONTINUOUS MANAGEMENT

Because a trustee is usually someone who is well versed in investments, the grantor can sometimes earn as high or higher rate of

¹Dacey, p. 14. ²Dacey, p. 15.

³George G. Bogert, Handbook of the Law of Trusts (4th ed., St. Paul, Minn.: West Publishing Co., 1963), p. 76.

⁴Dacey, p. 14.

return on his investment placed in trust with a paid trustee, as when the grantor manages it personally. People who are inexperienced in investment or unwilling or unable to manage their investments, may transfer some of their wealth to trust, thus freeing themselves of investment responsibilities.¹

Because the inter vivos trust is established during the grantor's life, the grantor has the opportunity to guide and observe the trustee during the grantor's lifetime. The grantor may retain power to replace the trustee or alter the trust agreement, but may lose some tax advantages - these tax advantages may be judged small when compared to the problem of a poorly performing trust. Additionally, if the grantor is experienced with the corpus, he may be able to offer the trustee sound advice, keeping trust asset productivity high.

SHIELDING THE GRANTOR OR BENEFICIARIES FROM CREDITORS, SPENDTHRIFTS, OR PROFLIGATES

A central reason to place assets in trust is sometimes to ensure that the corpus would not be unwisely spent or lost. An investor wanting to establish a rather risky business may transfer assets into trust to ensure that even if the new business fails, his dependents would be assured of support and his entire estate not lost.² Unless the trust was established with fraudulent intent, assets transferred into trust may not be eligible for attachment by the grantor's creditors.³

¹Gilbert T. Stephenson, Estates and Trusts (4th ed.; New York; Appleton - Century - Crofts, 1965), p. 95.

²Stephenson, p. 94.

³Dacey, p. 15.

Gifts to dependents may be made in trust rather than outright to prevent beneficiaries from unwisely spending or losing the entire amount of the gift. Gifts to ensure the support of mental or physical incompetents are often made in trust for this reason. If the beneficiary is simply inexperienced, a trust whereby the beneficiary is advised by a more experienced trustee allows the beneficiary to gradually learn management skills without the risk of losing the entire gift.

Spendthrift or support clauses are sometimes inserted into the trust terms to keep the beneficiary from wasting his inheritance and becoming destitute. The clause normally provides that the beneficiary can not sign away his interest. The prodigal son in the Gospels would probably not have had to slop hogs if his father had placed his inheritance in trust.¹

A gift in trust is protected at least partially by the trustee -- anyone who wishes to use the corpus must see the trustee. Such a device becomes an advantage where the beneficiary might be preyed upon by others if the gift was outright. Stephenson gives an example of a widow whose profligate son bedevils her for advances, allowances, or gifts. If her property was in trust, the son must go to the trustee in order to use the corpus.² A substantial wedding gift in trust can be protected from the improvidence of either spouse or possible divorce settlement. The trust corpus can be designated to benefit only the person whom the grantor desires, unlike an outright gift.

¹Luke 15.

²Stephenson, p. 97.

ASSURED STABLE INCOME TO A BENEFICIARY

Because of the usually secure nature of investments placed into trust or purchased by trustees, trusts may become a source of stable income for the beneficiary. Older parents sometimes object to estate plans that are economically sound involving lifetime gifts, because they feel this would deprive them of their independent income - they fear becoming "objects of charity." Part of the parents' estate placed in trust with the parents as beneficiaries could be a solution. The parents have an assured income, and the heirs, although probably still paying estate tax, would gain the advantage of avoiding probate. Adult children, whose parents are not self-supporting, may place assets into trust, assuring the parents of a stable income and helping them avoid the feeling of being burdensome. A trust established for a family member whose normal income is risky or fluctuating can help the family member avoid starvation in low income years.

Stephenson suggests establishing a trust with the wife as beneficiary, and using the trust distributions to pay household expenses, thus freeing the wife from depending on her husband for a household allowance. He infers that such an arrangement would create a happier family atmosphere.¹ While Stephenson might have overstated the benefit of a wife's independent household allowance, a spouse's independent income might be used to advantage when determining who provided how much consideration toward jointly held property, in avoiding taxable gifts between husband and wife, or introducing more flexibility into the grantor's financial planning.

¹Stephenson, p. 96.

DISADVANTAGES

Few arrangements have no disadvantages and inter vivos trusts are not exceptions. The two primary disadvantages of trusts are their cost and the loss of control over the trust property.¹

The cost of a trust is primarily the attorney fees and the trustee fees, although a substantial amount of gift taxes may be incurred when establishing the trust. The attorney is entitled to a reasonable fee for his drafting the trust instrument, counseling, and any other services he performs. In almost every case, a lawyer should be consulted before establishing a trust, so attorney fees should be considered almost unavoidable.

The trustee's fee varies with the value and nature of the trust corpus and the difficulty involved in managing the trust. Fees apparently run from \$50 to \$600 for an annual minimum fee, plus 1/2 of 1% of the trust corpus valued up to \$300,000 or \$500,000 with a lower percentage on large trusts, plus 5 to 6% of ordinary income.² If the donor wishes to manage the trust personally to save trustee fees, he must limit the trustee's powers, as explained in subsequent chapters, or lose some tax benefits.

The second major disadvantage of inter vivos trust may be loss of property control (the revocable trust is not subject to this problem). If the trust is to be a completed irrevocable trust, the donor loses control over the trust; if he retains certain powers, he may be taxed on the trust income and the trust corpus may be included in his gross

¹Graham, p. 71

²W. Harry Jack, "Fiduciary Fees - Variations and Complexities," Trusts and Estates, 112 (Sept. 73), 624.

estate. Of course, loss of control also occurs when making outright gifts to beneficiaries - with the trust, the donor can at least designate someone other than the beneficiary to manage the property, if he feels the beneficiary could not properly manage an outright gift.

SUMMARY

Inter vivos trusts offer non-tax economic advantages that may fit into a personal financial plan. Unless non-tax benefits are realized, establishing a trust only for tax avoidance is probably inadvisable. Trusts can be used to protect or to provide the grantor or beneficiaries with some attribute that he or she does not possess - investment expertise, a steady income, thriftiness, or mental capacity. Additionally, a properly established inter vivos trust need not go through the costly and time consuming probate process. The cost of such benefits are the trustee and legal fees and probably the loss of control over the property.

CHAPTER III

INCOME TAX ASPECTS OF INTER VIVOS TRUSTS

Since the trust may be taxed as a separate legal entity, and since trust income distributed may be taxed to the beneficiary, substantial income tax savings may result by establishing inter vivos trusts.

A taxpayer who wishes to split his income with a family member (other than his spouse), or otherwise to relieve himself of liability for taxes on income from certain property, may do so by conveying the property in trust for the family member. This is particularly desirable where the family member is a minor child or one to whom the taxpayer does not want to entrust property at this time. The taxpayer may thus avoid tax on part of his income, subject to the general requirement that he must in fact transfer income-producing property, rather than just income.¹

The higher the tax bracket of the transferor, and the lower the beneficiary's tax brackets, the greater will be the tax savings when the income is split.

For example, assume three taxpayers with taxable incomes of \$16,000, \$44,000, and \$100,000. They each establish a trust, funded with corporate bonds, with income payable for ten years to the donor's presently 8-year old child. The beneficiary has no other income and receives more than half his support from the taxpayer after the trust is established. Ignore the gift tax.

¹Commerce Clearing House, Inc., 1974 Federal Tax Course (Chicago, New York, Washington D.C.: Commerce Clearing House., 1973) p. 1844.

Initial situation

Taxpayer's income	\$16,000	\$44,000	\$100,000
Child's income	-0-	-0-	-0-
Taxpayer's tax	4,300	18,990	55,490
Child's tax	-0-	-0-	-0-
Total tax	4,300	18,990	55,490

Situation A -- Bonds producing \$2,000 transferred into trust.

Taxpayer's income	\$14,000	\$42,000	\$98,000
Child's income	2,000	2,000	2,000
Taxpayer's tax	3,500	17,830	54,110
Child's tax	185	185	185
Total tax	3,735	18,015	54,295
Income tax savings	595	975	1,195
Cost in after-tax dollars of transferring \$2,000 to child	1,405	1,025	805

Situation B -- Bonds producing \$4,000 transferred into trust.

Taxpayer's income	\$12,000	\$40,000	\$96,000
Child's income	4,000	4,000	4,000
Taxpayer's tax	2,830	16,670	52,730
Child's tax	547	547	547
Total tax	3,377	17,217	53,277
Income tax saved	953	1,773	2,213
Cost in after-tax dollars of transferring \$4,000 to child	3,047	2,227	1,787

This chapter will discuss both the Federal and the Kansas income taxation of trusts. However, because the Federal tax is more significant

(Federal income tax rates run from 14% to 70% while Kansas income tax rates run from 2% to 6½%), the bulk of this chapter will discuss income taxation implications from the Federal viewpoint. The chapter first discusses factors causing the trust income to be taxed to the donor, actual determination of trust taxable income, taxation of the trust beneficiaries, and finally, Kansas taxation of the trust and beneficiaries. Examples will be presented to help illustrate concepts, procedures, and the income tax effects of trusts on taxpayers in different income groups.

FACTORS CAUSING TRUST INCOME TO BE TREATED AS DONOR'S INCOME

If the trust is to allow the grantor to lower his tax bill by splitting income, the trust income must be taxed to the trust or the beneficiaries, not to the grantor. If certain powers and rights are retained by the grantor, the income is taxable to him, even though he might have no possibility of receiving the income. This section discusses the rights and powers that the grantor must not retain, if he is not to be taxed on some of the trust income.

The U.S. Supreme Court ruling in the Clifford case established that the donor of a trust is treated as the owner of the trust income if the grantor retains certain rights or powers.¹ These so-called Clifford doctrine powers include the following: (1) reversion of the corpus to the grantor in a short time; (2) power of the grantor or a non-adverse party to control the beneficial enjoyment of the trust income; and (3) reservation of important administrative powers to the

¹Commerce Clearing House, Inc., Standard Federal Tax Reporter 1974 (Chicago, New York, Washington D.C.: Commerce Clearing House, Inc. 1973) P. 1844.

grantor (or non-adverse party) other than in a fiduciary capacity. The Internal Revenue Code also specifies that trust income is taxable to the grantor if (1) the grantor or a non-adverse party has a power to revoke the trust or (2) if the grantor or a non-adverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse.¹ If the trust income is taxable to grantor, any distributions actually made to the beneficiaries are treated as a gift from the donor to the beneficiaries.

Reversion to Grantor in Short Time

The grantor is treated as owner of any portion of the trust corpus that can be expected to revert to him in a short time (a short time for this purpose is ten years or less) after its transfer to the trust.² However, if the reversion depends upon the death of the beneficiary, then the grantor is not treated as owner.³

For example, A, 60 years old, creates an eleven year trust for B, his 95 year-old mother. The trust agreement states that all the income of the trust is to be paid to B for five years. After five years, one-half of the income is to be paid to A and one-half to B. At the end of the eleven years, the trust is to terminate and be distributed to A or his estate. One-half of the income for the entire eleven years will be taxed to A, because of his five-year reversionary interest, and the remaining income taxed to B. During the first five years, the income going to B that is taxed to A is considered a gift from A to B.

¹Internal Revenue Code Sec. 676 & 677, cited by CCH, Reporter, p. 44007.

²IRC Sec. 673(a), CCH, Reporter, p. 44026.

³IRC Sec. 673(c), CCH, Reporter, p. 44026.

If the grantor reserves only the right to revoke the trust, the income of the revocable portion of the trust is still taxable to the grantor, even if the trust is not revoked.¹ However, if the trust is not revocable until at least ten years have elapsed, then the grantor is not taxable on the trust income until the non-revocable period has passed or if the power to revoke is relinquished.²

If the power to revoke is with an adverse party or with the grantor and an adverse party, then the trust income is not taxable to the grantor.³ An adverse party is defined as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he holds respecting the trust.⁴ A trustee,⁵ an employee of the grantor, or a beneficiary closely related to the grantor is not considered to have a substantial adverse interest.⁶ A beneficiary has an adverse interest in his portion of a trust, but not necessarily an adverse interest in the entire trust. For example, A, B, C, and D are beneficiaries of a trust that can be revoked by the grantor with A's consent. Three-fourths of the trust income is taxed to the grantor, because A's adverse interest applies only to one-fourth of the trust.⁷

¹IRC Sec. 676, CCH, Reporter, p. 44054.

²IRC Sec. 677, CCH, Reporter, P. 44054.

³Treasury Regulation 1.676(a)-1, CCH, Reporter, p. 44054.

⁴IRC Sec. 672, CCH, Reporter, p. 44017.

⁵Reg. 1.672(a)-1a, CCH, Reporter, p. 44018.

⁶Reg. 1.672(c)-1, CCH, Reporter, p. 44019.

⁷Reg. 1.672(a)-1b, CCH, Reporter, p. 44018.

If the grantor effectively holds the power to revoke, without the exceptions listed above, the trust's income tax effect is the same as if the trust had not been created. If the trust was not revoked, the trust income would be taxed to the grantor and the income distributed to the beneficiaries treated as gifts.¹

Control of Beneficial Enjoyment

If the grantor of a trust, or a non-adverse party, has a power of disposition over the beneficial enjoyment of the trust income, the grantor is taxed on the trust income.² However, the grantor or any person may retain or possess the following powers and not be taxed on the trust income:³

(1) the power to apply income to the legally required support of the donor's dependent (other than spouse)⁴ except for income actually applied or distributed for the dependent's support;

(2) the power to affect beneficial enjoyment only after the expiration of at least ten years, but not after the time period has elapsed, unless the power is relinquished;

(3) the power to control beneficial enjoyment by will, but not a power to accumulate income for disposition by will without the consent of an adverse party;

(4) the power to allocate irrevocably payable income among charitable beneficiaries;⁵

¹CCH, Tax Course, p. 1847.

²IRC Sec. 674(a), CCH, Reporter, p. 44034.

³IRC Sec. 674(b), CCH, Reporter, pp. 44034 to 44035.

⁴IRC Sec. 677(b), CCH, Reporter, p. 44066.

⁵Reg. 1.674(b)-1(b-4), CCH, Reporter, p. 44038.

(5) a power to distribute corpus to a current income beneficiary, provided the distribution is chargeable against the beneficiary's share of corpus and share of future income;

(6) a power to distribute corpus to a beneficiary or class of beneficiaries (whether or not current income beneficiaries) limited to a reasonable standard listed in the trust agreement;

(7) a power to withhold income temporarily, provided that the accumulated income is distributed eventually to the beneficiary, his creditors, or his estate, or that the accumulated income is divided among all income beneficiaries according to an irrevocable standard in the trust agreement;

(8) a power to withhold income during a legal disability of a beneficiary;

(9) a power to allocate receipts to either income or corpus;

(10) a power to add after-born or after-adopted children to the beneficiaries, but not a power to designate any other persons as beneficiaries.

If none of the trustees is the grantor or spouse, then the trustee board may have more powers without causing the trust to be donor-owned. The trustees may have the above listed powers, plus the power to distribute, accumulate, or apportion income among beneficiaries, without meeting the qualifications of (5) and (7) above, if such powers are limited by a reasonable standard in the trust agreement.¹

If none of the trustees is the grantor or spouse, and no more than one-half of the trustees are related or subservient to the

¹IRC Sec. 674(d), CCH Reporter, p. 44035.

grantor, the trustee board may hold still larger powers without causing the trust to be grantor-owned. Additional powers which this independent trustee board may hold include the following:¹

(1) a power to distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries, and

(2) a power to pay out corpus to or for a beneficiary or class of beneficiaries (whether or not this distribution is to current income beneficiaries).

The term "related or subservient to the grantor" includes those persons who are the grantor's spouse (if living with the grantor), father, mother, issue, brother, sister, or any employee of a company which the grantor owns, controls or manages.²

However, if the grantor reserves the right to remove, replace, or add a trustee at anytime, so that the resulting trustee board is less independent than the original board, then the powers that may normally be held by the original board of independent trustees may cause the trust to be grantor owned. A right to replace an independent trustee with another independent trustee does not cause the trust to be grantor-owned.³

It should be noted that reciprocal trusts, which are almost identical trusts established by two grantors with the other as trustee in order to take advantage of the allowable independent trustee powers listed above, are usually found to be invalid, resulting in the Internal Revenue Service declaring the trusts grantor-owned.⁴

¹IRC Sec. 674(c), CCH Reporter, p. 44035.

²Reg. 1.672(c)-1, CCH Reporter, p. 44019.

³Reg. 1.674(d)-2, CCH Reporter, p. 44042.

⁴CCH, Reporter, p. 44045.

Administrative Powers

If the grantor can administer the trust for his own benefit, rather than for the benefit of the beneficiaries, then the trust income is taxable to him. The administrative powers that may be held by the grantor or a non-adverse party that cause the grantor to be taxed on trust income are as follows:

(1) the power to purchase, exchange, deal with, or dispose of the trust assets or income for less than adequate consideration;¹

(2) the power to borrow, directly or indirectly, from the trust without adequate security or interest;²

(3) actual borrowing of the trust corpus or income without complete repayment by the end of the year, unless the loan is provided with adequate security and interest and made by an independent trustee;³

(4) a power to administer the corpus in a non-fiduciary capacity, such as the power to vote stock where the grantor and the trust combined hold a substantial voting control, a power to direct or veto investment of trust funds consisting of interests in business where the grantor and the trust hold substantial voting powers, or the power to reacquire corpus by substituting other assets.⁴

In short, if the grantor can use the trust corpus for his own benefit, such as by renting a trust-owned piece of real estate, he is in danger of creating a grantor-owned trust.

¹IRC Sec. 675(1), CCH, Reporter, p. 44050.

²IRC Sec. 675(2), CCH, Reporter, p. 44050.

³IRC Sec. 675(3), CCH, Reporter, p. 44050.

⁴IRC Sec. 675(4), CCH, Reporter, p. 44050.

Income for the Benefit of Grantor or Grantor's Spouse

Trust income of trusts established after October 10, 1969, is taxable to the grantor if the income is, or at the discretion of the grantor or non-adverse party, 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;
- (3) applied to the payment of life insurance premiums covering the life of the grantor or the spouse;
- (4) used for the support or maintenance of the spouse. However, if the spouse is required to include in his or her gross income the income from the trust, as in alimony or divorce trusts, then the grantor is not taxed on the trust income.¹

As in the case of revocable trusts, the grantor is not treated as owner if these powers cannot be exercised until at least ten years have elapsed from the transfer into the trust and until the grantor can exercise these rights. Additionally, the grantor is taxed only on the portion of the trust income that may be affected by the above powers.²

The donor is not taxed on trust income if any person acting as trustee has the power to apply trust income for the support and maintenance of a beneficiary, other than the grantor's spouse, whom the donor is required to support and maintain, except to the extent that such income is actually used for the beneficiary's support or maintenance.³ Because

¹Reg. 1.677(a)-1, CCH, Reporter, pp. 44066-44067.

²IRC Sec. 677(a), CCH, Reporter, p. 44066.

³Reg. 1.677(b)-1, CCH, Reporter, p. 44070.

the trust income is used to satisfy the donor's legal obligations, the distributions for support or maintenance are for his benefit, and as such are taxed to the donor.

FEDERAL INCOME TAXATION OF THE TRUST

The trust, in the eye of the law, is a legal entity, and as such is capable of owning property and paying taxes just as an individual.¹ This section discusses how trusts are taxed under the Federal Income Tax. A later section discusses the Kansas Income Tax.

Trust income is taxed either to the trust or the beneficiary, unless the trust is considered to be grantor-owned. For the remainder of this chapter, laws, regulations and procedures discussed apply to non-grantor-owned trusts. Beneficiaries are not taxed on distributions of the trust corpus, which are gifts from the donor. Trusts are like partnerships in that they may sometimes serve as non-taxed conduits of income, but unlike partnerships, may in some cases pay taxes.² The trust must report all income on the trustee-filed fiduciary Federal return, Form 1041, deducting income currently distributable, paid or credited to the beneficiaries. This income distribution is taxable to the beneficiary in the year of allocation, retaining the same character as it had in the hands of the trust. The balance is taxable to the trust; thus, trusts are conduits of income only for that income distributed to the beneficiaries.

Trusts are taxed in much the same manner as individuals. They may use any method of accounting that an individual may use. Unlike

¹CCH, Tax Course, p. 1812.

²CCH, Tax Course, p. 1813.

individuals, they may not claim exemptions for dependents, may make unlimited charitable contributions, and are not liable for declarations of estimated tax. If the trust is required to pay out all income currently, it is allowed a \$300 personal exemption; other trusts are allowed only a \$100 exemption; personal exemptions may not be claimed in the year the trust terminates or distributes its assets. A trust is taxed at the same rates as a married individual filing a separate return, using the regular tax computation, and is also liable for the 10% minimum tax on tax preference items.

Trusts are allowed to deduct all expenses that an individual may deduct, with a few exceptions. Trusts engaged in business are required to submit a detailed statement with the Form 1041 showing gross income, deductions, and net income from the business. The trust may deduct trustee fees and expenses, except for those costs incurred when producing tax-exempt income. It is allowed to deduct interest, taxes, depreciation (but not bonus first-year depreciation), and exclude a portion of dividends. It deducts losses in the same manner as an individual, and is allowed the capital gains deduction. Since it has no dependents, it may not deduct medical expenses.

Trusts may claim tax credit for taxes paid in a foreign country, and are allowed to claim investment credit for qualified investments placed in service in the year.¹ The investment credit is limited to the liability for tax due up to \$25,000 plus 50% of the liability over \$25,000. A tax credit of 20% of Work-Incentive Program costs may be claimed, not to exceed the same limits as the investment credit.²

¹IRC Sec. 46., CCH, Reporter, pp. 11151 to 11157.

²IRC Sec. 50A., CCH, Reporter, pp. 11399 to 11401.

A trust may deduct income paid to beneficiaries. In determining this deduction, simple trusts are treated differently than complex trusts. Simple trusts, sometimes called distributable trusts, are required to distribute all current income to the beneficiaries (whether or not the trustee actually does so), do not make charitable contributions, and do not make distributions of corpus. All other trusts are known as complex or accumulation trusts.¹ Accumulation of capital gains, however, does not cause an otherwise simple trust to be considered a complex trust.

In either case, the deduction for distributions to beneficiaries is limited to the amount of distributable net income, minus any distributions of income excludable from gross income (such as tax-exempt interest).

The Distributable Net Income Concept

In general, the distributable net income consists of the same income and expense items as is the taxable net income of the trust. However, certain adjustments are made to taxable net income to arrive at distributable net income. They are as follows:²

- (1) no deduction is allowed for distributions to beneficiaries,
- (2) the personal exemption (\$100 or \$300) is not allowed,
- (3) the dividend exclusion is not allowed,
- (4) the long term capital gain deduction is disallowed, except to the extent that the gains are to be paid or set aside for charities,
- (5) tax-exempt interest is included but reduced by expenses incurred in producing it,

¹Reg. 1.651(a)-1, CCH, Reporter, p. 43173.

²IRC Sec. 643, CCH, Reporter, pp. 43155 to 43156.

(6) capital losses are excluded, except for the amount used in determining the amount of capital gains distributable currently,

(7) capital gains credited to corpus or not required to be paid currently are excluded,

(8) extraordinary dividends or taxable stock dividends allocated to the corpus by the trustee acting in good faith are not included only if the trust is a simple trust.

The distributable net income figure is used in several calculations when determining taxable income. As already mentioned, the deduction for distributions is limited to the amount of distributable net income. It also determines the amount and character of the income distributed and taxed to the beneficiaries.

Several of the limitations on credits or deductions are affected by distributable net income. For example, individuals are entitled to a \$100 dividend exclusion. A trust's exclusion is limited to the ratio of actual distributions to distributable net income times \$100. Similarly, the individual's \$25,000 plus 50% limits on investment credit and WIN credit, and the \$30,000 exclusion for tax preference items are multiplied by the ratio of distributions to distributable net income to arrive at the amount of credit or exclusion available to the trust. Such a reduction in credits, exclusions, and deductions helps prevent multiple trusts created primarily to take advantage of these tax benefits. A beneficiary's limits in these items is not reduced, but must include both trust income distributions and other income when computing limits. For example, a trust has an investment tax credit of \$20,000 and distributes 90% of its distributable net income to its sole beneficiary.

Thus, the trust can claim a credit of \$2,000 and the beneficiary a credit of \$18,000. If the beneficiary has other investment tax credits from other sources, then he may utilize a total investment credit of \$25,000, plus 50% of his tax liability over \$25,000.

Unless modified somewhat by the trust instrument or local law, trust income and expenses retain their character when passing from the trust to the beneficiaries. That is, if income resulting from rentals is distributed, then income is taxed as if it was rental income earned by the beneficiary. Tax-exempt income earned by the trust, if distributed, is tax-exempt to the beneficiaries. This is a corollary of the principle that a trust is a conduit of income.

Incidentally, capital gains distributed to the beneficiaries are treated by them as capital gains. If the capital gains are accumulated for later distribution, tax results depend on to whom the gains are eventually distributed - if to someone other than the grantor, the gains are taxed to the trust (at later distribution, the beneficiary may be subject to a capital gains throwback); if the gains are to be eventually distributed to the grantor, the gains are taxed to the grantor during the current year.

Treasury Regulations specify the following method for allocating revenues, expenses and distribution to each component of distributable net income:¹

(1) allocate to each item of net distributable income expenses specifically associated with that income class;

(2) allocate all other expense items to any of the income classes, not reducing any income class to zero. Moreover, a proportion of these

¹Reg. 1.652(6)-3, CCH, Reporter, pp. 43178 to 43179.

expenses must be allocated to tax-exempt income other than the dividend exclusion;

(3) deduct the amounts determined under (1) and (2) above from the various classes of gross income and assign any excess deductions to other classes of income. However, excess deductions from tax-exempt income may not be offset against other income.

An Example

A trust is required to distribute one-half of its net income to its sole beneficiary, and to distribute or accumulate the income remainder at the trustee's discretion. It has the following income: rental income, \$10,000; dividend income, \$1,000; and interest income (of which \$1,000 is tax-exempt), \$5,000; and the following expenses: rental expense including trustee's fee on rentals, \$4,000; trustee's fee on interest income \$500; and trustee's fee on stock, \$100. During the year it sells a rental house for a long term capital gain of \$1,000, which is allocable to corpus and is eventually to be distributed to the beneficiary's son. The trustee distributed \$10,000 in the current year. Net amounts deemed distributed or accumulated in each income category would be computed as in Table 1. The taxable income and distributable net income are computed in Table 2.

TABLE 1

DETERMINATION OF NET AMOUNTS DISTRIBUTED
AND ACCUMULATED IN VARIOUS INCOME CATEGORIES

	Rental Income	Dividend Income	Taxable Interest	Tax-exempt Interest	Total
Trust Income	\$10,000	\$1,000	\$4,000	\$1,000	\$16,000
Less:					
Rental Expense	4,000				4,000
Trustee Fees	_____	<u>100</u>	<u>400^a</u>	<u>100^b</u>	<u>600</u>
Distributable Net Income	6,000	900	3,600	900	11,400
Net Amounts Deemed Distributed ^c	5,263	789	3,159	789	10,000
Net Amounts Deemed Accumulated ^d	737	111	441	111	1,400

^a(Taxable Interest / Total Interest income) x Trustee fees on interest income = (4,000/5,000) x \$500 = \$400.

^b(Tax-free Interest / Total Interest) x Trustee fees on interest income = (1,000/5,000) x \$500 = \$100.

^c(Total actual distribution / Total distributable net income) x account distributable net income.

^d(Total income accumulation / Total distributable net income) x account distributable net income.

TABLE 2
DETERMINATION OF TAXABLE INCOME
AND DISTRIBUTABLE NET INCOME

	Taxable Income		Distributable Net Income	
Rental Income	\$10,000		\$10,000	
less: expenses	<u>4,000</u>	6,000	<u>4,000</u>	6,000
Dividend Income	1,000		1,000	
less: exclusion ^a	12			
trustee fees	<u>100</u>	888	<u>100</u>	900
Taxable Interest	4,000		4,000	
less: expenses ^b	<u>400</u>	3,600	<u>400</u>	3,600
Tax-exempt Interest			1,000	
less: expenses ^c			<u>100</u>	900
Capital Gains	1,000			
less: long-term capital gains deduction	<u>500</u>	<u>500</u>		
		10,988		
Distribution to Beneficiary 10,000				
less: amount of tax-exempt interest distributed ^d	<u>789</u>			
Personal exemption	<u>100</u>	<u>9,311</u>		
Trust Taxable Income		<u>1,677</u>		
Distributable Net Income			<u>11,400</u>	

^a(Distribution / Distributable net income) x dividend exclusion = 10,000/11,400 x 100 = \$12.

^b(Taxable interest / Total interest) x Trustee fee on interest = (4,000/5,000) x 500 = \$400.

^c(Tax-exempt interest / Total interest) x Trustee fee on interest = (1,000/5,000) x 500 = \$100.

^d(Distribution / Distributable net income) x (Tax-exempt interest - Tax-exempt interest expense) = (10,000/11,400) x (1,000 - 100) = \$789.

INCOME TAXATION OF THE BENEFICIARY

A beneficiary of a trust is taxed on distributed trust income just as if he or she had personally earned the income. Therefore, unless modified by the trust agreement, distributions remain of the same character as if they were in the hands of the trust - in the previous example, \$789 would be net tax-exempt interest, and \$5,263 would be net rental income. This section discusses how beneficiaries are taxed, especially when distributions involve accumulation distributions or distributions from corpus. The throwback rules are also discussed.

A beneficiary of a simple trust reports all income required to be distributed to him (whether or not actually distributed) up to the amount of distributable net income. Amounts distributed over the amount of distributable net income are considered to be from the corpus, and as such are gifts to the beneficiary.¹

A beneficiary of a complex trust is taxed in a more complicated manner, to prevent trusts from accumulating income taxed at low rates for later tax-free distributions, except in certain cases.

A beneficiary of an accumulation or complex trust ...must include in his taxable income the income which is required to be distributed, whether or not it is actually distributed during the taxable year, plus any amounts which are properly paid, credited, or required to be distributed for that year.²

The income remains of the same type as it was in the hands of the trust, and is taxable only to the extent of distributable net income, plus eligible accumulation distributions. Should the required distribution

¹IRC Sec. 652, CCH, Reporter, p. 43176.

²CCH, Tax Course, p. 1832.

exceed the distributable income and eligible accumulation distributions, calculated without the charitable deduction, the excess is not included in the beneficiaries' gross income, allocated among the beneficiaries, as it is considered a gift from corpus.

Beneficiaries of complex trusts are generally taxed under a throwback rule, which subjects the beneficiary to a tax on the accumulated income when distributed. The income is taxed as if the beneficiary had received income when it was accumulated, with certain limitations and a credit for taxes paid.¹ Eventually, beneficiaries will be subject to an unlimited throwback rule, as the time period for throwbacks grows.

An accumulation distribution is defined as the excess of "other" amounts (the actual distribution minus the required distribution) over the amount of distributable net income reduced (but not below zero) by the amount of income required to be currently distributed. Thus, a required distribution can never be an accumulation distribution.² Accumulation distributions are treated on a first in, first out basis, so that the accumulation distribution is considered to be an accumulation from the earliest possible year, to the extent of that previous year's accumulated income.

Accumulation distributions made in any year after December 31, 1973, are taxed as income, if the income was accumulated in any tax year after January 1, 1969. Beneficiaries of trusts making accumulation distributions before January 1, 1974 and who could trace the distributions to income accumulations from taxable years over five years earlier were

¹Reg. 1.665(a), CCH, Reporter, p. 43366.

²Reg. 1.665b-(1A), CCH, Reporter, p. 43372.

not liable for tax on the distributions, leading to trusts that were designed to accumulate income for five years.¹ This loophole was eliminated in the 1969 Tax Reform Act.

Trusts not required to distribute all income currently are also subject to a capital gains throwback rule.² Essentially, all accumulations are considered to be from ordinary income until all ordinary income accumulations are distributed; only then can a distribution be considered to be of capital gains.³ However, trusts established before December 31, 1969, are not subject to this capital gains throwback rule on distributions made before January 1, 1973. Beneficiaries of multiple pre-1970 trusts may apply this exception to only one of their trusts.⁴ Capital gain distributions are, of course, taxed as capital gains to the recipient when distributed, unless the gains are accumulated for eventual distribution to the grantor - they are then taxed to the donor in the year recognized.⁵

Accumulation distributions are treated as though the income had been distributed to the beneficiary in the year the income was accumulated. Income taxes paid by the trust on the accumulation are considered to be distributed to the beneficiary when determining the amount of distribution, and are then allowed as a credit on the tax.⁶

¹See Olson and Gradishar, Saving Income Taxes by Short Term Trusts, for illustrations of tax avoidance under pre-1969 law.

²IRC Sec. 669, CCH, Reporter, p. 43465.

³Reg. 1.665(g)-1A, CCH, Reporter, p. 43383.

⁴Reg. 1.669(f)-2A, CCH, Reporter, p. 43479.

⁵IRC Sec. 667(a)(2), CCH, Reporter, p. 44066 and Reg. 1.671-3, CCH, Reporter, p. 44013.

⁶IRC Sec. 668, CCH, Reporter, p. 43427.

For example, a trust makes an accumulation of \$2,000 on which a tax of \$310 has been paid in an earlier year. Thus, the distribution is considered to be \$2,310 and the taxpayer is allowed a \$310 credit on his return.

The income tax liability of the beneficiary thus consists of his tax on non-trust related income, a partial tax on the trust's regular income distribution, a partial tax on any accumulation distribution, and a partial tax on any accumulation distribution of capital gains.¹ Of course, if the trust has no accumulations, then any excess over distributable net income is a distribution from corpus, and is not taxable. The partial tax on accumulation distributions can be calculated by using either of two alternate methods, the exact or the shortcut method. The exact method determines the tax that would have resulted had the trust distributed the income when earned -- the exact method yields the lowest tax when the beneficiary's early years are his lowest income years.² The shortcut method divides the accumulation distribution by the number of years of the trust, less the number of years when accumulations were less than 25% of distributable net income, and adds this average amount of accumulations to the beneficiary's previous three year's taxable income, and computes the tax on each year's sum of its annual income plus the average accumulation. The average increase in tax for the three years is then multiplied by the number of eligible tax years; the resulting figure is the partial tax on accumulation distributions. The shortcut method gives the lowest

¹Reg. 1.668(a)-3A, CCH, Reporter, p. 43431.

²Reg. 1.668(b), CCH, Reporter, p. 43432.

tax due if the last three years are the lowest income years, but may not be used if accumulation distributions from multiple trusts had been made in a previous year.¹

While the throwback rules effectively plug some of the tax advantages of pre-1969 trusts, especially those of accumulating trust income for at least five years for later tax-free distributions or utilizing the tax-free de minimus \$2,000 distribution,² some economic advantages remain with accumulation trusts. While the tax will eventually be paid, it may be retained in the trust as an earning asset. Essentially, intelligent use of accumulations will not lower the total tax bill, but will delay taxes, allowing the taxpayer to use the government's money interest-free.

TRUST ASPECTS OF THE KANSAS INCOME TAX

The Kansas income tax on the donor, the beneficiaries, or the trust itself is likely to be much less significant than the Federal Income Tax, because of the low Kansas rates. The Kansas taxable income is derived on the Federal taxable income, with a few adjustments and modifications. Subsequently, trusts taxed to the donor by Federal law are also taxed to the grantor for Kansas purposes. This section will discuss the rates of the Kansas Income Tax and the Kansas taxation of both beneficiary and trust; for simplicity's sake, only regulations pertaining to resident beneficiaries and trusts are discussed.

The Kansas Income Tax rates are low compared to the Federal Income Tax rates; Kansas rates are shown on Table 3. Residents are

¹Reg. 1.668(b)-1A(c), CCH, Reporter, p. 43433.

²Reg. 1.665(b)-2A(a), CCH, Reporter, p. 43374.

allowed a \$600 exemption for every personal exemption or dependency exemption allowed on his Federal Tax return,¹ and the trust allowed the same personal exemption claimed on its Federal return.²

TABLE 3
KANSAS INCOME TAX RATES

Taxable Income		Tax on Col. I	Tax on Excess
I From	II To		
0	2,000	0	2%
2,000	3,000	40	3½%
3,000	5,000	75	4%
5,000	7,000	155	5%
7,000	Balance	225	6½%

Source: KSA 79-32,110, KSA 1973 Supp. 79-1946. Rates are those effective on 27 September, 1973.

Kansas Taxation of Trusts

The Kansas taxable income of a resident trust is the same as the Federal taxable income for that trust, with some modifications.³ The trust must add to its Federal taxable income all income that is excluded for Federal purposes but taxed for Kansas purposes, and subtract any income that is taxable for Federal purposes but not for Kansas purposes, to the extent that such items are excluded from the Federal distributable net income.

¹John C. Weeks, compiler and ed., "KSA Sec. 79-32,121," KSA 79-1801, (Topeka, Kans.: Robert R. Sanders, State Printer, 1969), p. 134.

²KSA Sec. 79-32,134, KSA 79-1801, p. 137.

³KSA Sec. 79-32,134, KSA 79-1801, p. 137.

A share of Kansas fiduciary adjustment is also added or subtracted to the Federal Taxable income. The total fiduciary adjustment is simply those items described above that are included in the Federal distributable net income. The total fiduciary adjustment is split between the trust and its beneficiaries in the proportion of the ratio of actual distributions to the distributable net income.¹

Kansas Taxation of a Trust's Beneficiary

A resident beneficiary of a Kansas Trust also modifies its Federal Taxable income as does the trust itself. He or she may add or subtract the balance of the fiduciary adjustment as determined above and the other items either Kansas tax-exempt, Federal taxable or Kansas Taxable - Federal tax-exempt. Of probably the most significance, for Kansas purposes accumulation distributions are tax-exempt.²

SUMMARY

The tax laws allow opportunity for economic gain by splitting income between an owner and someone else. Such a gain is larger if the donor's tax brackets are much higher than the donee's income tax brackets. All non-tax-exempt income is taxed, either to the donor, the beneficiaries, or the trust. Intelligent use of exclusions and deductions could help minimize the tax burden, but throwback rules practically eliminate overall tax savings, but still allow for tax deferral.

Laws naming certain powers that cause a trust to be grantor-owned help eliminate the use of the inter vivos trust as a tax evasion

¹KSA Sec. 79-32, 134, KSA 79-1801, p. 137.

²KSA Sec. 79-32, 117, KSA 79-1801, pp. 131 to 133.

tool. Basically, if the grantor can use the trust corpus or income for his own benefit, control the beneficial enjoyment of the trust income or corpus, or will receive back the corpus in a short time, he will be taxed on the trust income. Such provisions ensure that if the taxpayer does not pay tax on the income, then he does not have control over or access to the income.

Since the 1969 Tax Reform Act and the 1971 Revenue Act, the income tax implications of trusts are basically the same benefits that occur when an outright gift of property, or a gift of an interest in property, is made. Some of the economic impacts of using inter vivos trusts to reduce income taxes instead of outright income-producing gifts are that it becomes possible for the corpus to revert to the grantor after 10 years (although a gift of an income interest for a term certain has the same advantage), that the grantor may retain limited powers (or an independent trustee more general powers) over the use of the gift's income, that the donor will be assured that the gift property will be managed correctly, and that because of exclusions and income-splitting between the trust and the beneficiaries, the advantage of tax deferral could be gained. Essentially, then, the trust allows a donor to give property to those whom he otherwise would not, because of age, mental condition, or managerial ability of the donee. So long as the grantor retains no powers as already mentioned, he may receive the same income tax treatment as would another donor who felt his donees were capable of receiving the gift.

CHAPTER IV

ESTATE AND GIFT TAX IMPLICATIONS
OF INTER VIVOS TRUSTS

An important economic impact of inter vivos trusts is the possibility of removing the trust property from the grantor's gross estate, saving on Federal and Kansas estate and inheritance taxes. Provided that the economic and personal results of effectively removing property from the donor's gross estate are consistent with other economic and personal objectives, the trust can be an effective tool for lowering the estate tax due and thus increasing the after-tax wealth given to the beneficiaries. Since removing wealth from the grantor's estate generally entails making a completed gift, subject to Federal Gift Tax, this chapter will discuss aspects of Federal Gift Tax, the Federal Estate Tax, and the Kansas Inheritance Tax that apply toward inter vivos trusts. The main areas of emphasis in this chapter will be on the nature of estates, inheritance and gift taxes and the regulations and laws that apply toward gift and death taxes. For purposes of clarity, information discussed is limited to the estates of Kansans who are resident citizens of the United States with all property located in Kansas.

THE BASIC STRUCTURE OF ESTATE,
INHERITANCE, AND GIFT TAX

The Federal Estate Tax is an excise tax levied on the transfer of a decedent's property to his heirs or beneficiaries. It is not a property tax or a tax on the privilege of an heir to receive property.¹

¹Commerce Clearing House, Inc., 1974 Federal Tax Course (Chicago, New York, Wash. D.C.: Commerce Clearing House, Inc., 1973) p. 2803.

It is a progressive tax with rates ranging from 3% on taxable estates of less than \$5,000, to 77% on taxable estates of over \$10,000,000. Rates are not affected by the number or relationship to the decedent of the beneficiaries. A credit is allowed for a limited amount of state death taxes paid, and a credit allowed for gift taxes unnecessarily paid on property included in the decedent's gross estate.

The Kansas Inheritance Tax, on the other hand, is a tax on the privilege to receive property from a decedent.¹ Its effective rates and exemptions do vary according to the number and the relationship to the decedent of the beneficiaries. Rates vary from $\frac{1}{2}\%$ on taxable bequests and devises of less than \$25,000 passing to the decedent's spouse to 15% of taxable bequests and devises over \$200,000 passing to a non-related person. If the Kansas Inheritance Tax does not equal or exceed the credit for state death tax on the Federal Estate Tax, the Kansas lawmakers thoughtfully provide for a Kansas Estate Tax, equal to the difference between the total Kansas Inheritance Tax and the allowable Federal credit for state death taxes.

The gift tax is a Federal excise tax (Kansas does not have a state gift tax) on transfers of property from one individual to another; it is not a property tax,³ and is payable by the donor.⁴ It is a

¹Samuel E. Bartlett, Kansas Probate Law and Practice (rev. ed., Kansas City, Mo.: Vernon Law Book Company, 1953), p. 407.

²John C. Weeks, compiler and ed., "KSA Sec. 79-1501" KSA 75-101 (Topeka, Kans.: Robert R. Sanders, State Printer, 1969), p. 411.

³CCH, Tax Course, p. 2849.

⁴Treasury Regulation 25,2511-1, cited by Commerce Clearing House Inc., Federal Tax Guide (Chicago, New York, Washington D.C.: Commerce Clearing House, Inc., 1973), p. 37816.

cumulative and progressive tax; taxable gifts push gifts in later years into higher percentage tax brackets. The tax is 3/4 of the Federal estate tax, rates thus running from 2 1/4% on taxable gifts of less than \$5,000 to a maximum of 57 3/4% on taxable gifts of over \$10,000,000. Therefore, the gift tax serves as both an economic incentive and a deterrent to life-time gift giving. It is a deterrent in that a tax may be imposed on a donor benefitting others or reducing his gross estate; it is an incentive in that the first property given is transferred from the highest estate tax brackets to the lowest gift tax brackets,¹ and may even be made gift tax-free because of exemptions, deductions and exclusions.

While the death and gift taxes can result in severe erosion of accumulated wealth in certain instances, in terms of the governmental units assessing the taxes, they are not large revenue producers. In 1972, \$5.4 billion² and in 1973, \$4.9 billion³ in estate and gift taxes were collected by the Federal government. While large in absolute amounts, they comprised only 2.58% in 1972 and 2.11% in 1973 of all Federal government receipts. In the fiscal year ending June 30, 1972, Kansas collected \$9.38 million in death taxes, only 1.787% of its total budget.⁴

¹CCH, Tax Course, p. 2849.

²U.S. Superintendent of Documents, The Budget of the United States Government, 1974 (Washington, D.C.: U.S. Government Printing Office, 1973), p. 61.

³The Budget of the United States Government, 1975 (Washington, D.C.: U.S. Government Printing Office, 1974), p. 45.

⁴Commerce Clearing House, State Tax Guide (Chicago, New York, Washington, D. C.: Commerce Clearing House, 1973), p. 515.

GIFT TAX REGULATIONS THAT APPLY TO
INTER VIVOS TRUSTS

Gift tax laws provide for certain exclusions, deductions and exemptions that may lessen or entirely eliminate any tax due on gifts. Certain of these exclusions are available only if the gift is a present interest¹ -- trusts often involve gifts of future interests. In order to minimize the taxability of gifts and to determine the gift tax consequences of transfers into an inter vivos trust, gift tax laws relating to the trust must be understood. This section discusses the general economics of gift taxation and areas of gift tax laws that pertain especially to trusts.

The gift tax laws provide that completed and irrevocable transfers (those with no actual or constructive rights retained by the grantor with certain exceptions), in trust or otherwise, are taxable to the extent not supported by adequate and full consideration in money or money's worth, at gift tax rates, with certain exemptions, deductions, and exclusions.² Every taxpayer is entitled to give away, without using his \$30,000 specific lifetime exemption, up to \$3,000 to each donee every year gift tax-free, if the gift is not a future interest.³ A future interest is an interest in which the donee can enjoy the property only after a passage of time or after a certain event occurs.⁴ It has been held that each beneficiary of a trust is also a donee⁵ -- if

¹Internal Revenue Code Sec. 2503(b), cited by CCH, Guide, p. 4498.

²Reg. 25.2511-1, CCH, Guide, p. 37816.

³Reg. 25.2503-2, CCH, Guide, p. 37813.

⁴IRC. Sec. 25.2503-3, CCH, Guide, p. 37814.

⁵Com. V. Hutchings, 41-1, USTC para. 10,026, 312 U.S. 393 and Early V. Reid, 41-1, USTC para. 10,033, 312 U.S. 661, cited by CCH, Tax Course, p. 2857

a trust has three beneficiaries, and the gift in trust is a present interest, the donor can claim an annual exclusion of up to \$3,000 for each beneficiary, or up to \$9,000, if the beneficiaries share the gift equally and the gift is worth more than \$9,000.

If the taxpayer is married, the taxpayer and spouse may elect to "split" the gifts made,¹ so that the couple may elect to give \$66,000 to one beneficiary completely tax-free in one year (husband's 30,000 specific exemption plus wife's 30,000 specific exemption plus husband's 3,000 annual exclusion plus wife's 3,000 annual exclusion). A 50% deduction is allowed for inter-spouse transfers,² meaning a taxpayer may give up to \$6,000 to his spouse each year for any number of years. Obviously, the economic result of these exclusions and exemptions is that the more donees one gives to, and the more tax years gifts are spread over, the more one may give gift tax-free.

Transfers Not Subject to Gift Tax

Gifts are taxable only if they are complete. The tax regulations state:

...any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending on all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.³

¹Reg. 25.2513-1, CCH, Guide, p. 37825-9.

²Reg. 25.2511-2 (b), CCH, Guide, p. 37819.

³Reg. 25.2511-2(b), CCH, Guide, p. 37819.

Subsequently, a transfer into trust with a reserved power to revoke at any time is not a taxable gift; however, the relinquishment of this power is a gift subject to possible gift tax.¹ If there is any possibility that the gift interest may be taken away from the donee by the grantor, then the gift is not complete. Thus, if the grantor can change the beneficiaries of the trust or alter their proportionate share, unlimited by a fixed or ascertainable standard, no gift has been made.² However, if the grantor retains only a power to change the manner or time of enjoyment of the interest, (for example, the power to accumulate income for later distribution to the income beneficiary), a completed gift has been made.³

If the grantor can invade income or corpus for his own benefit no gift has been made. However, if the grantor can invade only a part of the trust, only that part would be considered an incomplete gift. If the grantor holds a reversionary interest, the gift then consists of the total value of the corpus minus the value of the grantor's reversionary interest, actuarially computed as explained later. Thus, if the grantor declares himself trustee with no reversionary interests, powers to revoke, powers to affect beneficial enjoyment, or other powers over the trust, except fiduciary powers, and a power to allocate income among beneficiaries limited by a reasonable and ascertainable standard, then a completed gift has been made,⁴ even

¹Burnet V. Guggenheim, 3 USTC para. 1043, 288 U.S. 280, cited by CCH, Tax Course, p. 2815.

²Reg. 25.2511-2(c), CCH, Guide, p. 37819.

³Reg. 25.2511-2(d), CCH, Guide, p. 37819.

⁴Reg. 25.2511-2(g), CCH, Guide, p. 37820.

though such a trust income would be taxable to the grantor because of the power to allocate income.

If a transfer into trust is not deemed complete, and because of the overlap with the laws declaring certain trusts to be grantor-owned, any income actually distributed to the beneficiary would be taxed to the grantor and treated as a gift to the beneficiary.

Future Interests

As already mentioned, in order for a gift to qualify for the \$3,000 annual exclusion, it must not be a future interest, with an exception to be mentioned later. A future interest is:

"a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at a future date or time...."¹

but not outright gifts of notes, bonds or life insurance. It should be noted that a future interest can be a completed gift, subject to tax without the annual exclusion, or it may be an incomplete gift, not subject to gift tax. Thus, a gift from C in an irrevocable trust with income for life to A and at A's death, corpus to B, would be a completed gift, subject to the \$3,000 exclusion for A's present income interest, but not for B's future remainder interest.

If the grantor or trustee holds a power in a trust to withhold payments from a beneficiary, provided the beneficiary will eventually receive the accumulations, a transfer into this trust is a completed gift but not a present interest, as the beneficiary's enjoyment of

¹Reg. 25.2503-3, CCH, Guide, p. 37813.

the trust income may be delayed. Similarly, if the grantor's son acting as trustee has a power to allocate proceeds between beneficiaries without regard to a standard, no annual exclusion can be taken. In such a case, the income will be taxed to the grantor¹ even though the gift is complete and subject to gift tax,² because of the related trustee's unlimited allocating powers.

Section 2503(c) provides an exception to the rule of disallowing the annual exclusion for gifts of future interests. Gifts in trust for minors are not considered as gifts of future interests if the following conditions are met:

(1) both the corpus and the income may be expended for or by the donee before he reaches the age of 21 years, (2) the corpus or accumulated income will pass to the beneficiary at age 21, and (3) if the beneficiary dies before age 21, the corpus and any accumulations will be paid to his estate or his appointees.³

Trusts that qualify under this section are known as Section 2503(c) trusts. They are advantageous in that income may be accumulated if the minor has no need for the money (and may waste his income if distributed) and the advantage of the \$3,000 exclusion retained. If the donor feels that the beneficiary will not have enough business acumen to manage his gift, or will waste the distribution at age 21, he may provide that only accumulated income be distributed at age 21, with the corpus distributed at a later time; in such a case, only

¹Reg. 674(d)-1, cited by Commerce Clearing House, Standard Federal Tax Reporter (Chicago, New York, Washington D.C.: Commerce Clearing House, 1973), p. 44041.

²Reg. 25.2503-3, CCH, Guide, p. 37814.

³Reg. 25.2503-4, CCH, Guide, p. 37814.

the income interest is subject to the annual exclusion, as the possession of the corpus may be delayed, and so is a future interest.¹

Valuation of Gifts

In general, the value of a gift is the fair market value of the property transferred, less any money or money's worth received.²

Basis for capital gain remains same as the basis of the transferor increased by any gift tax paid,³ but the basis for capital loss is the lower of the donor's basis or the fair market value of the property when given.⁴

A problem arises when income interests, remainders, or reversions are given in trust, as these interests in the same property may be given to different beneficiaries. The Tax Reform Act of 1969 modified the procedure that was used for valuating assets before December 31, 1970; this paper discusses those valuation procedures for properties transferred after December 31, 1970. Essentially, the valuations are based on life expectancies and a discount rate of 6%. The gift tax regulations⁵ show tables giving factors for various ages and term certain; the taxpayer simply finds the factor corresponding to the age of the person determining the life estate (or the length of the term certain) and the type of interest held (income or remainder) and multiplies the value of the trust corpus by

¹Reg. 25.2503-4(c), CCH, Guide, p. 37815.

²Reg. 25.2512-1, CCH, Guide, p. 37819-3.

³Reg. 1.1-15-5, CCH, Guide, p. 36169.

⁴Reg. 1.1015-1, CCH, Guide, p. 36167-2

⁵Reg. 25.2512-9, CCH, Guide, p. 37825-6 to 37825-8.

the appropriate factor. The factor for a remainder interest is simply one discounted at 6% for the life expectancy of the person determining the life estate or the length of the term certain, and the income interest factor equal to a corpus yield of 6% discounted at 6%, or one minus the remainder factor. Thus, the sum of the value of income interest and the value of remainder interest equals the fair market value of the corpus.

For example, A transfers \$10,000 worth of stock into an irrevocable trust for B, his 65-year-old mother, with all ordinary income paid to B for life and corpus distributed at B's death to C. The factor for a life estate of a 65-year-old female is 0.55803, so the value of the income interest is $0.55803 \times \$10,000$ or \$5580.30, subject to the annual exclusion of \$3,000. The factor for a remainder interest of a life estate of a 65-year-old female is 0.44197,¹ so the remainder interest is valued at \$4419.70, a future interest, and the \$3,000 annual exclusion denied.

If the trust corpus yields more than 6% the donor pays less gift tax on the income interest than if the actual gift to the income beneficiary could be determined. Thus, if some property is expected to yield more than 6%, an economic advantage may result by transferring the property into trust, rather than giving the income as it is earned, and paying the gift tax on the actual gift. Of course, the \$3,000 annual exclusion for each year of the gift would not be available if the entire interest was given in one year.

¹Reg. 25.2512-9, CCH, Guide, p. 37825-7.

If the remainder interest depends upon two or more lives, or is dependent upon the surviving of some other persons, the Internal Revenue Service will supply, on request, factors to be used when valuating the income and remainder interests. The Service suggests that many of these special factors may be found in or derived from the publications "Actuarial Values I: Valuation of Last Survivor Charitable Remainders," and Actuarial Values II: Factors at 6 Percent Involving One and Two Lives."¹

Summary of Gift Tax Regulations

The taxpayer may be liable for a gift tax whenever he makes a completed gift, in trust or otherwise. A completed gift occurs when the donor retains no right to revoke or receive benefit from the gift property. The donor may retain a reversionary interest, and make a taxable gift of a life estate or a term certain income interest, or may give away the reversionary interest.

The Code and Regulations allow several exemptions, deductions, and exclusions that may significantly lower the amount of gift tax due. In order to qualify for the \$3,000 annual exclusion, however, the gift must be a present interest, not contingent on a passage of time or a future event, or upon a trustee's discretion to allocate income between beneficiaries.

Gifts in trust are valued for gift tax purposes at their fair market value when the gift is completed. Values for remainders, life estates, or term certain are computed at a 6% discount rate and standard mortality tables.

¹Obtainable from Superintendent of Documents, U.S. Government Printing Office, Washington D.C. 20402.

FEDERAL ESTATE AND KANSAS INHERITANCE REGULATIONS
THAT APPLY TOWARD INTER VIVOS TRUSTS

Generally, any property or interest that is owned by a decedent is included in his gross estate. Thus, the decedent's gross estate can be vastly larger than his probated estate, as property held in continuing trusts, property held in joint tenancy, retained remainders, life estates, or contingencies defeated at death do not pass through probate, but may be included in the decedent's gross estate. As mentioned in Chapter II, it is rather easy for an inter vivos trust to escape probate's cost and legal complexities. It is much more difficult to insure that property placed in trust will avoid death taxes. Accordingly, the remainder of this section will discuss powers and rights that cause trust property to be included in the grantor's (or some other person's) gross estate, with a short explanation of the Kansas Inheritance and Federal Estate Tax deductions and credits.

Federal Estate Tax Deductions and Credits

As already mentioned, the Federal Estate Tax is a progressive tax, with rates running from 3% on taxable estates if under \$5,000 to 77% on taxable estates of more than \$10,000,000. The taxable estate is the decedent's gross estate reduced by allowable deductions and the specific exemption; the tax payable may be reduced by certain tax credits.

The estate is allowed to deduct from the gross estate the decedent's debts, accrued interest on debts, administration expenses, and funeral expenses.¹ It may deduct theft and casualty losses²

¹Reg. 20.2053-1, CCH, Guide, p. 37663.

²Reg. 20.2054-1, CCH, Guide, p. 37671-3.

and public, charitable and religious contributions.¹ If property passes to the decedent's spouse, in trust or otherwise, the estate is allowed a marital deduction, limited to the lower of the value of the property passing to the spouse or one-half of the gross estate reduced by expenses and debts, providing the property interests passed to the spouse are not non-deductable interests.

A non-deductable interest is an interest not included in the present decedent's gross estate, a payment to the spouse to satisfy the decedent's deductible debt to the spouse, an interest that sustained a casualty or theft loss during the estate administration (to the extent of the theft or loss) or a terminable interest. A terminable interest is defined as an interest that will end at the end of a period of years or when an occurrence does or does not occur; examples of terminable interests are life estates or term certain income interests. However, if the spouse possesses a power of appointment over the interest, it then becomes eligible to be part of the marital deduction.²

Every estate of a U.S. citizen or resident is allowed a \$60,000 specific exemption.³ Thus, estates whose gross value is less than \$60,000 are not required to file Form 706, the Federal Estate Tax return. This \$60,000 exemption is deducted after debts and expenses are paid and the marital deduction taken. Estates of up to \$120,000 after debts and expenses, of which at least one-half

¹Reg. 20.2055-1, CCH, Guide, p. 37671-3.

²Reg. 20.2056, CCH, Guide, p. 37675.

³Reg. 20.2052-1, CCH, Guide, p. 37663.

pass to the spouse, are not liable for estate tax, but must file Form 706.

The estate tax may be reduced by certain tax credits. These credits include credit for gift taxes paid unnecessarily and a credit for estate taxes on property received from another decedent, depending upon the length of time the property was owned by the present decedent. The Internal Revenue Service allows a state death tax credit for state death taxes paid, up to a limit.¹ In Kansas, the maximum amount of the credit will be claimed by the state, so that this credit will be fully utilized.²

Kansas Inheritance Tax Deductions and Credits

The Kansas gross estate is essentially composed of the same property as is the Federal gross estate, except that it includes only that property within the jurisdiction of the state.³ The Kansas tax rates and exemptions depend upon the size of the estate and the relationship of the devisees and legatees to the decedent. The rates are as shown in Table 4.

Kansas Class A beneficiaries are the decedent's spouse, linear ancestors, linear descendants, adopted children, and spouses of children (natural or adopted). The spouse is allowed a larger exemption and taxed at rates of one-half of the other Class A beneficiaries. Class B beneficiaries are the brothers and sisters of the decedent, while Class C consists of anyone not included in Class A or B.⁴

¹Reg. 20.2053-9, CCH, Guide, p. 37669.

²KSA Sec. 79-1501, KSA 75-101, p. 411.

³KSA Sec. 79-1501, KSA 75-101, p. 409.

⁴KSA Sec. 79-1501, KSA 75-101, p. 409.

TABLE 4
KANSAS INHERITANCE TAXES

Class of Beneficiary	Spouse	A	B	C	
Exemption to each member of class	75,000	15,000	5,000	0	
Tax rate on amount over exemption:					
From	To				
0	25,000	½%	1%	3%	10%
25,000	50,000	1	2	5	10
50,000	100,000	1½	3	7½	10
100,000	200,000	2	4	10	12
200,000	500,000	2	4	10	15
500,000	Balance	2½	5	12½	15

Source: KSA Sec. 79-1501, KSA 75-101, p. 410. Rates are those effective January 1, 1972.

Kansas law provides that the funeral expenses, estate administration fees, the Federal Estate Tax, and the decedent's debts be paid out of the estate and deducted from the gross estate.¹ Any distribution to an heir of less than \$200 above the allowed exemption is not taxed.² Obviously, because of the generally lower rates, the Kansas Inheritance Tax is less likely to place a tax burden on the estate than is the Federal Estate Tax, and is a lesser, though real, incentive to remove property from one's estate.

¹John C. Weeks, compiler and ed., "KSA Sec. 59-1301," KSA 48-101 (Topeka, Kans.: Robert R. Sanders, State Printer, 1969), p. 349.

²KSA Sec. 79-1501, KSA 75-101, pp. 409-410.

Interests Included in the Gross Estate

Any property owned outright by the decedent is included in his gross estate, valued at its fair market value at the time of death or alternatively, six months after death or at time of sale, whichever occurs first, for both Federal¹ and Kansas purposes.² The Internal Revenue Service prescribes special rules for evaluating notes, business interests, personal belongings, options, or assets where the fair market value is hard to determine.³

Since trust assets are not usually owned outright by the beneficiaries or the grantor of a trust, determination and valuation of trust interests becomes more complex. The remainder of this chapter discusses the types of interests that may be included in a beneficiary's estate, the valuation of such interests, and the interests or powers retained by a grantor that cause some portion of the trust corpus to be included in his gross estate.

Transfers in Contemplation of Death

If the decedent transfers property or property interests for less than adequate consideration within 3 years of death for Federal purposes⁴ or 1 year of death for Kansas purposes,⁵ the transfer may be deemed by the taxing authorities as in contemplation of death and includable in the decedent's gross estate. The estate must prove

¹Reg. 20.2032-1, CCH, Guide, p. 37635-9.

²John C. Weeks, compiler and ed., "KSA Sec. 79-1504," KSA 1973 Suppl. 75-112 (Topeka, Kans.: Robert R. Sanders, State Printer, 1973), p. 198.

³Reg. 20.2031, CCH, Guide, pp. 37627-5 to 37631.

⁴Reg. 20.2035-1, CCH, Guide, p. 37639.

⁵KSA Sec. 79-1501, KSA 75-101, p. 410.

that the decedent transferred the interest with life-associated motives rather than with death-associated motives.¹ This provision also applies to releases of interests, such as a release of a power of revocability. For the remainder of this chapter, results of transfers and releases of powers, unless otherwise mentioned, are those results as if the gift is not in contemplation of death.

Interests That are Includable in a Beneficiary's Gross Estate

In this subsection, the term beneficiary shall exclude the grantor; that is, any interest discussed here is an interest received from some other person, not an interest retained when giving other interests to another person. Taxability of interests retained from prior gifts is discussed later.

Any interest which ends at the death of a beneficiary is excludable from the beneficiary's gross estate.² Thus, trusts in which the income beneficiary's estate has no rights or powers affecting the trust after his death are not includable in the decedent's gross estate. A special purpose trust, called a Grandfather trust, utilizes this provision to "skip generations." This type of trust provides that the trust income be paid to the grantor's children and the corpus distributed to the grandchildren at some specified age or time. Such a trust provides income for the children's life and allows the corpus to pass to the grandchildren without inclusion in the children's estates, increasing the after-tax wealth of the grandchildren.

¹Reg. 20.2035-1(d), CCH, Guide, p. 37640.

²W. E. Frew, Exr. (Est. of W. A. Nash) V. Bowers, CA-2 1 USTC para. 181, 12F. 2d 625, cited by CCH, Tax Course, p. 2807.

Interests which are defeated by the beneficiary's death are also excluded from the beneficiary's gross estate. For example, G establishes a trust with income to W, his wife, for life, with remainder to S, his sister. If S dies before W, then remainder passes at W's death to N his nephew, or N's estate. Thus, if W dies first, the corpus passes to S, and is not included in W's estate. If S dies first, her interest is defeated and so none of the trust corpus is included in her estate.

Suppose S dies first, then N. The value of the remainder interest, since it will sometime pass to N's estate, is included in N's gross estate. Remainders and contingencies not defeated by the beneficiary's death are included in his or her gross estate.¹

If the beneficiary-decedent possessed a general power of appointment over some interest held in trust, then that interest is included in the beneficiary's gross estate. A general power of appointment is a power given to the decedent by someone else.¹ Thus, a power to designate remaindermen of a life estate is a general power of appointment, if the life estate was given to the powerholder, as is a beneficiary-held power to alter, revoke, modify or terminate a trust. However, if the power of appointment is exercisable only with the grantor or an adverse party, or if limited to an ascertainable standard relating to the health, maintenance, education or support of the decedent, then the power will not cause inclusion of

¹Est. of J. G. Frazer V. Com., (CA-3) 47-1 USTC para. 10,562, 162.F.2d 167, cited by CCH, Tax Course, p. 2807.

²Reg. 20.2041-1, CCH, Guide, p. 37651.

the trust in the beneficiary's estate.¹ A power of appointment released, exercised or allowed to lapse in contemplation of death would be included in the decedent's gross estate.

Valuation of Limited Interests and Contingencies

The valuation of remainders, life estates, and contingencies is established in much the manner for Federal purposes as is the valuation of such interests for Gift Tax purposes -- the value is the fair market value at time of death or the alternative valuation date² multiplied by a factor based on a 6% discount rate and a life expectancy table. For example, in the above case where S died before N, if W was 37 years old, the factor for the remainder would be .13651.³ If the fair market value of the corpus was \$10,000, \$1,365.10 would be included in N's gross estate.

For Kansas purposes the valuation procedure is somewhat different. The value of a life estate (depending upon the life of another) or a term certain not defeated by death is determined by using the "American experience tables" (a mortality table) and a five percent discount rate. A remainder interest is determined by subtracting the discounted value of the outstanding life estate or term certain from the fair market value of the property at the beneficiary's death or alternate valuation date.⁴ Thus for Kansas purposes, the value of a contingency or remainder would be higher than for Federal purposes, because of the lower discount rate.

¹Reg. 20.2041-3(c), CCH, Guide, pp. 37652 to 37653.

²Reg. 20.2032-1-(f) (1), CCH, Guide, p. 37638.

³Reg. 20.2031-10, Table A(2), CCH, Guide, p. 37635-6.

⁴KSA 79-1504, KSA 75-101, p. 198.

Interests that are Includable in the Donor's Gross Estate

The tax laws are designed to prevent people from giving away their property during life yet still using the property until death, and escaping death taxes. The Treasury has developed rules for determining the powers that must be given up by the donor so as to exclude the gift property from his gross estate. If one of the objectives of the trust is to remove all or part of the corpus from the grantor's gross estate, these rules must be carefully studied and the desirability of retaining certain powers balanced against estate taxes resulting from retaining these powers.

The decedent's gross estate includes any property or property interests transferred for less than adequate consideration from which the decedent reserved or retained the use, income, or enjoyment for his life, for a period undeterminable without reference to his death, or for a period that had not ended before his death.¹ If the donor of a trust reserves the corpus or income to himself or his dependents or retains a power so that he may apply the corpus for his personal benefit, the trust corpus will be included in his gross estate. Similarly, if the donor can designate or change beneficiaries either with or without the consent of an adverse party, the corpus is includable in his gross estate. Thus, if the donor can use the corpus for his own benefit, or alter the trust benefits to others, then the portion of corpus over which he has this power is included in his gross estate.

If the donor retained an interest in the trust so that the property could return to the donor or his estate (or be subject to

¹Reg. 20.2036-1(d), CCH, Guide, p. 37640.

a power of disposition by the donor) if the beneficiary would not outlive the donor, and if this interest exceeded 5% of the corpus value, the entire value of the corpus would be included in the grantor's estate. If the value of the reversion did not exceed 5% of the corpus value, then only the actual value of the reversion would be included.¹ The value of the reversion is calculated in the same manner as already explained, using a table based on a 6% discount rate and life expectancies. Note that under this provision only corpus reversions to the donor are included in the donor-decedent's gross estate. Then if A establishes a trust with an income interest to B for A's life, and at A or B's death the corpus distributed to C, the corpus would not be included in A's gross estate, regardless of when either A or B died.

If the donor retains or possesses a power, either alone or with some person, to alter, amend, revoke or terminate the trust, then the property subject to this power is includable in the donor's gross estate.² This provision applies even if the donor had to give prior notice of his intention to alter the enjoyment and that notice had not been given at death. It applies even if the grantor has no possibility of ever applying the corpus or income for his own benefit, or if there exists a possibility that the grantor could later be named trustee with powers to alter the enjoyment of the trust. Thus, all revocable trusts and trusts with the donor, in any capacity, having the power to change the beneficial enjoyment of the trust are includable

¹Reg. 20.2037-1, CCH, Guide, p. 37641

¹IRC Sec. 2038, CCH, Guide, p. 4467.

in the donor's gross estate. For example, a trust, in which the grantor, acting as co-trustee, has a power to accumulate income, is included in the grantor's gross estate, because he retained the power to deny the beneficiaries the right to immediate enjoyment of the trust income.¹

EXAMPLE OF DEATH AND GIFT TAXES,
WITH THREE DIFFERENT SIZED ESTATES

To help illustrate the magnitude of gift and death taxes and the differential impacts of inter vivos trusts on taxpayers of different wealth levels the following example is given:

Mr. Brown, age 65, is a widower, with 3 married sons, age 23, 28 and 36. He knows that death taxes are significant, but he feels that he must not deprive himself of an independent income in his old age. He feels his sons are fine people, but fears that they will want to sell gift property to which he has sentimental ties. He decides that he would rather have all of his wealth pass through probate and be estate taxed than give some property to his sons and have them sell it or mismanage it during his life. He has used none of his \$30,000 lifetime specific exemption and has made no gifts this year.

In order to accomplish his objectives, he sets up the following estate plan: He establishes an inter vivos trust with his three sons as life income beneficiaries. At each son's death, the son's share of the corpus is to be distributed to his estate. Mr. Brown elects to place one-half of his estate into this trust in the current

¹U.S. V. C. E. O'Malley, Su. Ct., 66-1 USTC para. 12388, 383 U.S. 627., cited by CCH, Tax Course, p. 2813.

year, and names his local bank and his neighbor Joe Smith as co-trustees. He retains no powers that would cause the trust to be grantor-owned.

The rest of his property he decides to dispose of by will. He plans to leave one-fifth of his remaining estate to Sam Jones, a life-time friend, and four-fifths of his remaining estate to his sons, outright.

Five years after the trust was established, Mr. Brown dies and his property distributed as he wished. His funeral expenses, administration expenses, and other expenses were \$3,000, and his property had not appreciated or depreciated since the date he established the inter vivos trust.

To help illustrate the differential effects of removing property from the decedent's estate -- had the inter vivos trust not been available, Mr. Brown would have retained all his estate to his death -- the gift and death tax costs will be calculated for both the plan using the inter vivos trust and the plan without the inter vivos trust, at three different estate sizes. To help emphasize the tax-saving impacts of the trusts, it is assumed that only one-tenth of Mr. Brown's estate would pass to Mr. Jones if Mr. Brown had died without establishing the inter vivos trust. Table 5 traces through the death tax computations if Mr. Brown had died without establishing an inter vivos trust, while Table 6 computes both gift and death taxes had Mr. Brown established the trust for his sons. Tax savings are shown at the bottom of Table 6.

TABLE 5

ESTATE TAX EFFECTS ON THREE EXAMPLE ESTATES
WITHOUT USING AN INTER VIVOS TRUST

Mr. Brown's wealth at start	\$120,000	\$420,000	\$1,200,000
<u>Federal Estate Tax computation</u>			
Gross Estate:	120,000	420,000	1,200,000
less: expenses	3,000	3,000	3,000
Exemption	<u>60,000</u>	<u>60,000</u>	<u>60,000</u>
	63,000	63,000	63,000
Taxable Estate	57,000	357,000	1,137,000
Tax on 50,000	7,000		
7,000@ 25%	1,750		
250,000		65,700	
107,000@ 32%		34,240	
1,000,000			325,700
137,000@ 39%			53,430
Tax before state death tax credit	<u>8,750</u>	<u>99,940</u>	<u>379,130</u>
State death tax credit credit on 40,000	0		
17,000@ 0.8%	136		
240,000		3,600	
117,000@ 3.2%		3,744	
1,040,000			38,800
97,000@ 6.4%			6,208
Total credit	<u>136</u>	<u>7,344</u>	<u>45,008</u>
Total Federal Tax	<u>8,614</u>	<u>92,596</u>	<u>334,122</u>
<u>Kansas Inheritance Tax computation</u>			
Total Kansas Taxable Estate	108,386	324,404	862,878

TABLE 5 (Continued)

Amount passing to Jones	10,839	32,440	86,287
Tax on 10,839@ 10%	1,084		
32,440@ 10%		3,244	
86,287@ 10%			<u>8,629</u>
Tax on transfer to Jones	<u>1,084</u>	<u>3,244</u>	<u>8,629</u>
Amount passing to sons	97,547	291,964	776,680
Amount to each son	32,515	97,321	258,893
Exemption	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>
Taxable amount passing to each son	17,515	82,321	243,893
Tax on 17,515@ 1%	175		
25,000@ 1%		250	250
25,000@ 2%		500	500
32,321@ 3%		970	
50,000@ 3%			1,500
143,893@ 4%			<u>5,756</u>
Tax on transfer to each son	175	1,720	8,006
Tax on transfers to sons	525	5,160	24,018
Total Kansas Inheritance Tax	1,612	8,404	32,647
Kansas Estate Tax	0	0	12,361
Total Kansas Death Tax	<u>1,612</u>	<u>8,404</u>	<u>45,008</u>
Total Federal and State death taxes	<u>10,226</u>	<u>101,000</u>	<u>379,130</u>
Estate remaining after taxes	109,774	319,000	817,870
Percent of estate remaining after taxes	<u>91.5%</u>	<u>76.0%</u>	<u>68.1%</u>

TABLE 6
GIFT AND DEATH TAX EFFECTS ON THREE
EXAMPLE ESTATES USING INTER VIVOS TRUSTS

Mr. Brown's wealth at start	\$120,000	\$420,000	\$1,200,000
<u>Computation of Federal Gift Tax</u>			
Amount given into trust	60,000	210,000	600,000
Amount deemed present interest:			
For 23 yr.-old son (factor = .90292)	18,058	63,204	180,584
For 28 yr.-old son (factor = .87926)	17,586	61,548	175,852
For 30 yr.-old son (factor = .86750)	<u>17,350</u>	60,725	<u>173,500</u>
Total present interests	52,994	185,477	529,936
Amount deemed future interest:			
For 23 yr.-old son (factor = .09708)	1,942	6,796	19,416
For 28 yr.-old son (factor = .12075)	2,415	8,452	24,150
For 30 yr.-old son (factor = .13250)	<u>2,650</u>	<u>9,275</u>	<u>26,500</u>
Total future interests	7,007	24,523	70,066
less:			
Annual exclusion	9,000	9,000	9,000
Specific exemption	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>
Total taxable gift	<u>21,000</u>	<u>39,000</u>	<u>39,000</u>
Gift Tax on:			
20,000	1,200		
1,000@ 10½%	105		
100,000		15,525	
71,000@ 22½%		15,975	
500,000			109,275
61,000@ 26¼%			<u>16,012</u>
Total Gift Tax	<u>1,305</u>	<u>31,500</u>	<u>125,287</u>

TABLE 6 (Continued)

<u>Federal Estate Tax Computation</u>					
Estate remaining after Trust is established	60,000		210,000		600,000
Estate remaining after Gift tax is paid	58,695		178,500		474,713
Gross Estate	58,695		178,500		474,713
less: expenses	3,000	3,000		3,000	
Specific exemption	<u>60,000</u>	<u>63,000</u>	<u>60,000</u>	<u>63,000</u>	<u>63,000</u>
Taxable Estate	0		115,500		411,713
Tax on 100,000		20,700			
15,000@ 30%		4,650			
250,000				65,700	
161,713@ 32%				<u>51,748</u>	
Tax before state death tax credit		<u>25,350</u>	25,350		117,448
State death tax credit on 90,000		400			
20,000@ 1.6%		328			
240,000				3,600	
171,713@ 3.2%				<u>5,495</u>	
Total Credit			<u>728</u>		<u>9,095</u>
Total Federal Tax			<u>24,622</u>		<u>108,353</u>
<u>Kansas Inheritance Tax computation</u>					
Total Kansas Taxable Estate	55,695		150,878		363,360
Amount passing to Jones	11,139		30,176		72,672
Tax on 11,139@ 10%	1,114				
30,175@ 10%		3,018			
72,672@ 10%				7,267	
Tax on transfer to Jones	<u>1,114</u>	<u>3,018</u>			7,267
Amount passing to sons	44,556		120,702		290,688
Amount to each son	14,852		40,234		96,896
less: exemption	15,000		15,000		15,000
Taxable amount passing to each son	0		25,234		81,896

TABLE 6 (Continued)

Tax on 25,000@ 1%		250	250
234@ 2%		5	
25,000@ 2%			500
44,008@ 3%		—	<u>1,320</u>
Tax on transfer to each son	0	255	2,070
Tax on transfers to sons	0	765	6,210
Total Kansas Inheritance Tax	1,114	3,786	13,477
Kansas Estate Tax	0	0	0
Total Kansas death tax	<u>1,114</u>	<u>3,786</u>	<u>13,477</u>
Total Federal and State death taxes	<u>1,114</u>	<u>28,408</u>	<u>121,830</u>
Total Federal and State death and gift taxes using inter vivos trust	<u>2,419</u>	<u>59,908</u>	<u>247,117</u>
Wealth passing to heirs after taxes	117,581	360,092	952,883
Percent of wealth passing to heirs after taxes	<u>98.0%</u>	<u>85.7%</u>	<u>79.4%</u>
Total Federal and State death and gift taxes without using inter vivos trust	10,226	101,000	379,130
Tax Savings by using inter vivos trust	<u>7,807</u>	<u>41,092</u>	<u>132,013</u>
Percent of total wealth additionally passed to heirs by using inter vivos trust	<u>6.5%</u>	<u>9.8%</u>	<u>11.8%</u>

SUMMARY OF ESTATE, INHERITANCE, AND GIFT
TAX IMPLICATIONS OF INTER VIVOS TRUSTS

The very nature and purpose of inter vivos trusts necessitates a close study of gift and death taxes. A completed inter vivos trust may still pay gift taxes, but may still be included in the grantor's gross estate if certain powers are retained, neutralizing the important economic advantage of estate tax avoidance.

The grantor may give a remainder interest or an income interest in property to a trust; if the gift is a present interest, the \$3,000 annual exclusion is allowable. For the gift to be taxable, it must be complete, with no possibility of the grantor to reacquire or receive benefit from the property interest or change the beneficiaries or their proportionate share of trust benefits.

In general, any time that a gift is not complete, it will be included in the grantor's gross estate. Even if the gift was complete, if the grantor retained certain interests, such as a retained life estate or a power to accumulate trust income, the trust property will be included in his gross estate. Obviously, if one of the purposes of the trust is to escape estate tax, the donor's powers must be carefully limited, so that in no instance could he acquire a prohibited power. A trust with grantor as trustee or possible trustee and wide administrative or distributive powers in the trustee, is in danger of inclusion in the grantor's gross estate.

The differential aspects of trust creation, because of the progressive nature of death taxes, is apparent from the example presented. Wealthy taxpayers can benefit more with inter vivos trusts than can less wealthy taxpayers. In other words, wealthy people can

more dramatically allocate their "scarce" resources between the taxing authorities and their desired beneficiaries than can less wealthy individuals when removing wealth from their gross estate. The inter vivos trust can allow a taxpayer the option of making gifts of property interests in trust to those persons whom he otherwise would not entrust with an outright gift, thus possibly lowering the donor's gross estate. The larger the donor's gross estate, the more beneficial this becomes.

CHAPTER V

SUMMARY AND CONCLUSIONS

The inter vivos trust can be a very useful personal financial tool, with significant economic impacts. Its economic impacts are differential, as taxpayers of high incomes and large wealth holdings can benefit more from trust usage than less prosperous taxpayers, because of the progressive nature of both income and death taxes. Of course, such wealthy taxpayers also benefit proportionately more than poorer taxpayers when making outright gifts. The primary economic impact of inter vivos trusts is that the trust allows the individual to give, during his lifetime, property to an individual or individuals who are adjudged unable to receive an outright gift of the property.

The trust supplies to the beneficiary (or the grantor, if the grantor is also a beneficiary) some kind of personal trait that he or she is lacking. If the trait lacking is management expertise or financial skill, the trust can help contribute to sound economic asset usage. Of course, a management service can provide the same type of managerial skill for property held outright by the owner. If the trait lacking is personal judgement, a trust can help prevent squandering of wealth. No completed outright gift not in trust can force the donee to use his gift as wisely or prudently as a gift in trust -- if the donor deems it necessary, a trustee can be given the power to pay out only as much as the beneficiary needs for support until he "mends his ways."

The income tax laws assert that if the donor has the power to use the trust for his own benefit, can revoke the trust, or otherwise

alter the enjoyment of the trust income (other than for certain limited powers), then he will be taxed on the trust income. Here again, if the trust property was a completed outright gift, then the donor would not be taxed on the trust property's income. Donors who anticipate transferring property into trust, with themselves as trustee, should be aware of the grantor powers that cause income taxation to the donor, and balance the income tax cost of these powers against the benefits of retaining certain powers.

If the trust is not considered grantor-owned, then either the trust or the beneficiaries must pay tax on the trust income. Some tax advantages were once gained by allowing trusts to accumulate income taxed at low rates, distributed later tax-free--new throwback rules have helped eliminate this tax feature (Kansas trusts may still distribute accumulation distributions tax-free to the beneficiary, but the Kansas tax rates are so low that it makes little impact on after-tax income). Still, trusts can accumulate income for the beneficiary and reinvest this income tax-free until later taxable distribution --essentially using the government's tax money interest free. This is an economic advantage of trusts over outright property gifts, but is likely to be minor unless multiple trusts of large size are used.

Trusts are probably most often created by gift, so trust donors should be aware of the gift tax consequences. As long as the gift is complete, that is, beyond the recall or control of the grantor, gift tax is due unless the gift is less than the available exclusions and deductions. The gift is declared a future interest, not eligible for the \$3,000 annual exclusion, if some event must occur or some length

of time must pass before the beneficiary can enjoy the gift or if there exists any possibility that the gift may be altered in its enjoyment (such as by a trustee with an unlimited power to distribute, accumulate, or apportion trust income among several beneficiaries). Careful planning can help avoid losing exclusions by spreading transfers into trust over several years or by giving at least \$3,000 per donee in present interests per year. Certainly if a person is striving to lower his gross estate, paying gift taxes (at 3/4 of the lowest estate tax rates) on property transferred from the highest estate brackets can be an attractive tool to maximize the after-tax wealth of the heirs.

If one of the purposes of the trust is to remove the trust property from the donor's gross estate, the property must be transferred with no retained interests, such as a retained life estate, a power to control beneficial enjoyment of the property, or a power to revoke. Such powers cause even an outright gift to be thrown back into the donor's gross estate, so the trust does not have any estate tax advantages or disadvantages over giving outright gifts, other than the ability to give to donees who could not otherwise successfully control the gift. The trust does provide a convenient vehicle for skipping generations, as interests given to a donee that are defeated by the donee's death are not included in the donee's gross estate, thus permitting property to pass, for example, to the grandchildren with the donor's children enjoying the income from the property for life, while paying estate or gift taxes only on the original transfer into the trust. Such an arrangement skips the estate tax on the property had the children received the property outright from their parent.

In short, while the trust offers many economic advantages of differing impacts to persons of varying wealth, probably the most significant impact is that the inter vivos trust allows gifts to persons whom otherwise could not or would not use their gift wisely and protects persons who might lose their wealth through dotage or business reverses. Most of the other economic advantages of trusts, such as probate evasion, assured stable incomes, income splitting, or estate tax avoidance, can be realized by other personal financial tools; only the trust allows a person to protect himself, his dependents, or his heirs so well against their own personal weaknesses.

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THE INTER VIVOS TRUST AS
A PERSONAL FINANCIAL TOOL IN KANSAS

by

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The inter vivos trust is a powerful and useful personal financial tool, but is only occasionally used or understood by many who could benefit from a trust arrangement. The purpose of this report is to examine the tax and non-tax implications of personal inter vivos trusts.

Definition

The inter vivos trust is a fiduciary relationship established during the grantor's lifetime whereby a trustee holds legal title to property subject to an equitable obligation specified by the terms of the trust to the trust beneficiary.

Non-tax Advantages

The trust can supply to the grantor or beneficiary some personal characteristics that he or she is lacking. Personal non-tax advantages can be summarized as provision of competent and continuous management, protection from creditors, spendthrifts, or profligates, and assurance of stable incomes. Additionally, an important non-tax trust advantage is possible probate avoidance.

Income Tax Implications

Income tax laws assert that if the donor can use the trust for his own benefit, can revoke the trust, or otherwise alter the enjoyment of the trust income (other than for certain limited powers), he will be taxed on the trust income. If the donor is not required to pay tax on the trust income, then either the beneficiary or the trust itself must pay tax on the trust income. Throw-back rules help prevent multiple trusts from accumulating income taxed at low rates for later tax-free distribution.

Gift Tax Implications

Donors who create trusts by gift may be liable for gift taxes,

if the gift is complete and larger than allowable deductions and exclusions. If the gift includes a future interest, then the \$3,000 annual exclusion is not available.

Estate and Inheritance Tax Implications

If the trust property is to escape inclusion in the donor's gross estate, the property must be transferred with no retained interests or powers, such as a retained life estate or a donor-held power to control beneficial enjoyment of the trust income.

Summary

The trust has a differential economic impact, as persons of large wealthholdings can benefit more by utilizing trusts than can less wealthy persons, as illustrated by several examples in the report. However, the same differential aspects accrue when making outright property gifts - the inter vivos trust's primary impact is that gifts can be made to persons who otherwise could not or would not use the gift wisely. A gift can be protected by the trust agreement; this same protection can be gained by persons who wish to protect their estate from their own management mistakes. Most of the other economic advantages of trusts - probate avoidance, assured income stability, income tax savings through income splitting or estate tax avoidance - can be realized with other personal financial tools; only the trust allows a person to protect himself, his dependents, or his heirs so well against their own personal weaknesses.