Issues and Complexities with Income Splitting

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For the most part today we will be talking about shifting the recognition of taxable income -- usually ordinary income, but also realized gains --, typically from a taxpayer in a higher marginal rate bracket to a taxpayer in a lower rate bracket.

But this conversation occurs in a context: specifically, what are the policies underlying a progressive income tax? why are we using income rather than, say, wealth or consumption as the tax base? why do we have taxes at all? what is money?

Income as a tax base

Let us assume we are talking about funding the general operating budget, rather than specific government functions that might appropriately be covered by user fees. Everyone benefits more or less from roads, and from a functioning courts system -- though the argument has been made that the massive amounts we spend on the military, on and off budget, primarily benefit multinational corporations.

If we are collecting taxes to finance general government operations, then the burden of those taxes "should" be borne fairly. But how do we measure fairness?

It may be difficult for us to imagine this today, but prior to the adoption of the 16th Amendment in 1913 and the enactment of the predecessor to the present income tax, the federal government was financed primarily through tariffs and excise taxes. Today the income tax alone accounts for nearly half of federal tax receipts.

Another third comes from payroll taxes, which are paid into "trust funds" and then lent out to fund other government operations. This is a regressive tax, taking 12.4 pct. of only the first $132.9k in wages.

If a primary function of government is to protect the institution of private property -- maintaining not only the physical infrastructure that makes commerce possible, but also the mechanisms of law that help to stabilize it -- one might argue that those who have accumulated wealth "should" pay more. You didn't build this, etc.

In any event, at some point it becomes necessary to talk about "ability to pay." You cannot collect tax from someone who has nothing, but on the other hand, accumulated wealth might be illiquid, and we probably want to minimize the extent to which the tax regime distorts economic activity by requiring taxpayers to sell assets to generate cash.

And although currently realized income is subject to fluctuation from one tax year to another and may bear little correlation to the accumulation of wealth over a lifetime, it does have the virtue of liquidity.

What about progressivity

If you exempt some individuals at the low end of the income distribution from paying income taxes altogether, even a proportional, or "flat," tax is progressive. The marginal rate is flat, but the effective rate never quite approaches the marginal rate unless you phase out the exemption in higher income ranges.

But with a graduated rate structure, you introduce all kinds of complexities. Defining the taxable unit, timing of income and deductible expenses, differential treatment of realized long-term gains, debt versus equity, carryover of capital losses, structuring tax incentives in such a way as not to undermine the desired level of progressivity, and so on.

One of the stronger arguments against progressivity is that it incentivizes consumption over saving -- but the data are slight, and in any event there are those who would argue this is a feature rather than a bug, at least during periods of recession or stagnation.

Ultimately the rationale for progressivity must rest on a theory that money has a declining marginal utility. A progressive rate scheme seeks to impose "proportionate sacrifice" across income ranges, taking a dollar from a person with income just above the exemption amount, while taking somewhat more than ten dollars from a person with ten times that income.

How much more is the difficult question, as it seems impossible to define the utility curve, though we think intuitively it must be there. If the logic were extended to effecting "minimum sacrifice" among taxpayers in the aggregate, you would get a confiscatory tax at the top end, which runs you up against the argument that sufficiently high marginal rates will kill productivity.

But stopping somewhat short of that extreme, the theory does seem to justify some level of progressivity, and in doing so it brings the question of using the tax system as a tool to redistribute wealth right out onto the table.

Why do we have taxes

I am going to take you down a bit of a rabbit hole here, and suggest that there are plausible arguments for the view that taxes are primarily a monetary control mechanism. These arguments are advanced by a group calling themselves "modern monetary theorists," several of whom are based at the University of Missouri Kansas City.

In brief, the idea is that a national government that "floats" its own currency -- not convertible to precious metals or a foreign currency --, through lending into the banking system and through direct spending, does not "need" to collect taxes in order to spend. It spends first and taxes later.

But it does need to collect taxes in order to create a demand for its currency. And taxation then becomes a tool for controlling aggregate demand, providing a countercyclical stimulus, rising during economic expansions and falling during contractions. This is not so much counter-intuitive as it is a reversal of the narrative with which we have been familiar.

It may very well be that revenues of about 17 or 18 pct. of gross domestic product, expenditures of about 20 or 21 pct., and a running deficit of about three pct. is exactly what is needed to keep a postindustrial consumer economy reasonably stable. In effect, the federal government is feeding in net three pct. of new money annually.

Or it might be argued that a system that relies on perpetual "growth," measured in monetary terms, is unsustainable in a world of finite material resources. Unless we increasingly monetize immaterial transactions.

If the tax system is essentially a monetary control mechanism, then its specific features -- not only deductions, but the definition of the tax base itself -- are an amalgam of incentives and disincentives to various behaviors which have been monetized. If these incentives are not calibrated to prevent a speculative runup in prices of credit default swaps and other financial instruments, then we have a problem.

Part of the difficulty is that money created by private bank lending is added to the aggregate without having already been "floated" by the government. It is "floated" after the fact in the clearing process.

What is money

A little farther down the rabbit hole we get to the question why we have money at all.

It is a cliche to say money is a medium of exchange, and a mechanism for storing exchange value. Because it is fungible, it allows much greater flexibility in executing exchanges than a system of barter. And its value is at least potentially more stable than, say, a silo of rotting grain.

But skipping over a lot of history concerning cowrie shells and gold ingots, and stopping a little short of bitcoins, we can see that control of the monetary system is an essential component of centralizing political authority, right alongside the state monopoly on violence.

Assignment of income

So that is the context. We have an income tax because about a hundred years ago this seemed to someone like a workable mechanism for controlling cash flows in an industrial economy. A class of financial intermediaries has grown up around managing the interactions between this mechanism and the individual. The entire system becomes more complex over time. Today we are looking at a tiny slice of that complexity.

The transfer tax regime functions primarily as a backstop to the individual income tax. And with the recent doubling, at least temporarily, of the applicable exclusion from gift and estate taxation, planners are turning their attention to reducing the aggregate income tax burden on the extended family, often by "shifting income" from a taxpayer in a higher marginal rate bracket to one or more taxpayers in lower brackets.

As a practical matter this cannot be done with earned income, except through deferrals into qualified plans. The decision usually cited as seminal on this question is *Lucas v. Earl*, 281 U.S. 111 (1930). The taxpayer, a lawyer, had entered into a written agreement with his spouse that any property either of them might acquire, including by way of earnings, would be owned by the two of them as joint tenants with right of survivorship, "and not otherwise."

The quoted phrase might be taken to be a reference to community property under California law. And it should be noted that this agreement long predated the enactment of a federal income tax, or even a state income tax in California, so it is not as though the particular taxpayer was trying to game the system.

But the claimed effect here was to split the taxpayer's income with the spouse -- which, oddly enough, the state community property statute would have done, see *Poe v. Seaborn*, 282 U.S. 101 (1930) --, so that each could get a separate run up the rate brackets.

> [Note: these decisions predated legislation in 1948 that created a joint filer status. Numerous adjustments have been made to the rate brackets over the years to ameliorate the "penalty" on two-earner couples.]

Nonetheless, the Supreme Court ruled that what is now section 61 of the Code taxed wages and salaries to those who earned them, and the incidence of the tax could not be avoided by an anticipatory assignment. Or as Justice Holmes expressed it, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

So our discussion today will focus on shifting the incidence of tax on unearned income -- dividends, interest, rents, realized gains --, and the threshold question will be whether we have placed not just the fruit, but the tree itself, into the hands of a separate taxpayer.

The economic unit

The income tax regime treats as an economic unit the "household," or what might be understood as a slightly extended nuclear family.

A little over one-third of returns filed for 2016 were from spouses filing jointly, and on average each of these claimed one child as a dependent. About one-sixth were from heads of household, each claiming on average about one point six dependents. Not quite half of returns were filed by singles, who on average claimed no dependents.

Spouses may file jointly, or they may file separately -- which they might choose to do if each spouse has itemized deductions in excess of the standard deduction and the higher income spouse has much larger itemized deductions. Or they might choose to separate and each file as a head of household, each claiming to provide a home for one or more children.

Under the 2017 tax bill, through 2025 we no longer have personal exemptions, but we do still have the child tax credit, which under some circumstances a divorced or separated parent may claim even if the child is not living under the same roof, and we now have another credit for "other" dependents, who need not be related to the taxpayer.

But if you are claimed as a dependent on someone else's return, you are limited in the amount you yourself can claim as a standard deduction you and may be precluded from claiming various other credits.

Within the "household" there may be individuals whom a taxpayer has a legal obligation under state law to provide support, and this fact can limit your flexibility in shifting income, as we will see.

The "kiddie tax"

Prior to 1987, shifting income to a child was as straightforward as transferring income-producing property to a custodial account under the uniform transfers to minors act or to a section 2503(c) trust. In either case this would be treated as the gift of a present interest, eligible for the annual gift tax exclusion, because the child would have a right to complete distribution at age twenty-one.

Even if you were claiming the child as a dependent, as a separate taxpayer she would have her own exemption amount, and a separate run through the rate brackets.

But that calculation changed with the enactment in 1986 of the so-called "kiddie tax," which taxes unearned income in the hands of a child aged fourteen or younger at the parent's marginal rate, if higher. In 2008, the tax was extended to children aged eighteen or younger, and to full-time students up to age twenty-four whose earned income does not cover at least half their "support." The tax applies regardless whether the child could be claimed as a dependent by either parent.

There is a threshold, half what had been the personal exemption amount, and earned income itself is not subject to the "kiddie tax." Note, however, that for this purpose a taxable scholarship or fellowship grant is treated as unearned, nor is it considered as a contribution toward the "support" of a full-time student.

The 2017 tax bill has changed the rules yet again. Starting last year, the rate at which the "kiddie tax" is imposed is no longer keyed to the parent's marginal rate, but to the rate that would be paid if the income were accumulated in a trust.

The top marginal rate for a trust kicks in at $12.7k. So in many cases, shifting income or realized gains to a child through a transfer to a custodial account will no longer be advantageous. Specifically, where the parent is herself not in the top marginal rate bracket, shifting income to a child may actually be counterproductive.

attribution to transferor

There are circumstances in which distributions from a custodial account or from a section 2503(c) trust may be taxed directly to the parent. In Rev. Rul. 56-484, IRS took the position that income in a custodial account that is distributed for the "support" of the minor beneficiary is taxable to the parent who is legally obligated to support the child, even if that parent is not acting as custodian. And in Rev. Rul. 59-357 IRS extended this logic to distributions from a section 2503(c) trust.

The questions are, (a) what exactly is "support," and (b) under what circumstances might a parent not be "obligated." And the answers are specific to state law. In some states, for example, private school or college tuition might not fall within the scope of "support." And in some states a parent is not "obligated" to cover expenses of this nature if the child has sufficient resources of her own -- for example, the custodial account or the section 2503(c) trust itself.

Obviously a divorce decree might impose obligations of this nature, but these can be the subject of negotiation.

The nongrantor trust

Under section 677(a) the settlor of an irrevocable trust will be treated as the "owner" of the trust for income tax purposes if income may be distributed to him or his spouse, or accumulated for future distribution to either of them, without the consent of a party with an "adverse" beneficial interest in the trust.

Per section 677(b), the possibility that trust income might be distributed to support a beneficiary whom the settlor is obligated to support will not cause him to be treated as the "owner" unless distributions are actually made. If such distributions are made from corpus, or from accumulated income from prior years, these will be treated as carrying out distributable net income to the settlor under section 662(a).

But if an irrevocable trust is structured and administered in such a way as not to trigger any of the "grantor" trust rules of subpart E, the entire trust will be treated as a separate taxpayer, and if there are multiple discretionary beneficiaries, the trustee can sprinkle income among them, with a view to minimizing the aggregate income tax paid across the group. Because the rate brackets for a nongrantor trust are so tightly compressed, the trustee will be under some pressure to make distributions.

Per section 674(a), the settlor himself should not be a trustee of a discretionary trust, unless distributions would also require the consent of an "adverse" party -- *i.e.*, a trust beneficiary whose own interest would be adversely affected by the distribution.

The incomplete nongrantor trust

In recent years there have been dozens of private letter rulings confirming the viability of a strategy called the "incomplete nongrantor trust," or ING, in which

> (a) the settlor transfers property to an irrevocable trust for the benefit of a class of beneficiaries, typically including the settlor himself, children, and more remote descendants, while
>
> (b) reversing to himself a power, exerciseable in a nonfiduciary capacity, to direct distributions of principal to

current beneficiaries other than himself, subject to an ascertainable standard, but otherwise

(c) purely discretionary distributions of income or principal -- even to the settlor himself -- may be authorized by a committee comprised of members of the beneficiary class itself, either unanimously or by a majority vote with the consent of the settlor.

The settlor's retained powers are sufficient to make the transfer "incomplete" for gift tax purposes until distributions are actually made, but because the limited power he has reserved to direct distributions is nominally exerciseable only in a nonfiduciary capacity and is subject to an ascertainable standard -- tracking the exception at section 674(b)(5) --, this should be a nongrantor trust for income tax purposes.

Because the discretions committee is comprised entirely of "adverse" parties, the fact that they may also be children or grandchildren of the settlor will not trigger "grantor" trust status under section 674(a).

However, each of these ING letter rulings has reserved the question whether the settlor may have reserved an administrative power that might trigger "grantor" trust status under section 675.

These rulings date back to at least PLR 201310002, and are usually issued in batches of several identical rulings related to the same taxpayer. The most recent batch at this writing includes PLR 201908003.

Note also that the ING strategy typically includes selecting a corporate trustee domiciled in a state that does not tax trust income accumulated for the benefit of a nonresident individual.

Kaestner Trust* and *Fielding

While several states have statutes that purport to tax undistributed income in a nongrantor trust based only on the residence of the trust settlor or of one or more of the discretionary beneficiaries, there is a question whether these statutes might be invalid under the 14th Amendment due process clause. That question is presently before the Supreme Court, as to the discretionary beneficiary, in *Kaestner Trust*, No. 18-457, argued April 16, 2019, and as to the residence of the trust settlor, in *Fielding*, No. 18-664.

The petition for cert in *Fielding* has been held pending the decision in *Kaestner Trust*. There is some possibility the Court may remand these cases for further development of the question whether the state's claim of authority to tax a "nonresident" trust is consistent with the "dormant" commerce clause of Article One, section eight of the federal constitution.

Interests in closely held entities

A nongrantor trust may be an appropriate vehicle to hold nonvoting interests in a closely held business, or in a holding company that manages a portfolio of marketable securities. The settlor, directly or through a disregarded entity, would hold the voting interests, which in a typical plan might be as little as one pct.

Assuming the entity has elected to be taxed as a partnership, items of income and deduction will pass through to the trust, which in turn can cause some or all of these to be distributed to beneficiaries in lower brackets.

Often the partnership will make distributions to the trust in amounts sufficient to cover the beneficiaries' anticipated income tax. Note, however, that passthroughs are taxable to the trust regardless whether the partnership makes distribution, but the trust can push the incidence of the income tax out to the beneficiaries only by making actual distributions to them.

two cautionary notes

1. A settlor may seek to qualify transfers to a nongrantor trust as present interest gifts eligible for the gift tax annual exclusion by providing the beneficiaries "Crummey" withdrawal rights, which quickly lapse.

To prevent a lapse from being treated as the release of a general power, it may be necessary to limit the amount the beneficiary might withdraw to the greater of five pct. of the amount transferred or $5k, section 2514(e), with any excess "hanging" until the following year.

A taxable lapse would cause a portion of the trust to be treated as a "grantor" trust as to that beneficiary.

2. As a general rule, a nongrantor trust cannot hold S corporation stock without terminating the S election. There are two exceptions that are relevant to our present discussion.

One, a "qualified subchapter S trust," section 1361(d), which can have only one beneficiary during that beneficiary's life and must distribute net income currently. The QSST is treated as a "grantor" trust as to that beneficiary, meaning passthroughs from the S corp are taxed directly to her regardless whether the S corp actually makes distribution. Clearly this is not a workable model for a discretionary trust.

Two, an "electing small business trust," section 1361(e), which may have as many as a hundred beneficiaries, and is permitted to accumulate income. But passthroughs and realized gains on the sale of the stock are taxed at the highest marginal rates, and the ESBT is not allowed any deductions for administration expenses or for distributions to beneficiaries. Clearly this is not a workable model if we are seeking to shift income to lower rate brackets.

if transfer taxes are a concern

To qualify the gift of a nonvoting interest in a partnership or a limited liability company as a present interest gift -- and this would be critical for a gift to a custodial account or a section 2503(c) trust, or to a trust in which beneficiaries have "Crummey" withdrawal rights --, the controlling agreement must afford each partner or member what the Tax Court in *Hackl v. Commissioner*, 118 T.C. 279 (2002), called "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of property or of income from property."

In *Hackl*, the parents had created an LLC to hold and operate timber farming properties and transferred voting and nonvoting membership interests to their children. It was anticipated that it would be several years before there would be any income to distribute.

The parents retained the voting interests, and the father was designated manager of the LLC, for life or until resignation, removal, or incapacity. Removal could be accomplished by a majority of voting interests. The operating agreement provided that membership interests could be transferred to third parties only with the consent of the manager.

The Tax Court determined that under these circumstances -- no current income and no practical ability for a nonvoting member to realize her equity in cash -- the gifts were of future interests. The 7th Circuit federal appeals court affirmed, 335 F.3d 664 (7th Cir. 2003).

In *Price v. Commissioner*, T.C.Memo. 2010-2, the Tax Court applied the logic of *Hackl* to gifts of limited interests in a partnership that held commercial real estate -- despite the fact that the properties did yield current income --, where the actual distribution of income to the partners was discretionary with the corporate general partner, which in turn was wholly owned by the transferor parent.

However, in *Estate of Wimmer v. Commissioner*, T.C.Memo. 2012-157, the court found gifts of limited partnership interests did qualify for the annual exclusion, where the partnership agreement required the transferor general partner to distribute income currently, albeit only in amounts calculated to cover the partners' income tax liability on passthroughs.

While *Hackl* and its progeny have been criticized, this is the present condition of the law on the gift tax treatment of transfers of interests in limited partnerships and limited liability companies.

Repeal of the alimony deduction

The 2017 tax bill also repealed, permanently, the alimony deduction, section 215. The conforming amendments included of course a repeal of the inclusion of alimony in income of the recipient, section 61(a)(8), but also a repeal of section 682, which had created an exception to the "grantor" trust rules in the event of a divorce.

Former section 682 overrode any provision elsewhere in subtitle A of the Code that would have taxed income in what has sometimes been called an "alimony trust" to the settlor, and instead treated distributions to the recipient former spouse as though these were made from a "complex" trust. The settlor would still be treated as the "owner" of the trust with respect to undistributed income, realized gains, etc.

In Notice 2018-37, IRS sought comments on how the repeal of section 682 should affect various other sections of subpart E, the "grantor" trust rules, specifically

- section 672(e)(1)(A), which treats the settlor as holding any power or interest held by an individual who was the settlor's spouse at the time the power or interest was created,

- section 674(a), which treats the settlor as the "owner" of any portion of a trust as to which the settlor or a "nonadverse" party holds a power of disposition over income or corpus, exerciseable without the consent of an "adverse" party, and

- section 677(a), which treats the settlor as the "owner" of any portion of a trust the income of which may be distributed, in the discretion of the settlor or a "nonadverse" party, and without the consent of an "adverse" party, to the settlor or the settlor's spouse.

Formal guidance is not yet forthcoming. But for our present purposes the takeaway is that we will have to find other tools to shift income to a former spouse.

Unrealized appreciation

Per section 1015(a), the recipient of a gratuitous transfer takes a carryover basis in the transferred property. There is an adjustment at section 1015(d) for gift tax actually paid.

So when the transferee later sells, she will recognize gain with reference to the transferor's basis, as adjusted. But presumably she will pay tax at a lower marginal rate.

If at the time of the transfer the fair market value of the property is actually lower than the transferor's basis, the lower figure will function as a limit on the transferee's later recognition of a loss.

the 1031 like-kind exchange

But what if the trust is already holding real property -- possibly property transferred to it by the settlor herself -- with a relatively high tax basis, while the settlor is seeking to dispose of property of similar value in which she has a relatively low basis.

Would it be possible to swap the properties in a section 1031 like-kind exchange, allowing the trust to complete the sale using its higher basis?

The short answer is no, not if you are trying to cash out either end of this transaction immediately after the exchange, but yes, if you are willing to wait two years. But the longer answer is a bit more complex.

Section 1031(f) says that if a taxpayer exchanges property with a "related person" and either of them sells within two years, the exchange itself is treated as not having been a nonrecognition event after all -- except that any gain or loss is recognized at the date of the later sale.

Who is a "related person" is defined by cross-reference to

- section 267(b), which disallows the recognition of loss in an exchange with a sibling, a spouse, a lineal descendant or ancestor, a controlled corporation -- or in an exchange between the settlor and the trustee of a trust, or between the trustee and a beneficiary, or between trustees of different trusts created by the same settlor, etc., and to

- section 707(b)(1), which precludes the recognition of loss in an exchange between a partnership and a controlling partner.

There are three exceptions to the two-year rule:

(a) one of the parties has died,

(b) the later disposition is an "involuntary conversion" within the meaning of section 1033, or

(c) you are able to persuade IRS that neither the initial exchange nor the later disposition had tax avoidance as a "principal" purpose.

The Joint Committee report accompanying the 1989 legislation adding this provision to section 1031 said the exception for non-avoidance was meant to apply where the initial exchange was of undivided interests, resulting in each party holding an entire interest, or where the later disposition was itself a nonrecognition transaction.

Per section 1031(g), the running of the two-year period is suspended during any period in which the holder's risk of loss is "substantially diminished" by a put or a call or a short sale.

And footnote: another feature of the 2017 tax bill is that like-kind exchanges are now limited to real property only.

The below-market loan

Under section 7872(a)(1), a taxpayer who lends money at a rate of interest that is below the "applicable federal rate" is deemed to have made a gift to the borrower in the amount of the difference, and also to have received payment from the borrower of that amount, which is characterized as investment interest.

In the case of a demand loan, the determination is made month by month, as the AFR fluctuates. In the case of a term loan, the amount of foregone interest is determined at the outset by comparing the present value of the payment stream under the note with the present value of a note carrying interest at the then-current AFR.

In June 2019, the mid-term AFR, *i.e.*, for a loan with a term between three and nine years, with interest compounded semiannually, was 2.37 pct.

There is a *de minimis* exception at section 7872(c)(2) for a "gift loan" -- that is, a loan between individuals in which the forgoing of interest is in the nature of a gift --, where the principal balance does not exceed $10k. However, that exception does not apply where the loan is "attributable" to the purchase or carrying of income-producing assets.

Where the aggregate amount of "gift loans" from the lender to the borrower does not exceed $100k, section 7872(d) provides that the amount of imputed interest reportable by the lender is limited to the borrower's net investment income. Where there are multiple loans, net investment income is pro rated among the loans in proportion to amounts of imputed interest.

Split-interest trusts

An often overlooked vehicle for shifting income is the charitable remainder trust -- specifically, the net income charitable remainder unitrust, with "makeup" and with a provision to "flip" to a straight unitrust payout upon the occurrence of a specified triggering event.

At the inception of the trust, the present value of the remainder to one or more exempt orgs, after a term of years or the life or lives of one or more individual beneficiaries, must be at least ten pct.

The stated unitrust payout must be at least five pct., but section 664(d)(3) allows the trust to provide for distribution of the lesser of net income or the stated unitrust amount, with any shortfalls to be "made up" in years in which current income might exceed the stated unitrust amount.

And then reg. section 1.664-3(a)(1)(i)(c) allows a net income trust to "flip" to a straight unitrust upon the occurrence of a triggering event that is not in the control of the trustee "or any other person."

Distributions to the individual beneficiary are taxed under a four-tier, "worst in, first out" regime, with distributions carrying out first ordinary income, then short-term gains, long-term gains, exempt income, and finally corpus.

The trust itself is exempt from income tax, which makes it an attractive vehicle through which to sell highly appreciated assets, deferring the recognition of gain somewhat in the manner of an installment sale.

It may also be possible to control the flow of taxable income to the individual beneficiary by having the trust hold the transferred property in a single-member limited liability company, which is a disregarded entity as to the trust. If the unitrust payout is subject to a net income exception, passthroughs would be taxed to the beneficiary only as distributions from the LLC are actually made.

Although the receipt of unrelated business taxable income will no longer disqualify a charitable remainder trust, any UBTI received by the trust is taxed at one hundred pct., even though it is also being distributed to the individual beneficiary and taxed in her hands.

Also, a split-interest trust may subject to excise taxes on "excess business holdings" if it holds an interest in an entity in which "disqualified persons" collectively hold voting interests aggregating more than twenty pct.

Section 529 plans and HEET trusts

We want to briefly mention section 529 plans, not because they are a vehicle for shifting income, as such -- contributions must be made in cash, so there is no opportunity to shift unrealized appreciation --, but because qualifying distributions, *i.e.*, direct expenditures for educational expenses, are never taxed.

In other words, realized gains and income accumulated within the plan need never be taxed. Also, the designated beneficiary of unexpended funds can be repeatedly changed, within a fairly broad class of persons "related" to the initial beneficiary.

Also briefly, the "health and education exclusion trust."

Again, this is a device on which IRS has declined to provide formal or infomal guidance, but the basic concept is a multi-generational trust from which distributions for the benefit of grandchildren and more remote descendants can be made only by direct expenditure for qualifying health and educational needs.

That restriction exempts the trust from gift tax under section 2503(e), and the distributions themselves are exempted from the generation-skipping transfer tax by section 2611(b)(1).

In order to prevent the trust itself being treated as a "direct skip," to which the transferor would have to allocate some amount of her available exemption, the trust provides for current distribution of a unitrust amount, usually ten pct., to a charitable org, often a college or a hospital -- in other words, to a nonskip person to which distributions will be deductible under section 642(c).

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