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FIDUCIARY INCOME TAXATION AND THE *HOLLOWAY* ADJUSTMENT

by

DENNIS E. BIRES*

A GREAT DEAL of the complexity of the rules dealing with income taxation of trusts and estates¹ can be attributed to the imperfect compatibility of two different regimes of law: the federal taxation of income and local rules of trust accounting.² Just as the confluence of two rivers may generate turbulence exceeding that of either branch, the meeting of federal tax law and state trust law in Subchapter J of the Internal Revenue Code generates problems that neither discipline would present by itself.³

The operation of income tax rules often causes inequities among the beneficiaries of a trust or estate.⁴ In a few instances, state courts and legislatures have responded to tax-induced inequities by devising new rules of local trust law, known as equitable adjustments,⁵ to restore equity among such beneficiaries.⁶ These are local rules of fiduciary administration that would not

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¹Subchapter J of the Internal Revenue Code, §§ 641 through 692, is the source of income tax rules for fiduciaries. The field is sometimes referred to as "fiduciary income taxation."

²The Internal Revenue Code does not purport to impose rules for fiduciary administration. Rather, it defines income tax rules which are applied in the context of each state's law of trust and estate administration. See M. FERGUSON, J. FREELAND & R. STEPHENS, *FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES* 2-3 (1970).

³An important example of this inconsistency is the difficulty of reconciling the local law distinction of "income" versus "principal" with the federal concept of "taxable income." Congress has chosen to ignore the local income/principal distinction in some instances in the computation of taxable income for trusts, estates, and their beneficiaries. See, e.g., I.R.C. § 662(a)(2) (distributions includable in beneficiaries' gross income may consist of either trust income or principal); I.R.C. § 641(b) (taxable income of estates and trusts computed in the same manner as for individuals, therefore, expenses paid from principal are deductible against income for tax purposes); Treas. Reg. § 1.643(d)-2(a) (1985) (expenses paid from principal are deductible in computing beneficiaries' gross income).

⁴For instance, an executor's election under I.R.C. § 642(g) to deduct estate administration expenses for federal income tax purposes rather than for federal estate tax purposes may work to the detriment of the estate's principal beneficiaries. Administration expenses are paid largely from principal, and if deducted for estate tax purposes, reduce the amount of estate tax payable, also from principal. If the expenses are deducted for estate income tax purposes, the principal account of the trust loses twice. It loses by being charged for the expenses themselves and by receiving no deduction against federal estate tax to partially make up for the first loss. The benefit of the income tax deduction falls to the income account. See *In re Estate of Warms*, 140 N.Y.S.2d 169 (Sur. Ct. 1955); see also *infra* note 6.

⁵On equitable adjustments generally, see Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*, 36 TAX LAW 545 (1983); Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms*, 65 IOWA L. REV. 103 (1979).

⁶The inequity caused by the executor's election under I.R.C. § 642(g), see *supra* note 4, has been remedied in New York by the enactment of § 11-1.2 of the Estates, Powers and Trusts Law, codifying *In re Estate of Warms*, 140 N.Y.S.2d 169 (Sur. Ct. 1955). The statute provides that the income beneficiaries, or the income account of the estate, must reimburse the principal account in the amount of any increased estate taxes

have arisen but for a disturbance of trust administration occasioned by the federal tax law. A less well-known problem, only recently emerging as a concern for fiduciaries and the Internal Revenue Service, is the need to apply federal tax rules to the new relationships set up by local law equitable adjustments.⁷ The complex interaction of federal and state law here reaches a perhaps absurd extreme: federal tax rules must be applied to local rules of administration which themselves arose only in response to other federal tax rules. However, this third level in the interaction cannot be ignored. The income tax must be collected wherever income is earned, and new state law rules of fiduciary administration may occasion new variations on the application of the tax law. One can only hope that a fourth and fifth level of this state/federal interaction will not result.

In 1972, a New York Surrogate's Court introduced the *Holloway*⁸ adjustment to fiduciary accounting. This equitable adjustment was seen as necessary to restore the balance between the interests of income and principal beneficiaries of certain trusts after that balance had been upset by the effects of Subchapter J,⁹ particularly where executors had utilized a popular tax-saving technique known as the "trapping distribution."¹⁰ In these instances, the first element of the federal/local law interaction would be the Subchapter J tax rules that make "trapping distributions" possible. The second level, the response of local trust law to a tax-induced inequity, is the *Holloway* adjustment itself. The third level, and the subject of this article, is the federal tax law's treatment of the new relationships created by the *Holloway* adjustment. At this point, an introduction to trapping distributions and to the *Holloway* adjustment is necessary.

I. TRAPPING DISTRIBUTIONS

The Internal Revenue Code (Code) provides generally that trusts and estates are to be taxed on the income they earn, except to the extent the income is distributed to beneficiaries.¹¹ The Code uses the concept of

resulting from the executor's election to deduct administration expenses for income tax rather than estate tax purposes (the "Warms adjustment"). N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(A)(McKinney 1967).

⁷See Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 INST. ON EST. PLAN. 14-1 (1984); Blattmachr, *A Primer on the Effects of Equitable Adjustments*, 124 TRUSTS & ESTATES 21 (June 1985).

⁸*In re Holloway's Estate*, 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. 1972) [hereinafter referred to as "*Holloway II*" or "*Holloway*"], *modifying* 67 Misc. 2d 132, 323 N.Y.S.2d 534 (1971) [hereinafter referred to as "*Holloway I*"].

⁹See *infra* notes 25-37 and accompanying text.

¹⁰See *infra* notes 9-24 and accompanying text.

¹¹I.R.C. § 641(a) and (b) (imposition of tax on taxable income of estates and trusts; taxable income computed in the same manner as for individuals); §§ 651(a) and 661(a) (distribution deduction allowed to trusts and estates for amounts distributed to beneficiaries). On the computation of trusts' and estates' taxable income, the distribution deduction, and amounts includable in the gross income of beneficiaries, see generally A. MICHAELSON & J. BLATTMACHR, *INCOME TAXATION OF ESTATES AND TRUSTS* 5-29, 47-93 (11th ed. 1980); and M. FERGUSON, J. FREELAND & R. STEPHENS, *FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES*, 301-37, 381-458 (1970).

distributable net income (DNI), which is defined as taxable income with certain modifications,¹² to refer to the income which each year must be taken into account by either the fiduciary or the beneficiaries, or split between the two.¹³ Amounts of taxable DNI distributed to beneficiaries are deductible by the trust or estate against taxable income,¹⁴ but must be included in the gross income of the beneficiaries.¹⁵ To prevent fiduciaries from making what would otherwise be "tax-free" distributions of principal, rather than income, to beneficiaries, the Code provides that all distributions, *whether from income or principal*, "carry out" DNI to the beneficiaries.¹⁶ Therefore, corpus distributions, like income distributions, cause DNI to be included in the beneficiaries' gross income¹⁷ (and deductible by the fiduciary),¹⁸ to the extent the trust or estate has DNI in the year of distribution.¹⁹

The rule that all distributions, including those of trust or estate principal, carry out taxable income to beneficiaries has been used to great advantage by sophisticated fiduciaries. Often the residuary beneficiary of a decedent's estate will be a testamentary trust, which by the terms of the decedent's will is a simple trust, i.e., it is required to distribute all its income to its beneficiaries currently.²⁰ The executor can make a distribution to such a trust from estate *principal*²¹ in an amount sufficient to carry out all, or any predetermined portion of, the estate's taxable income for the year. The Code prevents this from becoming a "tax-free" distribution of principal. However, the executor's purpose is precisely to have the trust pay the tax on estate income "attributed" to

¹²I.R.C. § 643(a). The most important modifications of taxable income in arriving at DNI are the following: omission of most capital gains; and the deductions for distributions, personal exemption, and for long term capital gains; as well as the dividend exclusion; and inclusion of tax-exempt interest. I.R.C. § 643(a)(1), (2), (3), (5) and (7).

¹³Such income might not consist entirely of taxable income. For example, DNI includes tax-exempt interest. I.R.C. § 643(a)(5). An additional function of the DNI concept is to preserve the character of the various items of income which make up DNI and when distributions are made, to allocate these items to beneficiaries in the same proportions as they are earned in the trust or estate. I.R.C. §§ 652(b) and 662(b).

¹⁴I.R.C. §§ 651(a), 661(a).

¹⁵I.R.C. §§ 652(a), 662(a).

¹⁶I.R.C. § 662(a)(2) ("other amounts" not limited to accounting income). *See also* Treas. Reg. § 1.662(a)-3(a), (b)(1985).

¹⁷*Id.*

¹⁸I.R.C. § 661(a)(2). *See also* Treas. Reg. § 1.661(a)-2(c)(1985).

¹⁹I.R.C. §§ 661(a)(2), 662(a)(2) (deduction to trust or estate and inclusion in beneficiaries' gross income is limited to the amount of DNI of the trust or estate).

²⁰The complete definition of a simple trust is one which (1) is required by its instrument to distribute all its accounting income currently, (2) is not required by the instrument to make distributions to charity, and (3) does not distribute corpus or accumulated income in the current year. A trust which is not a simple trust is a complex trust. A trust may be a simple trust in one year and a complex trust in another year. I.R.C. § 651(a); Treas. Reg. §§ 1.651(a)-1, 1.661(a)-1(1985).

²¹Executors are virtually never required by will provisions to distribute all of an estate's income currently during administration. Moreover, estates are not subject to the throwback rules of Subchapter J, which are intended to discourage income accumulations by trusts. Treas. Reg. § 1.665(a)-0(1985). Therefore, it is not unusual for an executor to distribute only estate corpus during a taxable year of the estate and to accumulate all the income earned during the year.

it by the distribution.²² This would ordinarily be impossible because the trust, as a simple trust, is required to distribute all its income to *its* beneficiary (an individual)²³ currently. Therefore, all of a simple trust's taxable income, including income received from an estate, is generally carried out to the beneficiary, rendering the trust a nonpayer of income tax each year.²⁴

The executor succeeds, however, in making the trust the taxpayer for the estate "income" passed out to it because for fiduciary accounting purposes the distribution of estate principal retains its character as principal in the trust.²⁵ The trustee of the simple trust is not required by the instrument to distribute principal to the beneficiary; only trust income. The fact that for tax purposes the estate's principal distribution "carries out" taxable income to the trust is irrelevant to the trustee's responsibilities under the instrument and under local law. The trustee is not even permitted, in many cases, to pass on this income-laden principal to the beneficiary.²⁶ The trust is left to pay the income tax on the estate income attributed to it. The taxable income is "trapped" in the simple trust (it cannot be passed on to the beneficiary); hence, the term "trapping distribution."

The trapping distribution is particularly useful where the individual beneficiary of the simple trust is in a high income tax bracket. The tax on a portion of the estate's income is paid by the lower-bracket trust rather than the high-bracket individual or the estate. Nonetheless, the income beneficiary ultimately will receive all the income earned in both the estate and the trust.

II. THE *HOLLOWAY* ADJUSTMENT

The trust which has received a trapping distribution from an estate must pay the tax on income that was earned in the estate.²⁷ Ordinarily a trustee must

²²See R. COVEY, MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS 48-49 (1984); Cohan & Frimmer, *Trapping Distributions — The Trap That Pays*, 112 TRUSTS & ESTATES 766 (1973).

²³Although trusts may have multiple beneficiaries, hereinafter for convenience trust beneficiaries will be referred to in the singular.

²⁴Simple trusts frequently have no income tax liability because the distribution deduction, for amounts distributed to beneficiaries, reduces taxable income to zero or less. See I.R.C. § 651(a); Treas. Reg. § 1.651(b)-1(1985). However, simple trusts which realize net capital gains during a taxable year generally will pay income tax on the capital gains because capital gains are principal items for trust accounting purposes and are not affected by a trust provision requiring distribution of all income currently.

²⁵N.Y. EST., POWERS & TRUSTS LAW § 11-2.1(b)(2) (McKinney 1967); Uniform Principal and Income Act (1962) § 3(b), 7B U.L.A. 155-56 (1985).

The Service has privately endorsed this tax treatment of trapping distribution in Technical Advice Memorandum 7809057.

²⁶In its purest form, the instrument of a simple trust directs the trustee to distribute all income of the trust currently. It does not authorize corpus distributions until termination or until the occurrence of some other event fundamentally altering the character of the trust. Trustee discretion to distribute corpus, however, is not incompatible with simple trust status. Such a trust may be a complex trust in years when the trustee chooses to invade corpus and a simple trust in years when corpus remains untouched, provided all income is required to be distributed currently in every year. Treas. Reg. § 1.651(a)-1.

²⁷See *supra* text accompanying notes 20-24.

pay income tax using funds from the trust's income account.²⁸ This rule can be said to be based on fairness. Income taxes are imposed only if income is earned, and they increase as income increases. The beneficiary receiving the benefits of the income should be called upon to bear the burden of the tax. It must be borne in mind that although the "trapped" income resides for tax purposes in the *corpus* account of the trust, it originally was earned in the *income* account of the estate. Furthermore, setting aside for a moment all tax fictions, the actual dollars which were earned in the estate remain in the income account of the estate. These funds will ultimately be enjoyed by the income beneficiary of the trust.²⁹ Consequently, payment of the income tax on those dollars from the income account of the trust would locate the burden fairly.

A trust receiving a trapping distribution might have no income account from which to pay the tax. For example, the trust might not have been in existence long enough to earn any income. Even the trapping distribution itself consists wholly of estate principal. As was previously noted,³⁰ the distribution would retain its character as principal in the trust. The trustee would have no choice but to pay the income tax out of the trust's principal account,³¹ which would have ample assets for this purpose due to the distribution received from the estate.

This payment of income tax out of trust principal creates the unfairness which requires an equitable adjustment. Trust principal has paid an obligation that under fiduciary accounting rules³² should have been paid from income.³³

²⁸See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 11-2.1(1)(1)(B) (McKinney 1967); Uniform Principal and Income Act (1962) § 13(a)(6); G. BOGERT & G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 807 (rev. 2d ed., 1981). An important exception to this rule is the requirement that the trustee pay from principal any income tax on items of taxable income that are principal for trust accounting purposes, such as capital gains and income in respect of a decedent. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 11-2.1(1)(4)(C) (McKinney 1967).

²⁹The income beneficiary of a residuary trust will likely receive the income accumulated in the estate by one of two means. First, the executor may distribute the income to the simple trust in a subsequent year, setting in motion an automatic and equivalent distribution by the trust to its income beneficiary. Alternatively, the executor may distribute the income directly to the trust beneficiary, bypassing the pointless passage through the trust. Passing the accumulated estate income through the trust might have the disadvantage of triggering an accumulation distribution for the trust under § 665(b) of the throwback rules if the trust has any accumulated income.

Not only is the trust beneficiary likely to receive the accumulated income of the estate by one means or another, but he or she will most likely receive it tax-free. The DNI associated with the income will have been carried off to the trust in the trapping distribution, leaving accounting income that is tax-neutral in the estate. When ultimately passed on to the trust beneficiary, no DNI will be carried by this income. The beneficiary may receive estate DNI in the same year; however, its source will be current income of the year of the distribution, not the accumulated income.

³⁰See *supra* note 23 and accompanying text.

³¹Additional choices for payment of the tax may be provided by the executor, who may be a different person than the trustee. The executor could pay the portion of the trust's income tax attributable to the trapping distribution. In the alternative, the executor could distribute an additional amount to the trust to be used to pay the tax. In both alternatives, the amounts paid out by the executor would constitute additional distributions to the trust, carrying DNI with them. See Treas. Reg. § 1.662(a)-4(1985).

³²See *supra* note 26 and accompanying text.

³³To the extent a trapping distribution consists of income in respect of a decedent, I.R.C. § 691(a), which is always corpus, trust principal is the proper source for payment of the income tax. Principal is not discharg-

The remaindermen's interests have been reduced by the tax payment. Furthermore, the trust's income beneficiary will ultimately receive tax-free³⁴ the estate income which the executor accumulated in the year of the trapping distribution.

In *Holloway I*, a guardian ad litem for the remaindermen of four trusts which had received trapping distributions demanded that the income account of each trust reimburse the principal account for the tax which principal had paid.³⁵ This "equitable adjustment" would erase the unfairness detailed above. In its first opinion, the Surrogate's Court denied the request for the adjustment.³⁶ The Surrogate in *Holloway I* did not prohibit the adjustment but found that the trustee had not acted unreasonably in failing to make the adjustment.³⁷

The guardian moved to reargue the case. After a second hearing, with the aid of an amicus brief from the New York State Bankers Association (Trust Division) and with the acquiescence of the trustee, who on reargument took no position,³⁸ the guardian was awarded the adjustment from income to principal.³⁹

The Surrogate in *Holloway II* relied on "the purely equitable principle that the burden of income taxes should be charged to the account into which the taxed item goes The tax in fact is attributable to a receipt by the estate of income for accounting purposes."⁴⁰ The income account of the trust must assume the tax burden by reimbursing the corpus account for the amount it has paid. The reimbursement would occur in the trust year following receipt of the trapping distribution, when presumably some income will have been earned in the trust. Trust income can be compelled to pay the tax on income earned in the estate because the ultimate beneficiary of both estate income and trust income is the same person, and all benefits and burdens of both income accounts fall on that individual. *Holloway II* holds equity paramount and restores the balance between income and corpus beneficiaries that was upset by the operation of Subchapter J. As the Surrogate so aptly summed up; "While the Code provisions may fly in the face of reality, there is no reason for a court concerned with the proper administration of estates to follow suit."⁴¹

ing an obligation of trust income as to tax paid on such income, and no equitable adjustment is required for that portion of the trust's income tax. The parties seeking an adjustment in the *Holloway* case conceded this point. *Holloway*, *supra* note 8, at 365, 327 N.Y.2d at 868.

³⁴See *supra* note 29

³⁵67 Misc. 2d at 133, 323 N.Y.S.2d at 535.

³⁶*Id.* at 134, 323 N.Y.S.2d at 536.

³⁷*Id.* at 134, 323 N.Y.S.2d at 535.

³⁸68 Misc. 2d at 362, 327 N.Y.S.2d at 866.

³⁹*Id.* at 366, 327 N.Y.S.2d at 869.

⁴⁰*Id.* at 365, 327 N.Y.S.2d at 869.

⁴¹*Id.*

III. TAX ISSUES

Two income tax questions arise from the *Holloway II* decision. Both deal in some way with the trust income [hereinafter referred to as "*Holloway* income"] that is used to make the *Holloway* adjustment. First, who is the income taxpayer for *Holloway* income? The prime candidates are the income beneficiary of the trust and the trust itself. As this investigation will show, the answer is dependent on the local law dealing with the underlying equitable adjustment.⁴² In New York, where the local law is the *Holloway* case, the trust, and not the beneficiary, should be responsible for the tax on this income.⁴³

Second, if the beneficiary is not initially liable for the tax on *Holloway* income, might such liability arise later through the operation of the throwback rules?⁴⁴ This could occur if the *Holloway* adjustment is treated as an accumulation of income for which the beneficiary's day of reckoning is postponed only until the trustee makes an "accumulation distribution"⁴⁵ from the corpus. The correct application of the throwback rules, it will be shown, requires the exemption of the simple trust from their operation, saving the beneficiary again from a tax on *Holloway* income.⁴⁶

IV. THE IDENTITY OF THE TAXPAYER

In year two of the residuary trust, a portion of the income earned by the trust is transferred to the principal account as the *Holloway* adjustment. The rest of the trust's income is paid out to the income beneficiary, according to the terms of the will. There is no question that the income beneficiary must pay income tax on the portion of trust income that is distributed.⁴⁷ A more difficult question is the following: who is the taxpayer for the *Holloway* income that is paid over to the trust's principal account?

There are two possible answers. Since the income was earned in the trust and was not distributed, the trust could be responsible for the income tax. On the other hand, because the trust is a simple trust, all the income is required to be distributed to the income beneficiary. Perhaps the income beneficiary, therefore, is the taxpayer responsible for this tax on the theory that the *Holloway* income was in effect distributed to the beneficiary, then paid by the beneficiary to the trust's principal account. The plausibility of the latter interpretation is bolstered by the fact that although the *Holloway* adjustment is, as a practical matter, made from the trust's income account to its principal account, it is intended to adjust the interests of the income and principal

⁴²See *infra* text accompanying notes 55-70.

⁴³See *infra* text accompanying notes 69 and 70.

⁴⁴I.R.C. §§ 665-67.

⁴⁵I.R.C. § 665(b).

⁴⁶See *infra* text accompanying notes 116-46.

⁴⁷See *supra* notes 11-19 and accompanying text.

beneficiaries.⁴⁸ The idea that the income used to make the adjustment constructively passes through the income beneficiary's hands is consistent with the rationale for the adjustment.

The Internal Revenue Service has not taken a published position on the identity of the taxpayer for *Holloway* income.⁴⁹ Consequently, the question has not been litigated to date, and there exists no judicial authority. The commentators are split on the question. Professor Casner has advanced the income beneficiary as the appropriate taxpayer, suggesting that when the trustee makes the adjustment, the beneficiary is in effect repaying a debt to the trust.

[In a trapping distribution,] the life income beneficiary may be enriched at the expense of the corpus in that eventually he will receive the estate income on which the income tax was paid by the trust corpus, and if the trustee does not have discretion to distribute corpus to the life income beneficiary, the trustee may be required in some appropriate way to reimburse the corpus in the amount of the income tax that has come out of corpus. If this is done by the trustee's withholding of the necessary amount out of what would otherwise be trust income required to be distributed to the life income beneficiary, no income tax should be payable by the trust as a result of such withholding. The life income beneficiary should be treated as though he received all the trust income and then paid a debt owing to the trust, in determining the income tax consequences of the trust and the income beneficiary.⁵⁰

Jonathan Blattmachr has adopted the view that the trust is the appropriate taxpayer for *Holloway* income. His reasoning is that the *Holloway* adjustment reduces the trust's accounting income, thereby reducing the amount that is required to be distributed to the beneficiary under the terms of the will.

If the effect of the *Holloway II* adjustment is to reduce the amount of accounting income in the year the adjustment is made, the deduction to the trust and the inclusion in gross income by the beneficiary presumably are

⁴⁸The Surrogate's Court in *Holloway II* quotes with approval the following sentence from another equitable adjustment decision, *In re Bixby's Estate*, 140 Cal. App. 2d 326, 339-40, 295 P.2d 68, 76 (1956):

The ultimate result is salutary in that the reciprocal and correlative rights of all the takers under the will remain vested in the posture prescribed by the state rules governing rights and interests in the estates of decedents, undisrupted and undisturbed by the transient vagaries of the federal income tax laws.

68 Misc. 2d at 365-66, 327 N.Y.S.2d at 869.

⁴⁹The Service has ruled privately, in Technical Advice Memoranda 8501011 and 8501084, that the trust is the proper taxpayer for *Holloway* income. Both rulings deal with the same trust, which the Service and the taxpayer agreed was governed by New York law, including the *Holloway* decision.

I.R.C. § 6110(j)(3) provides that Technical Advice Memoranda "may not be used or cited as precedent." On the authority of private determinations of the Internal Revenue Service, see generally Portney, *Letter Rulings: An Endangered Species?* 36 TAX LAW 751 (1983).

⁵⁰A. CASNER, ESTATE PLANNING 206-07 (1978 Supp. to Vol. I). Professor Casner does not mention the *Holloway* adjustment in the 5th edition of the ESTATE PLANNING treatise (1983) or in any of the supplements subsequent to the 1978 supplement.

reduced. The thrust of the *Holloway II* decision seems to be that the effect of the adjustment is to reduce the amount of accounting income.⁵¹

The reduction of accounting income suggested here, while limiting the amount required to be distributed, cannot affect the amount of income subject to payment of tax by someone. As it is not required to be distributed to the beneficiary, the *Holloway* income, according to this view, must be taxed to the trust.⁵²

Before pursuing in detail the identity of the taxpayer for *Holloway* income, it is important to establish what is at stake for the participants. The reader may have observed that regardless of whether the income beneficiary or the trust is established as the proper taxpayer, the burden of the tax will ultimately fall on the income beneficiary. This is so because even if the trust pays the tax on *Holloway* income, it will be the income account of the trust that will be the appropriate source for funds to pay the tax.⁵³ By reducing the amount the income beneficiary receives in distributions from the trust, this resolution of the question places the tax burden squarely on the income beneficiary.

It is the weight of the tax burden, however, that can be different if the tax is paid by the trust. The trust may be in a lower income tax bracket than the in-

⁵¹Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 INST. ON EST. PLAN. 14-19 (1984).

⁵²*Id.* This reasoning was adopted by the Service in two Technical Advice Memoranda, Nos. 8501011 and 8501084, both of which dealt with the same trust. See *supra* note 49.

⁵³See *supra* authorities cited in note 28.

The obligation of the trust income account to pay this tax on *Holloway* income presents again (and perhaps again and again) the question of the identity of the taxpayer for income that is not actually distributed to the income beneficiary.

The scenario is as follows: The trapping distribution is made from the estate to the trust in year one of the trust. The distribution creates an income tax liability that is discharged by trust corpus for lack of any income in the trust at that early date. In year two, when the trust does have income, the trustee makes a *Holloway* adjustment to reimburse corpus from the income account. In year three, assuming the trust is the appropriate taxpayer for *Holloway* income, the trustee is faced with an income tax obligation (on April 15 if it is a calendar year trust) for the income retained in the trust in year two as the adjustment. The trustee uses income earned in the first three months of year three to pay this tax. Therefore, all of the year three income is not distributed. Furthermore, to the extent it is not, the trust presumably is liable for income tax on it, due in April of year four. Payment of this tax will create a tax obligation for the trust in year five, and so on.

Nonetheless, the pocket from which each year's tax is paid is in effect the income beneficiary's, through a reduction of income distributions each year exactly equal to the tax paid by the trust. The beneficiary may be quite satisfied to have the trust incur these multiple rounds of income tax, which utilize the trust's low and declining tax brackets rather than his or her own higher brackets.

A slightly more complex problem, that of multiple *Holloway* adjustments, arises if on April 15 of year three the trust has insufficient funds in its income account to pay the income tax on the *Holloway* income from year two (perhaps because trust corpus is invested in bonds which pay interest only after April 15, or because the income from the first three months of year three was distributed on March 31 to the income beneficiary in a quarterly distribution required by the instrument). The trustee is obliged in year three to use trust corpus to pay the tax on the *Holloway* income. Clearly, a second *Holloway* adjustment is necessary later in year three to reimburse corpus for this payment. The income used to make the year three *Holloway* adjustment will generate an income tax to the trust for year three. If on April 15 of year four the trust is again without income to pay the tax for year three, the trustee must use corpus again, necessitating a year four *Holloway* adjustment and triggering a year four income tax to the trust, and so on. Again, the beneficiary enjoys the benefit of having the tax on part of several years' trust income paid by the trust at the trust's low and declining tax brackets.

On multiple *Holloway* adjustments, see Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 INST. ON EST. PLAN. n. 102 and accompanying text (1984).

come beneficiary. Furthermore, even if both the trust and the individual are in their respective top tax brackets, the use of the trust as an additional taxpayer provides a second "ride" up the tax brackets, allowing some income to be taxed in each of the lower brackets.⁵⁴ A conclusion that the trust, rather than the beneficiary, is the proper taxpayer for *Holloway* income almost invariably will result in a lower total tax bill on income all of which, after taxes, will come to rest in the hands of the beneficiary.

A. *A Reduction of Income*

The starting point, and it may seem to be the ending point, of the inquiry into the proper taxpayer for trust income transferred to the principal account as a *Holloway* adjustment is Section 652(a) of the Code. Section 652(a) requires the income beneficiary of a simple trust to include in gross income the amount of the trust's income required to be distributed currently, "whether distributed or not."⁵⁵ This would seem to terminate the investigation abruptly because it apparently makes no difference whether the *Holloway* income is distributed. The Code appears to make the income beneficiary the taxpayer, no matter what the trustee does.

One means of avoiding this conclusion would be to characterize *Holloway* income as something other than trust accounting income. That is, trust accounting income is reduced by the amount of the *Holloway* adjustment — the argument attributed to Blattmachr previously noted.⁵⁶

The Code at Section 643(b) uses the unadorned term "income" to refer to trust accounting income and defines it as the trust's income for the year "determined under the terms of the governing instrument and applicable local law."⁵⁷ The question whether the *Holloway* adjustment reduces trust accounting income could be restated: does "applicable local law," in the form of the *Holloway* decision, redefine a portion of the trust's income as principal?

When the *Holloway* adjustment is made, the income transferred to the trust's principal account unquestionably *becomes* principal. However, it cannot be denied that the amounts transferred were originally accounting income. New York's Principal and Income Act⁵⁸ is the "applicable local law" which in the first instance defines accounting income for New York trusts as "the return in money or property derived from the use of principal."⁵⁹ The law provides examples of income, including dividends, interest, and rents.⁶⁰ The

⁵⁴This effect results from the fact that whatever a taxpayer's marginal tax rate, portions of the taxpayer's income are taxed in each of the tax brackets below the marginal rate. See I.R.C. § 1(a)-(e).

⁵⁵I.R.C. § 652(a).

⁵⁶See *supra* notes 51 and 52 and accompanying text.

⁵⁷I.R.C. § 643(b).

⁵⁸N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 (McKinney 1967 & Supp. 1986).

⁵⁹*Id.* at § 11-2.1(b)(1).

⁶⁰*Id.* at § 11-2.1(b)(1)(A) - (I).

Holloway decision is no less “applicable local law” than the Principal and Income Act, but the decision does not hold that certain dividends, interest, and rents are not accounting income. It merely requires that they be paid over to the principal account.⁶¹ The Surrogate in *Holloway II* directed an “adjustment from income to principal.”⁶²

A return to Subchapter J, however, reveals that the interpretation of the *Holloway* adjustment as reducing accounting income is conceptually correct, though a bit inaccurately presented. Section 652(a) does not measure the amounts includible in the beneficiary’s gross income from bare trust accounting income, which in Internal Revenue Code parlance would be referred to simply as “income.”⁶³ Rather, the amount includible for the beneficiary is “the amount of income for the taxable year required to be distributed currently.”⁶⁴ The phrase contains the word “income,” meaning trust accounting income determined under the instrument and applicable local law. However, it limits inclusion to the amount of “income” that is required to be distributed currently.

By definition, simple trusts are required by their instruments to distribute *all* their accounting income currently.⁶⁵ Therefore, ordinarily no distinction is drawn between trust accounting income and “income required to be distributed currently.” But, their coincidence is not always perfect. The most common exception is where the governing instrument requires the trustee to withhold annually a portion of accounting income for a depreciation reserve.⁶⁶ In such cases, the withheld income becomes principal.⁶⁷ The amount of trust accounting income earned by the trust is not affected by such a provision; only “income required to be distributed currently” is reduced, and with it the trust’s distribution deduction⁶⁸ and the amount for inclusion in the beneficiary’s gross income.

The *Holloway* adjustment must be seen as analogous to a depreciation reserve. The income transferred to corpus is genuine trust accounting income within the meaning of the Principal and Income Act. But as with a depreciation reserve, it cannot be said that the *Holloway* income is “required to be distributed currently.” It is expressly required by the *Holloway* decision *not* to

⁶¹68 Misc. 2d at 366, 327 N.Y.S.2d at 869.

⁶²*Id.* (emphasis added).

⁶³See I.R.C. § 643(b).

⁶⁴I.R.C. § 652(a).

⁶⁵I.R.C. § 651(a); Treas. Reg. § 1.651(a)-1.

⁶⁶Treas. Reg. § 1.651(a)-2(a). The regulations provide that “the retention of current income for [a depreciation reserve] will not disqualify the trust from being a ‘simple’ trust.” *Id.*

⁶⁷The purpose of such a reserve is to replace corpus that has been lost through wear and tear, or as the regulations state it, “keeping the trust corpus intact.” *Id.* As with the *Holloway* adjustment, the income amounts that go into a depreciation reserve are not “corpus” as they are earned. Rather, funds are transferred from income to corpus.

⁶⁸The distribution deduction, like the beneficiary’s income, is measured by income “required to be distributed currently.” Compare I.R.C. §§ 651(a) and 652(a).

be distributed.⁶⁹ Therefore, the "amount of income for the taxable year required to be distributed currently" within the meaning of Sections 651(a) and 652(a) is reduced by the *Holloway* adjustment.⁷⁰ The trust's distribution deduction and the beneficiary's gross income inclusion are reduced by the amount of the adjustment. The result is that the trust, and not the beneficiary, is the proper taxpayer for *Holloway* income.

B. A Mandatory or Permissive Adjustment?

It is fundamental that the *Holloway* adjustment be mandatory. If the adjustment were merely permissive, the amount of income *required* to be distributed would not be affected. In the absence of a mandatory rule, any such adjustment made by a trustee could be described best as the voluntary repayment of a debt owed by the income beneficiary to trust corpus, the view proposed by

⁶⁹A distinction that may seem pertinent between the depreciation reserve example in the regulations and the *Holloway* adjustment is the source of the requirement that income be withheld. In the reserve example, the requirement is imposed by the trust's governing instrument. Treas. Reg. § 1.651(a)-2(a). The *Holloway* adjustment, on the other hand, is imposed by local law, *viz.*, the *Holloway* decision. This difference may appear to have real significance in light of the definition of a simple trust in I.R.C. § 651(a)(1), which provides that the requirement that all the trust's income be distributed currently must be found specifically in the terms of the trust instrument. The question is raised whether "local law" can ever be a determinant of the amount of income required to be distributed under § 651. If it can not, then the *Holloway* adjustment does not reduce such income, and the beneficiary should be treated as receiving all of it.

However, it is not the classification of the trust as a simple trust, the subject of § 651(a)(1), which is at issue here. The issue involves the measurement of the trust's distribution deduction, for which § 651(a) makes a second mention of "income required to be distributed currently," this time in the flush language following § 651(a)(2). Of equal concern is the measurement of the beneficiary's gross income inclusion, in § 652(a), where income required to be distributed currently is again the standard. In both of these latter two instances, and unlike § 651(a)(1), income required to be distributed is not further qualified as income required *by the terms of the instrument* to be distributed.

Therefore, for purposes of measuring the distribution deduction and the beneficiary's income, although not for determining whether a trust is a simple trust, *applicable local law* is pertinent to the "requirement" to distribute all income currently. In the form of the *Holloway* decision, local law reduces the amount required to be distributed currently by requiring that a portion of current income be paid instead to corpus. The trust is still a simple trust because the *trust instrument* requires that all the income be distributed currently. The fact that local law supersedes the terms of the instrument as to amounts actually to be distributed in the year of the adjustment does not alter the terms of the instrument, which continue to qualify the trust as a simple trust.

For the same reason, the reference to "applicable local law" in the first sentence of Treas. Reg. § 1.651(a)-2(a) is not without authority in the Code. That sentence states: "The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law." The reference is to the second mention in Code § 651(a) of income required to be distributed currently, not to the definition of simple trusts in § 651(a)(1). This conclusion is consistent with the existence of a separate section in the regulations dealing with the definition of simple trusts, Treas. Reg. § 1.651(a)-1.

An important consequence is that a depreciation or depletion reserve required by local law, but not by the trust instrument, would have exactly the same effect as would either a reserve required by the instrument or the *Holloway* adjustment: income required to be distributed currently would be reduced, as would the distribution deduction and the beneficiary's income, but the trust would continue to qualify under its terms and under § 651(a)(1) as a simple trust.

⁷⁰Revenue Ruling 85-116, 1985-31 I.R.B. 19, contains an instance where income required to be distributed is *increased* by "applicable local law," the reverse of the *Holloway* situation. The trust described in the ruling had disposed of (by corporate liquidation) underproductive property in the form of shares of stock in a corporation that had paid very little or no dividends during the trust term. State trust law, as interpreted by the state's Surrogate's Court, required the trustee to distribute part of the liquidation proceeds to the income beneficiary to compensate for its failure to make the property productive earlier.

The Service ruled that the distribution is income required to be distributed currently under applicable local law. To the extent the distribution consists of capital gains from the liquidation, the distribution is included in the trust's DNI and therefore in the beneficiary's gross income. *Id.*

Casner as previously noted.⁷¹ Therefore, the beneficiary would be the proper taxpayer for *Holloway* income. There follows a consideration first of the *Holloway* adjustment's claim to mandatory status, and second of the tax treatment of such adjustments in jurisdictions where there is no mandatory rule.

1. The *Estate of Bosch* Problem

The Surrogate in *Holloway II* expressed the ruling in mandatory language.⁷² The *Holloway* adjustment is regarded by New York fiduciaries and their counsel as a requirement, and not merely an option.⁷³ Despite the mandatory force of the ruling for trustees subject to New York law, however, the attitude of a federal court deciding the question of the proper taxpayer for *Holloway* income is far from certain. Since the Supreme Court decided *Commissioner v. Estate of Bosch*⁷⁴ in 1967, federal courts deciding tax controversies have not been obliged to regard state trial court decisions as controlling for purposes of defining property rights and obligations to which federal tax rules apply.⁷⁵ The Supreme Court in *Estate of Bosch* ruled that only decisions of the highest court of each state define incontrovertably the common law of each state. The rationale of the ruling was to head off taxpayers' use of nonadversary proceedings and even collusive suits in lower state courts to obtain adjudications of their rights for the sole purpose of affecting their tax treatment.⁷⁶

[T]he underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court, then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State.⁷⁷

The Surrogate Court's *Holloway II* decision, then, is entitled to only "proper regard" by the Tax Court, the Claims Court, or a Federal District Court deciding an income tax case. Any such federal court that determines that *Holloway II* does not represent the law of New York as the New York

⁷¹See *supra* note 50 and accompanying text.

⁷²The holding in *Holloway II* is as follows: "[T]he prior decision is modified by sustaining the objection of the guardian ad litem and directing that the adjustment from income to principal, the extent to which has been agreed upon in the papers, be made." 68 Misc. 2d at 366, 327 N.Y.S.2d at 869. If there was any doubt as to the mandatory effect of the *Holloway II* ruling, it was dispelled by the holding in *In re Will of Coe*, 80 Misc. 2d 374, 363 N.Y.S.2d 265 (Sur. Ct. 1975), decided by Surrogate John D. Bennett, the author of both *Holloway* opinions. "[T]he fiduciary should not be surcharged for exercising its discretion in not having the principal account reimbursed for the taxes paid (EPTL 11-2.1) in view of the fact that Matter of *Holloway* was not decided when the taxes were paid." *Id.* at 381, 363 N.Y.S.2d at 271. A fair inference is that trustees could be surcharged for failing to make the *Holloway* adjustment in cases arising after *Holloway II*.

⁷³See Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*. 36 TAX LAW app. p. 614 item 3(b), p. 625 n. 53 (1983).

⁷⁴387 U.S. 456 (1967).

⁷⁵*Id.* at 465.

⁷⁶The majority in *Estate of Bosch* was convinced that the state court adjudications before it were obtained "for the purpose of directly affecting federal estate tax liability." *Id.* at 463.

⁷⁷*Id.*

Court of Appeals would define it, could decide that the proper level of regard for *Holloway II* is none at all. The "mandatory" adjustment under state law for New York fiduciaries could be deemed merely discretionary for purposes of federal taxation.

An *Estate of Bosch* ruling against the validity of a lower state court's decision can result in tax treatment that diverges materially from the economics of the transaction being taxed. For instance, a New York trustee would be no less subject to the state law requirement of *Holloway II* to transfer part of the trust's income to the principal account simply because a federal court ruled in a tax case that New York law requires no adjustment, and that New York law requires the trustee to distribute all the trust's income to the beneficiary. Only the taxpayers' payment of income tax would conform to the federal court's reading of New York law, not their actual behavior as to the trust and its income.⁷⁸

An effort can be made to predict what a federal court giving *Holloway II* "proper regard" would conclude. The decision has at least two strikes against it. First, *Holloway II* directly contradicts the Revised Uniform Principal and Income Act (Principal and Income Act), which has been enacted in New York.⁷⁹ The Principal and Income Act requires that trustees pay from principal "any tax levied upon profits, gain or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority."⁸⁰ There can be little doubt that the income tax on a trapping distribution of estate corpus is a tax on "other receipts allocated to principal." Thus, it would seem that the payment of the tax from trust principal was proper under the Principal and Income Act. On this basis, the Surrogate had decided in *Holloway I* that no adjustment from income to principal for the tax is required.⁸¹ In *Holloway II*, the Surrogate did not ignore the Principal and Income Act but restated the rationale for its first decision: "Unquestionably a literal interpretation of 'other receipts' would include principal distributions to testamentary trusts as here which are only 'deemed' income by the Internal Revenue Code."⁸² However, in *Holloway II*, "the purely equitable principle

⁷⁸See *Estate of Bosch*, 387 U.S. 456, 470 (1967) (Douglas, J., dissenting).

⁷⁹N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 (McKinney 1967).

⁸⁰*Id.* at § 11-2.1(1)(4)(C) (emphasis added); see also Uniform Principal and Income Act (1962) § 13(c)(4).

⁸¹67 Misc. 2d at 133-34, 323 N.Y.S.2d at 535. The *Holloway* case involved trapping distributions made in 1959, prior to the adoption in New York of the Revised Uniform Principal and Income Act in 1965, without retroactive effect. Nonetheless, the Surrogate in *Holloway I* found that the 1965 law codified prior New York decisions requiring payment of income tax on corpus items from the corpus account. Therefore, there would be no distinction between *Holloway* and a case arising under the Principal and Income Act:

[E]ven though the expense was incurred prior to the effective date of the Principal and Income Act, the fact that the Legislature has seen fit to adopt the above mentioned rule and that it is in effect a codification of prior case law would seem to preclude any argument that the trustees were unreasonable in not making the allocation urged by the guardian ad litem.

Id. at 134, 323 N.Y.S.2d at 535 (citation omitted).

⁸²68 Misc. 2d at 364, 327 N.Y.S.2d at 868.

that the burden of income taxes should be charged to the account into which the taxed item goes”⁸³ outweighed the rather imprecise reference to “other receipts” in the Principal and Income Act. The reasoning of *Holloway II*, based on equity between the two classes of beneficiaries, can certainly stand on its own. A federal court giving “proper regard” to the case, however, might reasonably conclude that the New York Court of Appeals would adhere more strictly to the Principal and Income Act.

A second infirmity of *Holloway II* in any “proper regard” determination would be the fact that *Holloway II*, unlike *Holloway I*, was a nonadversary proceeding. On reargument, the trustees, who had won in *Holloway I*, declined to take any position.⁸⁴ The guardian ad litem, who had initiated the proceedings by objecting to the trustees’ final account, requested the reargument.⁸⁵ The New York State Bankers Association (Trust Division) filed an *amicus curiae* brief in support of the guardian’s position.⁸⁶ The Surrogate in *Holloway II* twice cites the pre-*Holloway* practice of “most corporate fiduciaries” of making the adjustment from income to principal, even though not required to by statute or decision.⁸⁷ The appearance, in *Holloway II*, of a desire shared by all participants to salvage a long-time practice among local trust departments and counsel is, for better or worse, difficult to overlook. It is particularly damaging for a “proper regard” determination that when both sides of the controversy were actively represented, in *Holloway I*, the trustees prevailed, while the guardian succeeded only when the trustees chose not to respond.

Standards for federal courts giving “proper regard” to lower state court decisions under *Estate of Bosch* are nonexistent.⁸⁸ The cases have come out both ways, i.e., some lower state court decisions have been followed and some ignored.⁸⁹ But even given the uncertainty of the rule stated by the Supreme Court and even acknowledging the two negative aspects of *Holloway II* men-

⁸³*Id.* at 365, 327 N.Y.S.2d at 869.

⁸⁴*Id.* at 362, 327 N.Y.S.2d at 866.

⁸⁵*Id.*

⁸⁶*Id.*

⁸⁷*Id.*

⁸⁸See, e.g., R. STEPHENS, G. MAXFIELD, & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4-67 (5th ed. 1983); M. FERGUSON, J. FREELAND, & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES 47 (1970).

⁸⁹Lower state court decrees were not followed by federal courts in, *inter alia*, *Estate of Selby v. United States*, 726 F.2d 643, 645-48 (10th Cir. 1984); *Hunter v. United States*, 597 F. Supp. 1293, 1297 (W.D. Pa. 1984); *Lake Shore Nat'l Bank v. Coyle*, 296 F. Supp. 412, 417-18 (N.D. Ill. 1968), *rev'd on other grounds*, 419 F.2d 958 (7th Cir. 1970); *Krakoff v. United States*, 313 F. Supp. 1089, 1092-93 (S.D. Ohio 1970); *Schmidt v. United States*, 279 F. Supp. 811, 815-16 (D. Kan. 1968); and *Lakewood Plantation, Inc. v. United States*, 272 F. Supp. 290, 294 (D.S.C. 1967). The lower state court decisions were followed in proper regard determinations in, *inter alia*, *Harris v. Lukhard*, 733 F.2d 1075, 1082 (4th Cir. 1984)(a non-tax case); *Estate of Fulmer v. Comm'r*, 83 T.C. 302, 306-308 (1984); and *Underwood v. United States*, 407 F.2d 608, 610 (6th Cir. 1969). In *Mass v. Comm'r*, 81 T.C. 112 (1983), the Tax Court followed a lower state court ruling obtained by the taxpayer before the Tax Court, while rejecting prior rulings of lower courts in the same state on the same issue. *Id.* at 125-27. Undoubtedly, there have been numerous *sub silentio* proper regard determinations where federal courts have followed state court decrees but have not raised the issue in written opinions.

tioned above,⁹⁰ the odds in favor of a federal court's following *Holloway II* in a tax dispute are high. Addressing the first problem cited above,⁹¹ the fact that the Surrogate gave greater weight to equitable principles than to the Principal and Income Act should be of no concern to a federal court. Federal courts do have a legitimate concern to prevent taxpayers from engaging in collusive state court litigation for the sole purpose of affecting their federal tax liability. On the other hand, federal courts deciding tax cases generally are not, nor should they be, concerned to assure the "proper" development of the common law in the several states.

As to the nonadversary nature of the second *Holloway* proceeding,⁹² this should not be a barrier to a federal court's following of the rule of the case for two reasons. First, whatever motives the parties may have had, affecting their tax liability cannot have been one of them. The guardian ad litem, who initiated the proceedings and requested the reargument, as well as the remaindermen he represented, sought no tax benefit from the *Holloway* adjustment. The guardian was seeking a "refund" of income taxes paid by corpus, but not a refund from the government, rather from the income account on whose behalf corpus had paid the tax. There was no question before the state court that would affect the total amount of tax liability. That was established and had long been paid.⁹³ The trustees, who took no position on reargument, stood only to bear additional taxes as a result of the *Holloway* adjustment. If the trust is the taxpayer for the *Holloway* income, the trust will pay an income tax, where, as a simple trust, it likely would have owed nothing in the absence of the adjustment.⁹⁴ A federal court could never say of *Holloway II*, as the Supreme Court said in *Estate of Bosch*, that the "state proceedings were brought for the purpose of directly affecting federal . . . tax liability."⁹⁵

A second factor that may reduce the impact of the nonadversarial nature of the *Holloway II* proceeding is the fact that in any future federal tax controversy, it will not be the *Holloway* parties but some other taxpayers who will be before the federal court. In *Estate of Bosch* and many of its progeny to date,

⁹⁰See *supra* text accompanying notes 79-87.

⁹¹See *supra* text accompanying notes 79-83.

⁹²See *supra* text accompanying notes 84-87.

⁹³It is no doubt true that the use of a trapping distribution in itself affected the total tax liability of the estate, the trust, and the income beneficiary considered together. See *supra* notes 20-26 and accompanying text. However, the *Holloway* case did not deal with the question of whether trapping distributions can be made, but with the question of who bears the burden of income tax following a trapping distribution.

⁹⁴See *supra* note 24 and accompanying text.

⁹⁵387 U.S. at 463. It might be suggested that the trustees in *Holloway II* were acting in the interests of the income beneficiary of the trusts, who could very well have saved income taxes as a result of the adjustment. See *supra* text accompanying notes 53-54. For two reasons, this contention does not render the *Holloway* case "tax-motivated." First, the income beneficiary simply did not participate in the controversy. Attributing her interests to the trustees can only be purely conjectural. Second, the trustees did not initiate the proceedings. Therefore even if they had the income beneficiary's tax interests in mind, these cannot have been the reason the proceedings were initiated.

the issue has been whether a state trial court decision involving the taxpayer before the federal court was controlling.⁹⁶ The reach of *Estate of Bosch* certainly extends beyond cases where the taxpayer before the federal court has obtained a lower state court ruling affecting his tax liability.⁹⁷ The Supreme Court's holding was simply that in the absence of a decision by the state's highest court, a federal court must determine the state's law as the highest court of the state *would* find it. This determination must be made giving "proper regard" to decisions by "other courts of the State," without limitation to decisions involving the taxpayer before the court.⁹⁸ Nonetheless, a federal court is naturally more likely to be offended by a lower state court ruling obtained by the taxpayer before it in a nonadversary proceeding and for the purpose of affecting tax liability. This will not be the case for future taxpayers relying on the *Holloway II* decision.

The chances that *Holloway II* would survive a "proper regard" inquiry are not as bleak as they might first appear, and can even be described as good. Thus, for a federal court, *Holloway II* should represent the law of New York even though it is not a decision of the state's highest court. For the time being, it appears that the *Holloway* adjustment is indeed mandatory for trustees in New York for state law and federal tax purposes. As a mandatory adjustment, it reduces "income required to be distributed," and also the amount which the income beneficiary must include in gross income.

2. Other Jurisdictions

The question remains whether a "*Holloway*" adjustment is mandatory in states other than New York. One state, Michigan, by statute prohibits all equitable adjustments.⁹⁹ In no other jurisdiction is there any decision or statute addressing the need for an adjustment from trust income to principal in the context of a trapping distribution.¹⁰⁰ A 1983 joint study by the American Bar Association and the American College of Probate Counsel established that in only six states, aside from New York, "*Holloway*" adjustments are made as a

⁹⁶See, e.g., *Estate of Selby v. United States*, 726 F.2d 643, 645-48 (10th Cir. 1984); *Underwood v. United States*, 407 F.2d 608, 610 (6th Cir. 1969); *Lake Shore Nat'l Bank v. Coyle*, 296 F. Supp. 412, 417-18 (N.D. Ill. 1968).

⁹⁷See, e.g., *Harris v. Lukhard*, 733 F.2d 1075, 1082 (4th Cir. 1984); *Hunter v. United States*, 597 F. Supp. 1293, 1297 (W.D. Pa. 1984); *Estate of Fulmer v. Comm'r*, 83 T.C. 302, 306-308 (1984); *Mass v. Comm'r*, 81 T.C. 112, 125-27 (1983).

⁹⁸387 U.S. at 465.

⁹⁹MICH. COMP. LAWS § 700.829(2). The provision is in pertinent part as follows:

[W]here the applicable provisions of the internal revenue code confer a benefit or impose a detriment upon a trust or estate or persons designated to benefit from a trust or estate, a trustee or personal representative shall not restore an interest to the position otherwise contemplated by the person having authority to act in respect to that interest through adjustment between income and principal.

Id.

¹⁰⁰Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*, 36 TAX LAW. 545, 606, 608, 610, 612, 614, 616, 618, item 3(a) app. (1983).

matter of practice.¹⁰¹ It may be assumed that on occasion trustees in other states make such adjustments in the interest of fairness among beneficiaries.

The tax question considered above regarding the adjustment in New York must be raised again for all other jurisdictions: who is the taxpayer for income transferred to the principal account for the *Holloway* adjustment? As in the discussion of this question for New York trusts, the key to the answer is the answer to another question: is the adjustment mandatory under state law? If it is not mandatory, then the adjustment can be seen as a voluntary repayment of a debt to the trust's principal account by the income beneficiary, who would then properly pay the tax on the income used for the adjustment.¹⁰² If the adjustment is mandatory, then it is accurate to say that "income required to be distributed" to the beneficiary is reduced by applicable local law. Therefore, the trust, rather than the beneficiary, should be the taxpayer.¹⁰³

Where state law is silent, a *Holloway* adjustment would be merely permissive. The adjustment would certainly not be prohibited. A trustee could not very well be surcharged for taking the initiative to correct the imbalance between the interests of income and principal beneficiaries resulting from the income tax payment from corpus.¹⁰⁴ Nor would a trustee be in the wrong for failing to make an adjustment in the absence of a pre-existing judicial or statutory requirement. Even in New York, a trustee in one case was absolved from liability for not making a *Holloway* adjustment because the case arose before the *Holloway II* decision.¹⁰⁵

The question of the identity of the taxpayer for *Holloway* income, therefore, has two answers. In New York, where the adjustment is mandatory, the trust is properly the taxpayer. In other jurisdictions, where state law to date is silent and the adjustment consequently is merely permissive, the income beneficiary of the trust is the appropriate taxpayer, despite the fact that the *Holloway* income never reaches that individual.¹⁰⁶ The rationale, again, is that the income beneficiary has used the *Holloway* income to repay a debt to the principal account of the trust, which has paid an income tax obligation of the

¹⁰¹*Id.* at 606, 610, 612, 616, item 3(b) app. The six states are Colorado, Connecticut, Maryland, Nevada, Oregon, and Rhode Island.

¹⁰²See *supra* text accompanying note 50.

¹⁰³See *supra* text accompanying note 51.

¹⁰⁴In *Holloway I*, which held that an adjustment was not required, the Surrogate remarked in dictum:

This is not to infer [sic], however, that the trustees would necessarily have been found imprudent had they made the allocation urged by the guardian ad litem provided they were authorized under the will to make such discretionary allocations, since the court will not interfere with an allocation even though it might have exercised the discretion differently in the absence of an abuse of discretion.

67 Misc. 2d at 134, 323 N.Y.S.2d at 535 [citations omitted]. It is unclear whether the discretion referred to by the Surrogate would have to be affirmatively granted to the trustee by the instrument or merely not denied the trustee by the instrument.

¹⁰⁵*In re Will of Coe*, 80 Misc. 2d 374, 381, 363 N.Y.S.2d 265, 271 (Sur. Ct. 1975).

¹⁰⁶In Michigan, the question of the identity of the taxpayer for *Holloway* income cannot arise because the adjustment is prohibited by statute. See *supra* note 99 and accompanying text.

income account.¹⁰⁷

3. The Prognosis for More *Holloways*

New York will remain alone in the “mandatory adjustment” camp only until another state court or legislature imposes a *Holloway* adjustment requirement on trustees. It is worthwhile to consider briefly the likelihood that a “*Holloway* bandwagon” will develop, by examining the considerations a probate court or state legislature faces in deciding whether to require an adjustment.

The most obvious hurdle to a *Holloway* requirement in a majority of states¹⁰⁸ is the provision, previously quoted,¹⁰⁹ in the Revised Uniform Principal and Income Act. This provision requires that funds to pay income taxes on items of accounting principal must come from the principal account.¹¹⁰ The *Holloway II* decision demonstrated persuasively that considerations of fairness among beneficiaries can override this requirement. The inequity created by the use of corpus to pay income tax in the trapping distribution context is real. A court can justifiably conclude that the drafters of the Principal and Income Act did not have this situation in mind when the provision was framed. The Principal and Income Act will be useful primarily for a court that is determined not to require a *Holloway* adjustment and is seeking to amass authority for that position.

On the other side, a probate court must decide whether the fiduciary duty of impartiality impels a trustee to make a *Holloway* adjustment. In its broadest statement of the duty of impartiality, the Restatement Second of Trusts expresses the rule as follows: “When there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.”¹¹¹ Dealing impartially with income and corpus beneficiaries, it can be argued, invariably requires reimbursing the corpus account when it pays taxes on income never received by the corpus beneficiaries. The *Holloway II* case was decided on grounds of the duty of impartiality,¹¹² though without express citation. For a number of reasons, however, a court in another jurisdiction would be justified in concluding that the duty of impartiality does not lead inexorably to the *Holloway* adjustment.

¹⁰⁷See *supra* text accompanying note 50.

¹⁰⁸The Revised Uniform Principal and Income Act has been adopted in 29 states. 7B U.L.A. 145 (1985).

¹⁰⁹See *supra* note 80 and accompanying text.

¹¹⁰Uniform Principal and Income Act (1962) § 13(c)(4), 7B U.L.A. 177 (1983).

¹¹¹RESTATEMENT (SECOND) OF TRUSTS § 183 (1959). In expressing the duty of impartiality, another section of the Restatement refers more specifically to the competing interests of income and corpus beneficiaries: “If a trust is created for beneficiaries in succession, the trustee is under a duty to the successive beneficiaries to act with due regard to their respective interests.” *Id.* at § 232. See also A. SCOTT, THE LAW OF TRUSTS §§ 183 and 232 (3d ed. 1967).

¹¹²The Surrogate’s “purely equitable principle that the burden of income taxes should be charged to the account into which the taxed item goes,” 68 Misc. 2d at 365, 327 N.Y.S.2d at 869, is nothing more than the trustee’s duty not to discriminate against the remaindermen for the benefit of the income beneficiary, i.e., the duty of impartiality.

The duty of impartiality expresses the presumed intent of all testators and grantors that their fiduciaries act fairly as between the various trust beneficiaries. On the other hand, testators have other intentions, both presumed and expressed, which may conflict with the intent underlying the duty of impartiality. For instance, it can be presumed that testators in general desire an expedient administration of their probate affairs. The desire for quick and efficient administration is generally strong enough that testators would be willing to accept a limited amount of inequity among beneficiaries if necessary to avoid complicated and time-consuming adjustments.¹¹³ Nor are testators the only group with an interest in promoting swift and easy administration of estates. Probate judges, perhaps more than anyone, recognize the costs of complexity. On grounds of efficiency alone, a court could decide that a *Holloway* adjustment is not required by the duty of impartiality.

A related consideration is the fact that in many situations where a *Holloway* adjustment could be made, the amounts involved are small.¹¹⁴ Such instances are unlikely ever to reach a court, as all parties may be satisfied to avoid the trouble of making an adjustment, if they are even aware of the issue. Furthermore, even in a case where the adjustment would be large, a court might be hesitant to rule in favor of an adjustment. It might be unwilling to impose such a requirement on all trusts, including those for which the adjustment would be too small to justify the time and effort required of the trustee. A more sensible rule, in many judicial minds, might be to permit trustees to make the adjustment where they feel the amounts involved call for an adjustment, while allowing trustees to forego the adjustment in less compelling cases. That is, the status quo in most jurisdictions, in which the adjustment is neither required nor forbidden, may be the most appealing alternative.

Another factor that may compete with testators' general intention to treat beneficiaries equitably is an actual preference for one group of beneficiaries.¹¹⁵ In most testamentary plans where there are successive beneficiaries, the income beneficiaries are the primary objects of the testator's bounty. In vast numbers of such plans, the income beneficiary is the testator's surviving spouse. Remaindermen often are named as simply "issue per stirpes." Courts may be reluctant to order an adjustment that will reduce the benefits paid to these favored income beneficiaries. It may not seem an egregious wrong, for instance, if the children's remainder interest on one or two occasions pays part of the tax on their mother's income interest. Such considerations surely prevent some potential *Holloway* cases from ever becoming disputes and could enter the balance where the question is litigated to persuade a court not to order an adjustment.

¹¹³See Dobris, *Limits on the Doctrine of Equitable Adjustment*, 66 IOWA L. REV. 273, 287-88 (1981).

¹¹⁴See *id.* at 288.

¹¹⁵See *id.* at 289.

In short, though the trustee's duty of impartiality might seem to require a *Holloway* adjustment in every instance where one could be made, several competing considerations, all based on the presumed intent of testators in general, counsel a permissive, rather than a mandatory, approach. There is certainly no guarantee that courts outside New York, if faced with the *Holloway* question, will follow the New York answer.

The consequence for the tax issue concerning the identity of the taxpayer for *Holloway* income is that two different rules are likely to persist. In New York and in other jurisdictions that may follow its example on the need for the adjustment, the trust will properly pay the tax on the income transferred to principal. In states where no ruling has been made or where the *Holloway* adjustment may be repudiated, the income beneficiary should be liable for the tax.

V. THE THROWBACK RULES

Having concluded that where the *Holloway* adjustment is mandatory under state law, the beneficiary cannot be taxed currently with the trust income used to make the adjustment, the question remains whether the beneficiary can be taxed with this income in some future year through the operation of the throwback rules¹¹⁶ of Subchapter J. The throwback rules are intended to assure that the income beneficiary, and not the trust, is the ultimate taxpayer for income that is accumulated in a trust rather than distributed currently.¹¹⁷ The rules accomplish this by requiring a beneficiary to pay a tax on trust accumulations in the year they are ultimately distributed. The tax is imposed in a manner designed to approximate the income tax effect such amounts would have had if currently distributed each year.¹¹⁸ A brief outline of the throwback rules follows.

In a year in which a trust¹¹⁹ does not distribute all of its DNI, the income which is retained in the trust becomes, under the Code, "undistributed net income" (UNI).¹²⁰ When, in a subsequent year, the trustee makes a distribution in excess of that year's DNI, the UNI is deemed to pass out to the beneficiary as an "accumulation distribution."¹²¹ The Code treats an accumulation distribution as a distribution on the last day of the earliest taxable year for

¹¹⁶I.R.C. §§ 665-67.

¹¹⁷See Treas. Reg. § 1.665(a)-0A(a)(1).

¹¹⁸See Treas. Reg. § 1.665(a)-0A(a)(4). On the operation of the throwback rules, see generally A. MICHAELSON & J. BLATTMACHR, *INCOME TAXATION OF ESTATES AND TRUSTS* 33-47 (11th ed. 1980).

¹¹⁹The throwback rules apply only to trusts. They do not apply to estates. I.R.C. § 666(a).

¹²⁰UNI is defined as the amount of DNI for any taxable year minus amounts actually distributed and minus income taxes paid by the trust on the undistributed income. I.R.C. § 665(a). The latter subtraction is necessary to reflect the fact that part of any accumulation of income must be used to pay the trust's income tax on that income and, therefore, cannot remain in a trust's "UNI account."

¹²¹I.R.C. §§ 665(b), 666(a).

which the trust had UNI. If the accumulation distribution exceeds the UNI for the earliest year, the excess is treated as a distribution on the last day of the next earliest year in which the trust had UNI, and so on, until the accumulation distribution has been completely allocated ("thrown back") to years in which income was accumulated.¹²² The process of allocating accumulation distributions to prior years is designed to recreate the tax environment as it would have existed had all income been distributed currently in those years.

The beneficiary, who is thus deemed to have received distributions on the last day of one or more preceding taxable years, is not required to amend prior income tax returns to include the additional income. Rather, the beneficiary must compute a special tax on the accumulated income, payable along with the income tax for the year in which the accumulation distribution is made.¹²³ By a complicated averaging method,¹²⁴ the approximate amount of additional tax the beneficiary would have paid in prior years had the UNI been distributed is added to the beneficiary's income tax for the year of the accumulation distribution.¹²⁵

The effect of this belated payment by the beneficiary of tax on belated distributions of accumulated income is to reduce the appeal of accumulation trusts as a tax-saving device. Any attempt by grantors and trustees to take advantage of the low tax brackets of trusts¹²⁶ in order to accumulate income for future distribution to high-bracket beneficiaries for the most part will be thwarted. When the accumulated income is distributed, the throwback rules assure that a tax will be paid in roughly the amount that in preceding years was saved.

VI. THE THROWBACK RULES AND SIMPLE TRUSTS

The relevance of the throwback rules to trapping distributions and the *Holloway* adjustment may not be immediately evident, in light of the limitation of the *Holloway* discussion to estate distributions to simple trusts. An accumulation trust by definition cannot be a simple trust. A simple trust is required by its governing instrument to distribute all its income currently.¹²⁷ A grantor who wishes to accumulate income in a trust will create a complex trust rather than a simple trust. Nevertheless, there are a few occasions when it is

¹²²I.R.C. § 666(a); Treas. Reg. § 1.666(a)-1A(a), (b).

¹²³I.R.C. § 667(a), (b)(1).

¹²⁴I.R.C. § 667(b)(1).

¹²⁵I.R.C. § 667(a)(1), (2).

¹²⁶The income tax brackets for trusts roughly parallel those for individuals, and both have a top marginal rate of 50%. Compare, e.g., I.R.C. §§ 1(a)(3) and § 1(c)(3) with § 1(e)(3). However, portions of the taxable income of trusts even in the top bracket are taxed at the lower rates on the rate schedule, ranging from 11% to 49%. It is these "low brackets" of even very large trusts that provide opportunities for tax savings through income-splitting.

¹²⁷I.R.C. § 651(a)(1).

appropriate for the throwback rules to apply to simple trusts.¹²⁸ For instance, a simple trust holding shares in companies which have paid extraordinary dividends may act much like an accumulation trust. This is because such dividends may be deemed income for tax purposes,¹²⁹ while under local law or the trust instrument the trustee may be entitled to treat them as principal for trust accounting purposes.¹³⁰ Thus, items of taxable income are "accumulated" in corpus. Upon any subsequent corpus distribution, it is appropriate that the beneficiary pay a throwback tax.

Perhaps because of the difficulty of foreseeing all of the circumstances in which a simple trust can act as an accumulation trust, Congress left the task of defining those circumstances to the Treasury Department. The Code provides in Section 666(a) that the throwback rules apply only to complex trusts. However, Section 665(e) adds that simple trusts are to be treated as complex trusts "in accordance with regulations prescribed by the Secretary"¹³¹

The regulations address the problem by means of defining two terms of art: "preceding taxable year" and "outside income." A preceding taxable year is a year to which an accumulation distribution can be "thrown back."¹³² The regulations provide that a year in which a trust was a simple trust cannot be a "preceding taxable year" unless in that year the simple trust received "outside income."¹³³ Outside income is defined as amounts that are included in DNI but are not trust accounting income.¹³⁴ Therefore, in the extraordinary dividend example outlined immediately above, the simple trust would have outside income. The dividends are part of DNI,¹³⁵ however, under the instrument or local law, the dividends are not part of trust accounting income. The outside income makes the extraordinary dividend year a "preceding taxable year." Therefore, a subsequent accumulation distribution can be thrown back to the

¹²⁸On the application of the throwback rules to simple trusts, see generally Covey, *Recent Developments Concerning Estate, Gift and Income Taxation — 1972*, 7 INST. ON EST. PLAN. 1-30 through 1-35 (1973).

¹²⁹Extraordinary dividends which the trustee in good faith allocates to corpus generally are not included in DNI of a simple trust. I.R.C. § 643(a)(4). However, solely for purposes of the throwback rules, such dividends are deemed to be included in DNI when paid. Treas. Reg. § 1.665(e)-1A(b), Ex. 2.

¹³⁰See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 11-2.1(e)(1) - (3), (6), (10), (12) (McKinney 1967).

¹³¹I.R.C. §§ 666(a), 665(e).

¹³²Treas. Reg. § 1.665(e)-1A(a)(1)(i).

¹³³Treas. Reg. § 1.665(e)-1A(b).

¹³⁴*Id.* The regulation lists three examples of outside income: (1) income in respect of a decedent, (2) unrealized accounts receivable, and (3) distributions from another trust that include DNI or UNI. The regulations do not express these examples as exclusive. *Id.*

Outside income, according to the regulations, does not include distributions from an estate, with two exceptions: income in respect of a decedent and unrealized accounts receivable. *Id.* Therefore, a trust receiving a trapping distribution from an estate will not have outside income as a result of the distribution unless the trapping distribution includes income in respect of a decedent or unrealized accounts receivable. If, however, a revocable trust has been used as a will substitute, a trapping distribution from the inter vivos trust to a simple trust may consist entirely of outside income. The simple trust's beneficiary will be liable for a throwback tax when that trust makes an accumulation distribution. See R. COVEY, MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS 53 (1984).

¹³⁵See *supra* note 129.

year the dividends were paid despite the fact that the trust is a simple trust.

Application of the "outside income" regulation to the *Holloway* adjustment raises some of the same issues presented by the question of the proper taxpayer for *Holloway* income. There is no doubt that *Holloway* income is included in DNI; that portion of the outside income test is met. Whether or not *Holloway* income is trust accounting income recalls the earlier discussion of whether the *Holloway* adjustment reduces trust accounting income.¹³⁶ This was important in determining whether the income beneficiary should be held responsible for the tax on *Holloway* income. The conclusion was that the income which makes up the *Holloway* adjustment is initially trust accounting income, and that the *Holloway* decision requires an adjustment *from income* to principal.¹³⁷ The transfer to the principal account does not alter the fact that the dividends, interest, and rents earned by the trust are, upon receipt, trust accounting income. Only the amount of income *required to be distributed* is reduced by the adjustment.¹³⁸

Holloway income, therefore, fails the second part of the outside income definition. *Holloway* income is trust accounting income and thus cannot be outside income.¹³⁹ The taxable year in which the trustee of a simple trust makes a *Holloway* adjustment is not a "preceding taxable year" within the regulations' meaning, unless there is some other source of outside income. The trustee apparently can make the adjustment with confidence that the beneficiary will not in some future year be faced with a tax on the *Holloway* income under the throwback rules.

Although the *Holloway* adjustment flunks the letter of the regulations' definition of outside income, it is pertinent to inquire whether Congress' purpose is thwarted by the above quite literal interpretation of those regulations. If this interpretation allows an income accumulation to occur free of the throwback rules, perhaps the interpretation should be re-examined. Doubts should be explored especially carefully here, where Congress' purpose is effected not by statute, but by legislative regulations.¹⁴⁰ If the Secretary has car-

¹³⁶See *supra* text accompanying notes 55-70.

¹³⁷See *supra* text accompanying notes 58-62.

¹³⁸See *supra* text accompanying notes 63-68.

¹³⁹In Technical Advice Memorandum 8501084, the IRS concluded that *Holloway* income is not trust accounting income. Consequently, *Holloway* income is outside income and subject to the throwback rules.

The fundamental error which led the Service to these conclusions was the assumption that the *Holloway* adjustment reduces trust accounting income. As explained in more detail above, (*see supra* text accompanying notes 58-62) accounting income, though transferred to the corpus account, is undeniably accounting income when earned. Thus, it is not trust accounting income that is reduced by the *Holloway* adjustment but income "required to be distributed," the measuring rod for the trust's distribution deduction and the beneficiary's gross income in I.R.C. §§ 651(a) and 652(a). *Holloway* income, because it is trust accounting income, cannot be outside income.

¹⁴⁰Legislative regulations are issued by the Treasury in response to a specific directive from Congress to devise the rules to govern in a particular area. They are subject to less scrutiny by the courts than are interpretive regulations, which are issued on the authority of Congress' general directive in I.R.C. § 7805(a) to prescribe rules necessary for the enforcement of the tax laws. *See, e.g., Anderson, Clayton & Co. v. United*

ried out Congress' mandate by adopting definitions of "preceding taxable year" and "outside income" that are too broad or blunt for the task, then perhaps the regulations should be clarified to cover all the situations Congress intended.

The Congressional purpose for making the throwback rules occasionally applicable to simple trusts is difficult to divine from Section 665(e) itself. The section merely places the responsibility on the Secretary of the Treasury to establish when simple trusts are covered. The legislative history is of some help. The throwback rules originated with the 1954 Internal Revenue Code. The Senate Finance Committee Report for the Code mentions the addition of the simple trust provision,¹⁴¹ which had not been included in the House version of the bill. The Report offers one sentence to explain the addition: "Thus, distributions of extraordinary dividends accumulated by the trustee, which are not treated as income by the trustee in the year in which received by the trust, will fall within the provisions of subpart D [the throwback rules]."¹⁴²

It would be erroneous to conclude that Congress intended simple trusts to be subject to the throwback rules only when they receive extraordinary dividends which the trustee may add to trust corpus. Extraordinary dividends are not mentioned in the Code provision the Committee drafted.¹⁴³ Furthermore, the Secretary is given authority to adopt regulations dealing with all circumstances in which simple trusts are to be treated as complex trusts. Nor has the Secretary interpreted the grant of authority as limited to the extraordinary dividend situation. The regulations furnish three other examples of situations where simple trusts must be treated as complex trusts.¹⁴⁴ The best interpretation of Congress' intent is the one obviously adopted by the Secretary: simple trusts are to be subject to the throwback rules in situations similar to the extraordinary dividend example, i.e., in any of those relatively rare circumstances where a simple trust acts like an accumulation trust.

The *Holloway* adjustment is not one of those circumstances. At first glance, it might seem that any transfer of funds from income to corpus will serve to "accumulate" income in the trust. However, in the *Holloway* context, income is transferred to principal as a *reimbursement* for principal that was previously in effect transferred to income. The corpus account's payment of income tax in year one on behalf of the income account is refunded by income in year two. The *Holloway* adjustment merely restores the status quo between the income and corpus accounts. It does not achieve a net transfer of funds

States, 562 F.2d 972 (5th Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); *Union Elec. Co. of Mo. v. United States*, 305 F.2d 850 (Ct. Cl. 1962). The examination of the "outside income" regulations suggested here is intended to be from the Treasury's point of view and not from the courts'.

¹⁴¹Senate Finance Comm. Rep., I.R.C. of 1954, 83d Cong., 2d Sess. 3, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4999.

¹⁴²*Id.*

¹⁴³I.R.C. § 665(c), now § 665(e).

¹⁴⁴Treas. Reg. § 1.665(e)-1A(b); *see supra* note 130.

from income to principal. Therefore, no accumulation occurs.

In each of the three examples in the regulations¹⁴⁵ and in the one example from the legislative history, true accumulation of taxable income occurs in the corpus account of a simple trust. Equity between complex trusts and simple trusts requires extension of the throwback rules to these simple trust contexts. It does not require extending them to the *Holloway* adjustment.

VII. CONCLUSION

In dealing with the income tax effects of the *Holloway* adjustment, as with most issues in fiduciary income tax, it is necessary to pay careful attention to the underlying local law to correctly apply the Subchapter J rules. Here the underlying local law, the *Holloway* adjustment, happens to owe *its* existence to the tax law: the tax rules that make trapping distributions possible.

The most important local law question in connection with the *Holloway* adjustment is whether the adjustment is mandatory or merely permissive. In states outside New York, the adjustment clearly has only permissive status, even in that handful of states where the adjustment is routinely made. In New York, the adjustment is mandatory. The *Holloway II* decision requires it.

This conclusion, which prior to the Supreme Court's 1967 *Estate of Bosch* decision would have been relatively obvious, can be reached today only after agonizing over the odd question of whether a federal court would recognize *Holloway II* as a valid statement of New York law. Because the Surrogate Court in which *Holloway* was decided is not the highest court of the state, any federal court owes the Surrogate's opinion only what one federal judge referred to as "'proper regard' . . . whatever that means."¹⁴⁶ Despite the uncertainty attached to all such conclusions as a result of *Estate of Bosch*, it can be said with some confidence that even for a federal court, *Holloway II* imposes a mandatory adjustment on New York trustees.

The mandatory payment of part of a trust's accounting income to corpus removes that income from the category of "income required to be distributed," a key classification in Subchapter J. Because the *Holloway* income is not "required to be distributed," the income beneficiary of the trust is not obliged to include it in his or her gross income. In New York, then, the trust is by default the taxpayer for income used to make a *Holloway* adjustment.

Having escaped taxation once, the beneficiary may fear that it has merely been postponed and that some future "accumulation distribution" will trigger a large tax under the throwback rules. A careful analysis of the "outside income" regulations, however, as well as the policy behind them, reveals that the

¹⁴⁵*Id.*

¹⁴⁶*Lake Shore Nat'l Bank v. Coyle*, 296 F. Supp. 412, 418 (N.D. Ill. 1968), *rev'd on other grounds*, 419 F. 2d 958 (7th Cir. 1970).

throwback rules do not apply here, in letter or in spirit.

Are all these levels of complexity inevitable? They are part of the cost of a federal system, where the underlying legal relationships to which a single tax code applies may have as many as 50 variations. Complete uniformity and simplicity can come only when the probate and trust laws of all the states are homogenized in a single monolithic legal system. Until then, local law will continue to shape tax law, which occasionally will cause local law adjustments, which may require fresh analysis for tax purposes, and so on.

