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Any progressive tax invites efforts to splinter the base. Two taxes on half are almost always less than one on the whole. Without clear limitations on income splitting, progressivity soon evaporates. In the case of the federal income tax, Congress enacts limitations by statute, and the Treasury promulgates limitations by regulation. Sometimes, the Supreme Court construes either a statute or a regulation. Sometimes, too many cooks spoil the broth.

Central to the operation of any tax, and *crucial* to any progressive tax, is taxpayer status. The more a tax respects artificial taxpayers, the less its actual progressivity. Although always nominally progressive, the federal income tax has also always respected the existence of many artificial taxpayers, including *most* trusts. Currently, the main repository of rules as to which trusts are separate taxpayers are the so-called grantor trust rules.[1] They are the spawn of *Helvering v. Clifford.*[2] Long before *Clifford*, however, Congress had already enacted its own grantor trust rules. As early as 1924, these original grantor trust rules provided, as their successors still do, that the settlor (or, in the terminology of the Internal Revenue Code, the "grantor") of an inter vivos trust who reserved the right to revoke the trust or retained beneficial enjoyment of the trust income was taxable individually on the trust's income.[3] Thus, the original grantor trust rules, like their successors, disregarded the taxpayer status of certain trusts.

The Bureau of Internal Revenue concluded that the original grantor trust rules were under-inclusive. When Congress balked,[4] the Bureau litigated, and, in 1940, *Clifford* reached the Supreme Court. The settlor had created an irrevocable trust for a five-year term for the benefit of his wife and had retained a reversion in the entire corpus. As

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1 I.R.C. §§ 673-679, or "Subpart E."

2 309 U.S. 331, 337-38 (1940).

3 Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 219(g), (h), 43 Stat. 253, 277 (codified as amended at I.R.C. §§ 676-677).

4 *An Act to Provide Revenue, Equalize Taxation, and for Other Purposes: Hearing on H.R. 7835 Before the Comm. on Finance*, 73d Cong. 1-2, 5 (1934).

trustee, he had also retained substantial control over the trust, including the power to determine how much, if any, trust income his wife would actually receive.[5] The issue before the Court was whether the settlor remained individually subject to taxation on the trust's income, notwithstanding the fact that, until the trust terminated, the income was payable exclusively to his wife.[6]

In an expansive opinion by Justice Douglas, the Court held that the settlor was indeed taxable on the trust's income.[7] The Court anchored its opinion on the predecessor of the vacuous section 61.[8] "The broad sweep of [the statute] indicates the purpose of Congress to use the full measure of its taxing power . . . . Th[e] issue is whether the grantor after the trust has been established may still be treated . . . as the owner of the corpus."[9] Of course, the predecessor of section 61 offered nothing even vaguely like an answer to that question, and the grantor trust rules already on the books suggested to almost everyone else that Congress had deliberately accorded separate taxpayer status to trusts of this and many other sorts.[10] Undeterred, the Court continued: "In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer . . . must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation."[11]

The remainder of the opinion pointed out, but in only the most general of ways, the terms of the trust and the attendant circumstances that required disregarding the trust's taxpayer status. First, there was the family relationship: "[W]here the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as [the predecessor of section 61] is concerned."[12] Of course, the vast majority of trusts are for the benefit of family members, and settlors often serve as trustees. Next, the Court

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[5] Any income that did not go to her currently would, however, go to her upon termination. 309 U.S. at 332.

[6] For the year at issue, the settlor, as trustee, had in fact distributed all of the trust income to his wife, and she had reported it on her own return. *Id.* at 333-34.

[7] *Id.* at 336.

[8] Revenue Act of 1934, Pub. L. No. 216-73, ch. 277, § 22(a), 48 Stat. 680 (codified as amended at I.R.C. § 22(a) (1939)); I.R.C. § 61(a) ("[G]ross income includes all income from whatever source derived . . . .").

[9] Helvering v. Clifford, 309 U.S. 331, 334 (1940).

[10] *See* Erwin N. Griswold, *Forward to* BERNARD WOLFMAN, JONATHAN L. F. SILVER & MARJORIE SILVER, DISSENT WITHOUT OPINION: THE BEHAVIOR OF JUSTICE WILLIAM O. DOUGLAS IN FEDERAL TAX CASES (1975).

[11] 309 U.S. at 335.

[12] *Id.*

focused on three aspects of the trust: "[T]he short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of [the predecessor of section 61]."[13] Of course, none of these features, singly or together, had yet led Congress to enact legislation ignoring the trust's taxpayer status. Finally, the Court got to what seems to have been for Justice Douglas the heart of the matter: "So far as [the settlor's] dominion and control were concerned . . . the trust did not effect any substantial change. . . ."[14]

Plainly, the Court relied on the fact that the term of the trust was unusually short, and that the settlor had retained a reversion, but the Court was unwilling to say that short-term trusts, or trusts with reversionary interests in their settlors, or short-term trusts with reversionary interests in their settlors would always be grantor trusts. Likewise, the Court relied on the fact that the trust's primary beneficiary was the settlor's wife, although, here too, the Court was unwilling to say that all trusts that provided for the payment of income to the settlor's spouse would be grantor trusts. Finally, the fact that, as trustee, the settlor had retained substantial control over the trust corpus seems to have been relevant; yet, here again, the Court was unwilling to say that all trusts over which the settlor had similar sorts of control would be grantor trusts. "[N]o one fact is normally decisive[;] all considerations and circumstances of the kind we have mentioned are relevant . . . ."[15]

Predictably, the floodgates of litigation opened wide.[16] After *Clifford*, just about the only inter vivos trusts whose taxable status remained clear were those described in the original, statutory grantor trust rules.[17] Five years later, hoping to stem the flood, the Treasury issued the so-called *Clifford* regulations.[18] They called for taxing the settlor in three additional situations. First, the settlor was subject to taxation on the trust's income if he or she had a reversionary interest following a trust term of less than 10 years.[19] Second, subject to numerous exceptions, the settlor was taxable on the trust's income if either the settlor or a non-adverse party had a power to control beneficial enjoyment of either

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13 *Id.*

14 *Id.*

15 *Id.* at 336.

16 1 Stanley S. Surrey, William C. Warren, Paul R. McDaniel & Hugh J. Ault, Federal Income Taxation: Cases And Materials 1340 (1972) ("[T]he *Clifford* case set off a large volume of litigation. In the Courts of Appeals alone, over a hundred cases were decided that involved trusts and the section defining gross income.")

17 *See* Kohnstamm v. Pedrick, 153 F.2d 506, 510 (2d Cir. 1945).

18 T.D. 5488, 1946-1 C.B. 19.

19 Treas. Reg. § 29.22(a)-21(b)(1), (c)(1) (codified as amended at I.R.C. § 673).

income or corpus.[20] Third, the settlor was subject to taxation on the trust's income if he or she had various administrative powers.[21] In 1954, Congress elevated the new regulations to the statutory canon, codifying them, alongside the original grantor trust rules, at sections 671 to 678 of the Internal Revenue Code, where they remain today, in mostly the same form as when they were enacted.

One reaction to *Clifford* is that although the Court went well beyond prior congressional intent, Congress eventually embraced the gist of the decision and folded it into the Code. Moreover, in the last six decades, few stretches of the Code have proven more durable. But such adulation is entirely unwarranted. In fact, Congress reversed *Clifford*'s actual holding. The Code now unequivocally designates Subpart E as the sole repository of rules regarding the effect of a settlor's retention of dominion and control on a trust's taxpayer status.[22] Congress has thus pointedly stripped the courts of the interpretative space to which Justice Douglas laid claim. In addition, much water has by now passed under the bridge. Congress continues, *as it should,* to enact new rules and to amend old ones. Two such changes, all by themselves, render *Clifford* superfluous on its own facts. In 1948, Congress created the joint return, and in 1969, Congress expanded section 677, whose predecessor predated *Clifford*, to describe not only trusts in which the settlor has interests in powers over income but also trusts in which the settlor's spouse has such interests or powers.[23] Thus, it is now possible to reach the *Clifford* result on the *Clifford* facts, without reference to *any* of the provisions Congress added, cleaning up after *Clifford.*

But all that's small potatoes. In 1986, Congress turned the fiduciary income tax world upside-down with a single, breathtakingly simple change: bracket compression in section 1(e). The federal income tax for taxpaying trusts is now basically a flat tax—imposed at the highest rate. The big-picture objective was also breathtakingly simple: to eliminate the income tax incentive to create a taxpaying trust. The change has worked brilliantly; these days, no one creates a taxpaying trust, just to save income taxes. The concomitant effect of making a taxpaying trust much less attractive, however, has been to make a grantor trust, i.e., a trust whose settlor continues to pay the taxes on the income the trust produces, much more attractive. In short, bracket compression re-

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[20] Treas. Reg. § 29.22(a)-21(b)(2), (d) (codified as amended at I.R.C. § 674).

[21] Treas. Reg. § 29.22(a)-21(b)(3), (e) (codified as amended at I.R.C. § 675).

[22] I.R.C. § 671 ("No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 . . . or any other provision of this title, except as specified in this subpart.").

[23] I.R.C. § 677(a)(1).

versed the polarity of the grantor trust rules. Conceived as limitations on the use of *taxpaying* trusts as tax-saving devices, the grantor trust rules now offer numerous ways to save taxes by creating *non-taxpaying* trusts. By creating a trust that includes among its terms an interest or a power that "runs afoul" of Subpart E, a settlor can ensure that the income is not subject to taxation under section 1(e). Instead, the income is subject to taxation at the settlor's own, possibly lower, rate. Moreover, paying what are for all intents and purposes other people's income taxes makes very good transfer tax sense. In short, what was once an anti-tax-avoidance device has become a candy dispenser for rich folk smart enough to retain ACTEC counsel. Since 1986, the grantor trust rules really have been too good to be true. They should be repealed.[24] Yet they remain. Shame on Congress. But, *mostly*, shame on the Supreme Court.

Thus ends my tale. In *Clifford,* the Supreme Court examined an area of tax law in which Congress had repeatedly legislated but had not yet satisfied the tax collector. Resorting to cosmic statutory interpretation, the Court "fixed" the "problem." Luckily for the Court, regulations rationalized its slovenly work, and Congress eventually codified it. The mutant product worked well enough until 1986, when Congress invented a vastly better mousetrap. Now, the grantor trust rules are just a candy dispenser for well-counselled rich folk. All because, back in 1940, the Supreme Court spoiled the broth.

[24] Mark L. Ascher, *The Grantor Trust Rules Should Be Repealed,* 96 IOWA L. REV. 885, 940 (2011).