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Purpose trusts – aside from charitable purpose trusts – can be traced back to trusts for masses, gravesites, and the like.[1] In America, by far the most familiar noncharitable purpose trust is a "pet trust."[2] There are a host of other potential noncharitable purposes for which a trust could lawfully be created, however. Although noncharitable purpose trusts have been recognized, in fits and starts, for over a hundred years, authority on their treatment for purposes of the federal income tax is sparse.[3] The taxation of purpose trusts has been described as "complex and not clearly defined."[4] The aim is this paper is to outline South Dakota's treatment of purpose trusts and identify unresolved federal income tax issues concerning purpose trusts.

Beginning in 2006, South Dakota authorized special purpose or honorary trusts with a statutory enactment stating that "a trust may be performed if the trust is for a specific lawful noncharitable purpose."[5] Other statutes enacted alongside this provision relate to trusts for the care of a designated animal, such as a pet.[6] A purpose trust may be enforced by a person designated by the trust instrument or appointed by the court.[7] The court may also reduce the amount with which the trust was funded "if it determines that the amount substantially exceeds the amount required for the intended use."[8] Nothing in the current purpose trust statutes appears to prohibit a drafter from blending an honorary trust with a trust for designated individual beneficiaries.[9] Nothing in the three purpose trust statutes bars the grantor from funding the trust with the property to be honored, either.[10]

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[1] *E.g.*, S.D.C.L. §§ 55-1-20, 55-1-21, 55-1-22 (2012); *compare* UNIF. TRUST CODE § 409 (2000); UNIF. PROBATE CODE § 2-907 (1990, 1993). For excellent scholarship on purpose trusts see Professor Ausness' recent article. Richard C. Ausness, *Non-Charitable Purpose Trusts: Past, Present, and Future*, 41 REAL PROP. TR. & EST. L.J. 321 (2017).

[2] *See* BARRY SELTZER & GARRY W. BEYER, FAT CATS & LUCKY DOGS: HOW TO LEAVE (SOME OF) YOUR ESTATE TO YOUR PET (2010).

[3] Gerry W. Beyer and Jonathan P. Wilkerson, *Max's Taxes: A Tax-Based Analysis of Pet Trusts*, 43 U. RICH. L. REV. 1219 (2009).

[4] Wendy S. Goffe, *An Introduction to Lesser-Known but Useful Trusts – Part II*, 37 EST. PLAN. 3, 3 (2010).

[5] S.D.C.L. § 55-1-20 (2012).

[6] S.D.C.L. §§ 55-1-21, 55-1-22 (2012).

[7] S.D.C.L. § 55-1-22(4) (2012).

[8] S.D.C.L. § 55-1-22(6) (2012).

[9] *See* S.D.C.L. § 55-1-22(1) (2012) (stating: "Except as expressly provided otherwise in the trust instrument, no portion of the principal or income may be converted to the use of the trustee or to any use other than for the trust's purposes").

[10] *Compare* 12 DEL. C. § 3555(e) (authorizing the pet for which a pet trust is created to be transferred to the trustee in the event that the pet's designated successor owner disclaims ownership); Isle of Man Purpose Trusts Act of 1996 pt. 1 § 5 ("No land or any interest in any land in the Island shall be held, directly or

In 2018, it is anticipated that a bill will be introduced in the South Dakota Legislature to amend its three purpose trust statutes. The proposed changes will be part of the South Dakota Governor's Task Force on Trust Administration Review and Reform's bill. In anticipation of that proposal and its successful enactment, certain key elements of the bill will be briefly explicated below.[11]

First, "*res* purpose trusts" are specifically authorized in the projected legislative bill. The statute will state: "Any property may form a part or all of the trust estate, including some, all, or an interest in some or all of the property which is the subject or purpose of a purpose trust."[12] Thus, a trust may benefit a settlor's pet, for example, while retaining ownership of that pet as a part of its trust estate. Or a trust may benefit a ranch while also maintaining an ownership interest in that ranch.

Second, "hybrid purpose trusts" will be specifically authorized.[13] When the interests of beneficiaries and the advancement of a purpose are concurrent, the trustee is directed to maintain separate shares, "one for the beneficiaries; and a second for the purposes..."[14] If a trustee fails to do so, the purpose trust is not rendered invalid, but the trustee "may be liable to the beneficiaries for the actual damages caused thereby, if any, for failing to do so."[15] Out of concerns with the uncertainty of how hybrid trusts might be treated for income tax purposes, the task force elected to direct trustees to segregate amounts for beneficiaries and purposes into separate trust shares.[16] The separate shares should be taxed at least in part as if they were separate trusts.[17]

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indirectly, in a purpose trust.") Isle of Man special purpose trusts' duration are limited to 80 years. *Id.* pt. 1 § 1(1).

[11] The full text of the to-be-proposed purpose trust statute changes are set forth in Appendix B to this paper.

[12] S.D.C.L. § 55-1-20 (Supp. 2018).

[13] S.D.C.L. § 55-1-22 (Supp. 2018).

[14] *Id.*

[15] *Id.*

[16] E-mail from Frances Becker, member, South Dakota Governor's Task Force on Trust Administration Review and Reform, to author (Nov. 3, 2017, 11:42 CST) (on file with author).

[17] *See* Morris Trusts Nos. 401 through 410 v. Commissioner, 51 T.C. 20 (1968) *acquiescence in part and nonacquiescence in part recommended*, 1968 WL 16716 (I.R.S. AOD 1968), *aff'd per curiam*, 427 F.2d 1361 (9th Cir. 1970). *See also* 26 C.F.R. § 1.641(a)-O(c) (2017) (providing that multiple trusts without substantially independent purposes, the same grantor, the same beneficiary, and having as their principal purpose the avoidance or mitigation of progressive income tax rates will be treated as one trust for income tax purposes); *but see* Edward L. Stephenson Trust v. Commissioner, 81 T.C. 22 (1983) (reasoning that the foregoing trust consolidation regulations are invalid); *see also* Boyce v. United States 190 F.Supp. 950 (W.D. La. 1961), *aff'd*, 296 F.2d 731 (5th Cir. 1961) (holding that where trustee did not maintain separate accounts and books, 90 trusts should be consolidated for income tax purposes). Technically, the foregoing authority deals with separate trusts, not separate shares. *See* 26 U.S.C. § 663(c) (2017) (providing that "[f]or the sole purpose of determining the amount of distributable net income ... in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts."). Separate shares as separate trusts under section 663(c) does not equate to filing separate tax returns for each share or applying the progressive rate structure. *See* 26 C.F.R. § 1.663(c)-1 (2017). "The effect of having separate shares exists only in situations in which one beneficiary's income is accumulated, whereas income is distributed to another beneficiary in excess of that beneficiary's income share." JERE D. MCGAFFEY, 3A MCGAFFEY LEGAL FORMS WITH TAX ANALYSIS § 16:23 (2017).

A third notable aspect of the South Dakota legislation is its fleshing out of the role of the purpose enforcer. Enforcers are deemed to be fiduciaries and, as a default rule, entitled to reasonable compensation for their role in trust administration.[18] Enforcers may be removed for breaching their duties.[19] Thus, real expectations for the office of the purpose trust enforcer are clarified. The enforcer must take the place of ascertainable beneficiaries or – in the case of charitable trusts – the office of the Attorney General.[20]

A purpose trust often involves, as internationally-respected Boston, Massachusetts trusts attorney Alexander A. Bove, Jr. notes, "some tricky if not odd, tax considerations" which must be taken into account.[21] In particular, I am concerned here with the federal income tax implications of noncharitable purposes trusts. If an *inter vivos* purpose trust is structured as a grantor trust, then all of the tax activity of the trust will be taxed as if the grantor still owned the trust's property.[22] If a purpose trust is – or later becomes – a non-grantor trust, then the trust will report trust income and incur federal income tax liability under the steeply compressed trust income tax rates. The trust marginal income tax rates reach the current maximum of 39.6% at a mere $12,500 in income.[23]

A trust, however, is allowed to claim a distribution deduction for its distributions.[24] Corresponding tax code sections provide that a beneficiary receiving distributions must report the distributions in her gross income.[25] And this is where things get particularly interesting. As Bove explains:

> [W]hat happens to these rules in the case of a purpose trust that distributes income for the upkeep of an automobile or the care of a cat? Obviously neither the car nor the cat will be filing a tax return, and it wouldn't seem fair that the trust should simply be denied the distribution deduction and taxed at the higher trust tax rates, since it is not accumulating the income. On the other hand, to allow a deduction for trust distributions that are not taxed to anyone just won't fly under our tax laws.[26]

In 1976, the IRS issued a revenue ruling that continues to be the primary authority for the income tax rules for purpose trusts, although its reasoning can be criticized, at least with regards to hybrid and *res* purpose trusts.[27] In the 1976 revenue ruling, the IRS was faced with a simple pet trust. It reasoned that distributions to pet (a non-person) could not be deductible as distributions, since no

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[18] S.D.C.L. § 55-1-21(5) (Supp. 2018).
[19] S.D.C.L. § 55-1-21(6) (Supp. 2018).
[20] The Attorney General's office has charitable trust oversight authority.
[21] Alexander A. Bove, Jr., *The Purpose of Purpose Trusts* in II ASSET PROTECTION STRATEGIES: WEALTH PRESERVATION PLANNING WITH DOMESTIC AND OFFSHORE ENTITIES, 277, 287 (Alexander A. Bove, Jr., ed., 2005) (hereinafter, *Purpose of Purpose*).
[22] 26 U.S.C. §§ 167-679 (2017).
[23] 26 U.S.C. § 1(3) (2017); Rev. Proc. 2016-55, Table 5.
[24] 26 U.S.C. §§ 641, 651 (2017).
[25] 26 U.S.C. §§ 642, 652 (2017).
[26] Bove, *Purpose of Purpose*, *supra* note 21, at 287.
[27] Rev. Rul. 76-486, 1976-2 C.B. 192.

one would be taxed on them.[28] Since the taxpayer question arose out of a pet trust, the IRS concluded – correctly – that an animal could not qualify as a "beneficiary" under the Code.[29]

However, the IRS went on, the trust should not be taxed at the higher trust tax rates since the trustee had not accumulated the income, but had distributed it for pet care costs.[30] Instead, the trust should be taxed at the rate of a married individual filing separately.[31] The continuing reliability of this reasoning, however, was weakened when Congress enacted section 1(e) of the tax code adding a new rate of tax for both trusts and estates.[32] Today, most commentators agree, a purpose trust would be taxed on its distributions to non-persons at the compressed trust income tax rates.[33] The trust would be taxed (as a complex trust) as if it had not made any distributions.[34]

Things get stickier with a hybrid purpose trust, however. Consider two similar trusts: The first is a typical trust for a testator's two surviving children which continues until the youngest reaches her 30th birthday. The children are both in their early 20s and receive, as net income distributions, rents from their deceased parent's farmland, which is now an asset of their trust. The trustee maintains and insures the farmland and distributes the rental income to the two beneficiaries.

The second trust is "a hybrid purpose trust." That is, it is a trust for a noncharitable purpose, while at the same time (concurrently), it is a trust for the benefit of ascertainable beneficiaries. The beneficiaries of the trust are the testator's two surviving children. The noncharitable purpose of the trust is to maintain and preserve the testator's farmland, which is an asset of the trust. (Thus, the trust is also a "*res* purpose trust" – a trust which maintains as part of the trust estate property which the trustee is directed to preserve, maintain, or perpetuate.) The trustee applies income from trust investments to maintain and insure the farm and distributes additional income to the two beneficiaries.

With the first trust, as the trustee incurs ordinary expenses associated with maintaining and insuring the agricultural property owned by the trust, the trustee may deduct them from otherwise taxable trust income. Should not the second trust – identical to the first except with regards to the additional noncharitable purpose of preserving the farm ground – receive the same treatment?

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[28] *Id.* at 3.

[29] *Id.* at 2. A "beneficiary includes "heirs, legatees, and devisees" – all of whom "are persons." *Id.*, *citing* 96 C.J.S. *Wills* § 1097 (1957). A "person" means "an individual, trust, estate, partnership, association, company, or corporation." *Id.*, *citing* 26 U.S.C. § 7701(a). "Since animals do not fall within this category, they cannot be beneficiaries ..." *Id.*; *accord*, Rev. Rul. 78-105, 1978-1 C/B/ 205, 2-3 (concluding that a trust with unitrust distributions for the care of an animal, remainder to charity, does not qualify as a charitable remainder trust for purposes of deductibility since animals are not "beneficiaries").

[30] Rev. Rul. 76-486, 1976-2 C.B. 192 at 3.

[31] *Id.*, *citing* 26 U.S.C. §1(d).

[32] 26 U.S.C. § 1(e) (2017).

[33] Beyer & Wilkerson, *supra* note 3, at 1227-28; *but see* DONALD H. KELLEY, DAVID A. LUDTKE, AND BURNELL E. STEINMEYER, JR., ESTATE PLANNING FOR FARMERS AND RANCHERS § 5:1.50 (2017) ("Distributions would be deductible at the trust level only if made to the caretaker [of an animal] as an individual beneficiary of the trust").

[34] Darin I. Zenov and Barbara Ruiz-Gonzalez, *Trusts for Pets*, 79 FLA. B.J. 22, 25 (2005). Zenov and Ruiz-Gonzalez recommend, "In order to ensure that someone is responsible for the pet at all times, the client should bequeath the animal to the trustee..." *Id.*

Congress has imposed the federal income tax on trusts' net income, with an allowance for deductions of reasonable expenses as "determined under the terms of the governing instrument and applicable local law."[35] Whether a given expense should be charged to income or principal depends on the nature of the expense in question, the terms of the trust, and the particular local accounting principles governing fiduciaries.[36] Thus, setting aside a portion of income to account for the depreciation of a wasting asset can be appropriate, depending on the trust terms and local law.[37] If an expense is deductible, then taxable income is reduced.[38] (This point neatly avoids being pulled into the swamp of simple and complex trusts, distributable net income concepts, and whether the ultimate tax liability falls on the trust or a trust beneficiary.) Generally, "repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income."[39] Likewise, expenditures from an operational business held in trust may be allocated to the business income being generated.[40]

In its 1976 Revenue Ruling, the IRS seemed to premises its analysis on the idea that the trustee would be making distributions to (or at least for the direct benefit of) a dog. In other words, the pet trust functioned just like a trust for the benefit of a human in which distributions might also be made either directly or for the benefit of, the human beneficiary. The trustee of a trust for an individual, for example, might distribute cash to the individual, or it might make distributions to third parties for the individual's benefit, prepaying tuition, advancing rental payments to the individual's landlord, reimbursing medical providers who treated the individual, and so on. Of course, it would be impossible to convey cash to a dog, but a trustee certainly could purchase dog food for the dog in a manner very similar to a trustee purchasing potato chips for a human. The difference, for the IRS, lay in the fact that the purchase of potato chips for a human would result in a K-1 tax form and the human would then report the value of the chips as taxable income. Dogs don't file 1040s and dogs don't pay income tax, so the dogfood distribution could not be deducted as a distribution to a human or other taxable person.

The 1976 Revenue Ruling did not conclude that the pet trust could never deduct any of *expenses*, however. It concluded that it could not deduct any of its *distributions*. It certainly seems that the IRS contemplated that in calculating its taxable income, a pet trust could deduct its investment losses, the trustee's fees, the investment manager's fees, and the accountant's charge for preparing the trust's tax return.[41] It seems, therefore, that the IRS retained for noncharitable purpose trusts the distinction between distributions and deductible expenses. Typically, a distribution can be distinguished from an expense because an expense either represents a value retained within the trust (e.g., in repairing fence on trust property, the trustee is preserving and maintaining trust

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[35] 26 U.S.C. §643(b) (2017).

[36] M. CARR FERGUSON, JAMES J. FREELAND, AND MARK L. ASCHER, FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, & BENEFICIARIES §7.02 (Supp. 2004).

[37] Levin v. Commissioner, 335 F.2d 987, 988 (5th Cir. 1966); Estate of Little v. Commissioner, 274 F.2d 718, 719 (9th Cir. 1960).

[38] Treas. Reg. § 1.652(b)-3(b) (2017).

[39] Treas. Reg. §1.652(b)-3(a) (2017).

[40] *Id.*

[41] *But see* Knight v. Commissioner, 128 S.Ct. 782 (2008).

property) or an expenditure outside the trust which represents taxable income to its recipient (e.g., paying the trust's income tax preparer for her services).

Extending this rationale, some commentators have suggested that pet trusts could mitigate their unfavorable income tax treatment by naming the pet's caretaker as a beneficiary (e.g., a hybrid purpose trust). A trust adopting this idea might provide:

> In addition to preserving the testator's dog Rover, the trustee will distribute $400 each month to the current beneficiary. The 'current beneficiary' means the individual or individuals in whose household Rover resides as of the 15th day of the previous month.

With this kind of pet trust, the trustee's distributions to the beneficiaries would represent distributions taxable to the beneficiaries and therefore deductible by the trust. Alternatively, could not the trustee of a pet trust without any concurrent ascertainable beneficiaries hire a caregiver for Rover? Employment-related (payroll) taxes would then also need to be accounted for. The point here is that tax avoidance (the concern with distributions to a dog) is not an issue.

Consider again, two similar trusts: The first is a trust for the benefit of a deceased couple's two minor children. Tragically, the children's parents both died and left them orphans. The children have gone to live with the mother's sister, Gladys, who has taken them into her home. When the children's parents died, they were survived by their two children, Ken and Kay, and the beloved family pet, a three-year-old goldendoodle named Franklin. When the grieving siblings were taken in by their aunt, the aunt also took in Franklin. Franklin has proved to be important emotional support for the two children suffering the shock of loss. The aunt phones the trustee one day and explains:

> We love this dog, but it sure can be expensive what with the dog food, veterinary bills, and monthly grooming. We're taking the kids on a family vacation to New York this July and we'll hire a doggy babysitter which will also set us back a couple hundred dollars. If I sent you receipts for these kinds of expenses, do you think you could reimburse me? After all, Franklin has really helped Ken and Kay adjust to live without their parents. It seems to me that the expenses we're incurring for Franklin are very important to Ken and Kay's well-being.

How do you think a trustee would respond?

Assuming that there are adequate trust resources, it seems to me that most trustees would agree to reimburse Aunt Gladys for Franklin's expenses. Moreover, I'd guess that most trustee's tax advisors wouldn't give a second thought to claiming as deductions the amounts the trustee has expended for Ken and Kay's swimming lessons, food, and shelter, as well as the amounts consumed for Franklin on the trust's form 1040. Essentially, the distributions for the costs of having Franklin are as much indirect distributions to Ken and Kay as are distributions for their swimming lessons or soccer shoes. (Note that under this analysis, the "distributions" to Frankilin do escape income taxation at the trust level, but not at the beneficiary level, seemingly satisfying

the concerns articulated by Revenue Ruling 76-486, but avoiding the compressed income tax brackets of non-grantor trusts.)

The second hypothetical trust is identical in every way to the first, except that it contains one additional sentence within the trust instrument:

> Without diminishing the foregoing provisions for the benefit of our children, the trustee may, in its discretion, distribute for the benefit of preserving and maintaining our family pet, Franklin.

This second trust, then, is what we might call a "hybrid purpose trust." Although its primary purpose is to provide financial support for the two minor trust beneficiaries, it is also a purpose trust, the purpose of which is to maintain and preserve the family pet. Let's also assume that Franklin is owned by the trust: the trust is a *res* purpose trust as well as a hybrid purpose trust.

If Aunt Gladys is reimbursed for Franklin's grooming bills by the trustee, can the trust deduct those costs as trust distributions? Revenue Ruling 76-486 suggests that the trustee cannot, but the IRS was not there presented a fact pattern in which there were concurrent noncharitable purposes alongside ascertainable beneficiaries. It was not presented, in other words, with a hybrid purpose trust. Nor was the IRS presented with a *res* purpose trust.

Out of an abundance of caution, the anticipated 2018 South Dakota purpose trust legislative proposal will strongly discourage trustees from comingling a trust share for ascertainable beneficiaries (Ken and Kay in this example) with a trust share for the purpose or purposes (the goldendoodle Franklin, in this second example) of a hybrid purpose trust.[42] (Presumably Franklin himself would be allocated to the trust share for the purpose of the trust, not the trust share for the beneficiaries.)

The caution of the task force should be commended, especially given the total lack of any authority on how the IRS would treat a hybrid purpose trust. But presumably, the only damages that can be projected for failing to maintain separate shares would be income tax losses. Therefore, if the trustee is reasonably assured that income tax benefits would *accrue* from deviating from the directive to maintain separate shares, the fiduciary duty of care would suggest that the trustee should consider ignoring the directive to maintain separate shares. As argued above, a reasonable case for income tax benefits can be outlined, at least for some purpose-motivate distributions which would otherwise qualify as distributions for the benefit of ascertainable trust beneficiaries. The "safe harbor" created by the anticipated 2018 South Dakota purpose trust legislation will permit a trustee to create separate shares if the trustee chooses to do so. On account of the legislation, the trustee would not be liable for any lack of tax savings that are bypassed by doing so. But if beneficiary consents are first obtained, I would personally encourage our more adventuresome trustees of *res*/hybrid purpose trusts to decline to create separate shares. I believe that there is then a much stronger argument that reasonable expenses incurred towards achieving the trust purpose

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[42] *See supra* notes 15-16; *infra* appx. B, section 3 (stating: "When the interests of the beneficiaries and purposes are concurrent, the trustee shall maintain not less than two separate shares, one for the beneficiaries; and a second for the purposes, and the trustee may be liable to the beneficiaries for the actual damages caused thereby, if any, for failing to do so.").

which are either in fact indirect beneficial distributions to the beneficiaries or reasonable repair and maintenance costs associated with preserving the trust corpus ought to be deductible as, respectively, distributions taxable to beneficiaries or reasonable deductible expenses. (Alternatively, the trustee might seek a private letter ruling if the tax consequences justify the cost. We desperately deserve an updated private letter or two ruling addressing *res* purpose trusts and hybrid purpose trusts. Better still, treasury regulations on point would clarify these unsettled issues and provide precedential authority on which trustees and their advisors could rely.)

I would assert that a new framework for distinguishing allowable distributions for the indirect benefit of beneficiaries from distributions to a chattel or realty. In theory, the trustee's discretion to reimburse Aunt Gladys for Franklin's expenses is wider in the second trust (which identifies Franklin's support as a noncharitable purpose) than in the first (which simply provides for distributions which benefit Ken and Kay). Move lavish expenditures on Franklin are probably contemplated when Franklin's preservation is identified as a purpose of the trust than if it is not. And here perhaps can be found a line of demarcation between allowable and non-allowable trust distributions for a goldendoodle. (Note again, however, that under this analysis, the at least a reasonable portion of the "distributions" to Frankilin again escape income taxation at either the trust level or the beneficiary level and it is difficult to reconcile this result with the text of Revenue Ruling 76-486.) Purpose trusts hold great promise. The days of greater clarity with regards to their income tax consequences lie ahead.

Thomas E. Simmons
Associate Professor
University of South Dakota
School of Law 212
414 East Clark Street
Vermillion, SD 57069
Tel. 605.677.5361
Email: tom.e.simmons@usd.edu

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APPENDIX A: Revenue Ruling 76-486
(1976-2 C.B. 192)

Trust for care of pet animal. In the absence of a state law to the contrary, a bequest in trust to provide for the care of a decedent's pet animal is void from its inception, and unless otherwise indicated in the will or specified by statute, the trust property passes to the residuary legatee and income earned on such property is includible in the income of such legatee. In jurisdictions where such a trust is not invalid, it is subject to the imposition of the tax of section 1(d) of the Code pursuant to section 641 and no deductions are allowable for distributions under sections 651 and 661.

Advice has been requested whether, under the circumstances described below, a bequest in trust for the care of a pet animal creates a valid trust for purposes of the imposition of tax under section 641 of the Internal Revenue Code of 1954.

A, a resident of State *X,* died testate in 1976. Under the terms of *A*'s will *A*'s entire property passed to designated individuals, including a residuary legatee, with the exception of a fund that was established to care for *A*'s pet animal. The income of the fund, to the extent required, is to be used for the care of the animal. Upon the death of the animal, the corpus of the fund is to be distributed to *A*'s heirs, if living, or their descendants.

Under the common law rule against perpetuities, the period during which vesting of interests in property may be postponed is limited to a life or lives in being plus twenty-one years and any period of gestation involved in the situation to which the limitation applies. It has generally been assumed that the lives that measure the period of perpetuities should be human lives. II SCOTT ON TRUSTS, section 124.3 (3rd ed. 1967); RESTATEMENT OF PROPERTY, section 374, comment h (1944).

In the absence of statutory abrogation, the rule against perpetuities is part of the common law in most jurisdictions in the United States. State *X* has adopted no statute that would render the rule against perpetuities inapplicable in the circumstances set forth in the instant case. Since the life of an animal is not a proper measuring life in being under the rule against perpetuities in State *X,* the bequest in trust to provide for the care of the animal was void from its inception.

The law of State *X* provides that personal property comprising any bequest that fails, is void, or is otherwise incapable of taking effect, will be included in the residuary bequest, if any, contained in the decedent's will, unless a contrary intention appears in the will.

Accordingly, in the instant case, since the bequest in trust for the care of the pet animal was void from its inception, a valid trust never came into being for purposes of the imposition of tax under section 641 of the Code. Further, the property passed to the residuary legatee pursuant to the law of State *X,* because no contrary intention appears in the will, and the income earned on such property is includible in the income of the residuary legatee in the year the income is received.

A bequest in trust for the care of a pet animal is not void from its inception in all states. In those jurisdictions where a trust created by such a bequest is valid, the trust is unenforceable because

there is no one who as beneficiary can compel the trustee to carry out the purpose of the testator. Such intended trusts have been characterized as 'honorary trusts,' the conscience of the trustee being the only compelling influence on performance. However should the trustee fail to perform the intention of the testator, the trustee will not be allowed to keep the property; instead a resulting trust will arise in favor of the testator's residuary legatees. *See* SCOTT ON TRUSTS, sections 123(2) and 124 (3rd ed. 1967). The income tax consequences of an honorary trust will depend on whether it will qualify as a valid trust for purposes of section 641 of the Code.

Section 641 of the Code provides, in part, that the taxable income of a trust is computed in the same manner as in the case of an individual, except as otherwise provided. Also, a trust is generally allowed, in computing its taxable income, the deduction provided by either section 651 or section 661 and the regulations thereunder, relating to distributions to beneficiaries.

Section 651 of the Code provides for a deduction in the case of a trust that distributes current income only. The deduction is limited to the amount of the distributable net income regardless of whether the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year. Section 652 provides, in part, that the amount of income for the taxable year required to be distributed currently by a trust shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. Such includible amount shall be an amount equal to each beneficiary's share of distributable net income of the trust.

Section 661 of the Code allows a deduction to a trust not qualifying under the provisions of section 651 in computing its taxable income, for any amount of its income for such taxable year required to be distributed currently and any other amount properly paid or credited or required to be distributed to a beneficiary for the taxable year to the extent such deduction does not exceed the distributable net income of the trust. Section 662 provides generally that the beneficiary of a trust must include in gross income all amounts that are deductible by the trust under section 661(a).

Section 301.7701-4(a) of the Income Tax Regulations provides that in general, the term 'trust' as used in the Internal Revenue Code refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate court. The term 'beneficiary,' for purposes of Part I, subchapter J, of the Code, is defined in section 643(c) to include heirs, legatees, and devisees. Heirs, legatees, and devisees are persons. *See* 96 C.J.S. *Wills,* section 1097 (1957). For purposes of the Code, where not otherwise distinctly expressed to the contrary or manifestly incompatible with the intent thereof, the term 'person' is construed to mean and include an individual, trust, estate, partnership, association, company or corporation. Section 7701(a). Since animals do not fall within this category, they cannot be beneficiaries for purposes of section 643(c).

Since a beneficiary is lacking, a bequest in trust for a pet animal does not fit into the traditional concept of a trust, as set out in section 301.7701 of the regulations. Such an arrangement, however, should nonetheless be classified as a trust for tax purposes under section 641 of the Code in those jurisdictions where it would not be invalid. To treat this arrangement as not being

a taxable trust would, in addition to ignoring its validity under local law, cause the income on the bequest to escape taxation altogether, since the distributions of income for the benefit of the pet animal would similarly not be taxed.

Accordingly, the taxable income of a fund, which is not invalid under state law, bequeathed in trust for the benefit of an animal, is subject to the imposition of the tax of section 1(d) of the Code pursuant to section 641. *See* Rev. Rul. 58-190, 1958-1 C.B. 15, which holds that a trust is created for purposes of section 641 where funds are received by a cemetery company or corporation for the perpetual care of an individual lot or mausoleum crypt.

Furthermore, since the amounts of income required to be distributed under section 651 of the Code and amounts properly paid, credited, or required to be distributed under section 661 are limited to distributions intended for beneficiaries, a deduction under those sections is not available for distributions for the benefit of a pet animal. Similarly, such distributions are not taxed to anyone under sections 652 and 662.

APPENDIX B: 2018 Anticipated Purpose Trust Legislation in South Dakota

Section 1. *That 55-1-20 be amended to read*:

Sections 55-1-4(2) and 55-1-5(2) notwithstanding, a purpose trust may be performed pursuant to this section and §§ 55-1-21 and 55-1-22 if the trust is for a lawful noncharitable purpose or purposes. Any property may form a part or all of the trust estate, including some, all, or an interest in some or all of the property which is the subject or purpose of a purpose trust. A governing instrument of such a trust shall be liberally construed in favor of its validity, to presume against the merely precatory or honorary nature of the disposition, and to carry out the trustor's intent. If necessary, extrinsic evidence is admissible to determine the trustor's intent. Neither the common law rule against perpetuities, nor any rule restricting the accumulation of income, nor any common law rule limiting the duration of noncharitable purpose trusts is in force in this state.

Section 2. *That 55-1-21 be amended to read*:

(1) The following purpose trusts are valid:

(A) A trust for the care of a designated animal or animals;

(B) A trust for the care, maintenance, promotion, continuation, conservation, upkeep, protection, furtherance, or preservation of any other property;

(C) A trust for any other lawful noncharitable purpose or purposes.

(2) Except as otherwise provided in the governing instrument, a trust described in subdivision (1)(A) of this section terminates when no living animal is covered by the trust.

(3) A court may reasonably reduce the amount of the property transferred to the trustee of a purpose trust if the court determines that the trust corpus substantially exceeds the amount required for the intended purposes. The court should consider allowing the trust to be administered for a reasonable period of time before undertaking such a determination. The amount of the reduction, if any, passes as unexpended trust property under subdivision (9) of this section.

(4) If the court finds that the fulfillment of the purposes are or have become impossible, inexpedient, or unlawful, the court shall make an order directing that the trust be administered in such manner as, in the judgment of said court, will, as nearly as can be, accomplish the general purposes, the objects, and intentions of the trustor.

(5) The purposes of a purpose trust may be enforced by an enforcer designated in the governing instrument and if no enforcer is acting pursuant to the terms of the

governing instrument, the court may appoint one or more enforcers and successor enforcers. No purpose trust shall fail for want of an enforcer. An enforcer may petition for, consent to, waive, or object to any matter regarding a purpose trust with regards to the purpose of the trust which the enforcer represents and regarding the administration of the purpose trust. Enforcers are fiduciaries and, except as otherwise provided in the governing instrument, are entitled to reasonable compensation as determined by the trustee. An enforcer may also serve as a trust protector or a family advisor under S.D.C.L. chapter 55-1B, but an enforcer may not serve as an enforcer while serving as a trustee or a distribution trust advisor of the same trust.

(6) Any trustee may petition the court for the removal of an enforcer. An enforcer may be removed if the court finds:

(A) The enforcer committed a serious breach of the purpose enforcer's responsibilities or is unfit or unwilling to serve;

(B) A significant and unjustified lack of cooperation or hostility between the enforcer and the trustee, or the trust protector, or the trust advisor; or

(C) There has been a substantial change in circumstances and removal of the enforcer would best serve the purpose or purposes of the trust.

The governing instrument may provide additional procedures for the removal of an enforcer.

(7) Except as otherwise provided in the governing instrument, a trustee of a purpose trust is vested with full discretion in:

(A) Interpreting the purposes of the trust consistent with the terms of the governing instrument; and

(B) Applying, distributing, or expending principal and income to further the trust's purposes.

(8) If no trustee is designated or no designated trustee is willing or able to serve, a court shall name a trustee. A court may order the transfer of the property to another trustee if required to ensure that the intended purposes are carried out and if no successor trustee is designated in the governing instrument or if no designated successor trustee agrees to serve or is able to serve. A court may also make such other orders and determinations as are advisable to carry out the intent of the trustor and the purpose of §§ 55-1-20 to 55-1-22, inclusive.

(9) Upon termination of a purpose trust, the trustee shall distribute any remaining trust property as directed in the governing instrument. Only in the event that the governing instrument is silent shall the trustee, upon termination of a purpose trust, distribute any remaining trust property as follows:

(A) If the trust was created in a nonresiduary clause in a testator's will and the will fails to direct the distribution of unexpended trust property, then under the residuary clause of the testator's will, and for the purposes of § 29A-2-707, the residuary clause is treated as creating a future interest under the terms of a trust;

(B) Otherwise, to the trustor's heirs under § 29A-2-711.

(10) Except as ordered by the court or required by the governing instrument, no filings, reports, periodic accounting, separate maintenance of funds, appointment, or registration of a purpose trust are required.

(11) Except as expressly provided otherwise in the trust instrument, no portion of the principal or income may be converted to the use of the trustee or to any use other than for the trust's purposes or for the benefit of a covered animal.

Section 3. *That 55-1-22 be amended to read:*

(1) A hybrid purpose trust which meets the description of a purpose trust in § 55-1-20 and also includes one or more beneficiaries is valid and may be performed.

(2) When the interests of the beneficiaries and purposes are concurrent, the trustee shall maintain not less than two separate shares, one for the beneficiaries; and a second for the purposes, and the trustee may be liable to the beneficiaries for the actual damages caused thereby, if any, for failing to do so.

(3) The beneficiaries' share of a hybrid purpose trust is governed by §§ 43-5-8 and 43-6-7.

(4) A hybrid purpose trust may:

(A) Contain a spendthrift provision; and

(B) Also qualify as a trust described in § 55-16-2.

(5) The provisions of § 55-1-21 apply to a hybrid purpose trust except that:

(A) Under subdivision § 55-1-21(2), except as otherwise provided in the governing instrument, a trust described in § 55-1-21(1)(A) terminates when no living animal is covered by the trust unless the trust may continue for the benefit of the beneficiaries; and

(B) Under subdivision § 55-1-21(3), a court has no power to reduce the amount of trust property intended for or allocated to any beneficiaries or any charitable purposes.

(6) Except as otherwise provided in the governing instrument, a trustee of a hybrid purpose trust is vested with full discretion in administering the trust and to consider the best interests of the beneficiaries and the purposes of the trust.

(7) In addition to § 55-1-21(5), an enforcer may also not be a beneficiary of a hybrid purpose trust.

Section 4. *That § 21-22-1(3) be amended to read:*

"Fiduciary, a trustee, custodian, enforcer, trust advisor, trust protector, or trust committee, as named in the governing instrument or order of the court, regardless of whether such person is acting in a fiduciary or nonfiduciary capacity;

Section 5. *That § 53-3-27 be amended to read:*

Except as otherwise provided by the terms of the trust, if the value of the trust property of a noncharitable trust is less than one hundred fifty thousand dollars, the trustee may terminate the trust. On petition by a trustee or beneficiary, the court may modify or terminate a noncharitable trust or appoint a new trustee if it determines that the value of the trust property is insufficient to justify the cost of administration involved. Upon termination of a trust pursuant to this section, the trustee shall distribute the trust property in accordance with the trustor's probable intention. The existence of spendthrift or similar protective provisions in a trust does not make this section inapplicable. The court, when considering the termination of a trust containing spendthrift or similar protective provisions, shall consider the feasibility of appointing a new trustee to continue the trust. This section shall not apply to a § 55-1-21(1)(A) purpose trust.

NOTE: The draft printed above represents the language approved by the South Dakota Governor's Task Force on Trust Administration Review and Reform prior to any style revisions by the Legislative Research Council.