

The Legal Compendium of Private Common Law Trusts: Contractual Provisions and Statutory Deferral

Section 1: Definitional and Common Law Foundations

According to *Black's Law Dictionary* (9th ed.), a **trust** is defined as a fiduciary relationship in which one person holds legal title to property, subject to an equitable obligation to keep or use the property for the benefit of another, who holds equitable title. A fundamental requirement of trust law is the strict separation of legal and equitable title:

- The trustee holds sole **legal title** to the corpus, granting administrative and managerial authority.
- The beneficiaries hold sole **equitable title**, granting beneficial interest without managerial control or legal ownership of trust assets.

A **spendthrift trust** is defined by *Black's Law Dictionary* (9th ed.) as a trust that restrains both voluntary and involuntary alienation of the beneficiary's interest. Under this structure, creditors cannot reach the trust corpus or mandatory future distributions before actual receipt by the beneficiary. The trust corpus is deposited into the care of the fiduciary and is held strictly subject to the covenants, conditions, powers, and restrictions established within the governing contract.

The Contractual Function of the Escrow Corpus

The trust operates contractually as an escrow by analogy because assets are deposited into the care of the trustee to be held strictly subject to the covenants, conditions, and restrictions of the governing contract. The trust does not establish an escrow account at a financial institution, nor does it appoint an external escrow agent.

The trustee administers standard trust checking and savings accounts under sole legal title and unilateral fiduciary authority.

In this specific trust contract, utilizing the term "escrow corpus" rather than a generic "corpus" or "principal" establishes a dedicated, contractually restricted holding governed by mandatory fiduciary rules:

- **Irrevocable Loss of Title:** Under the terms of the trust, the escrow corpus represents a permanent, closed escrow holding. When property is transferred into the trust, the contract specifies that the transfer is final, and the transferor forfeits all interest and ownership, with the property being held strictly in the escrow corpus subject to the trust terms. Utilizing the word "escrow" reinforces the legal reality that the assets are locked in a neutral, contractually bound container managed by a fiduciary, completely severed from both the creator and the beneficiaries.
- **Safeguarding Spendthrift and Discretionary Protections:** The agreement explicitly mandates that the Trustee shall not designate any percentage of the Trust escrow corpus to any beneficiary or beneficiaries in any manner whatsoever. This prevents a beneficiary from ever claiming a vested percentage of the principal, keeping their interest completely unascertainable and out of reach of creditors.
- **Forfeiture Upon Attempted Alienation:** If a beneficiary attempts to assign their interest, or if they face bankruptcy or insolvency, the trust dictates that their right to receive payments immediately ceases, and those funds are redirected to augment the remaining beneficiaries or remain in the escrow corpus at the sole discretion of the Trustee.

Section 2: Constitutional Authority and Contractual Nature

Non-Grantor Irrevocable Complex Discretionary Spendthrift Trusts derive their legal existence from fundamental common law contract rights rather than state legislative enablement.

Constitutional Protections Under Article 1, Section 10

Article 1, Section 10, Clause 1 of the United States Constitution explicitly provides:

"No State shall... pass any... Law impairing the Obligation of Contracts."

This constitutional mandate guarantees that private indentures created under common law are shielded from retroactive state legislative interference.

Distinction Between Common Law Trusts and Statutory Entities

- **Statutory Entities:** Corporations, limited liability companies, and statutory business trusts are artificial entities created exclusively by legislative privilege. They depend upon state statutes for their existence, filing compliance, and legal status.
- **Common Law Contractual Trusts:** Private non-grantor trusts are established through the execution of private contractual agreements between the settlor and the fiduciary. They exist by right of contract under common law rather than by state franchise or legislative grant.

Establishment and Complete Alienation of the Settlor/Trustor/Grantor

The private contract shall designate a Settlor/Trustor/Grantor who will create the private non-grantor trust, appoint the initial trustee, and provide the initial nominal consideration. To prevent the trust from being recharacterized as a grantor trust under the Internal Revenue Code, the Settlor/Trustor/Grantor must entirely relinquish all administrative control, reversionary interests, and beneficial enjoyment over the trust corpus. The governing agreement must strictly forbid related or subordinate parties from serving in a fiduciary or an administrative capacity. This restriction includes a spouse who is living with the Settlor/Trustor/Grantor, parents, lineal descendants, siblings, or direct employees. Furthermore, a corporation or an employee of a corporation in which the holdings of the Settlor/Trustor/Grantor and the trust are significant from the viewpoint of voting control cannot serve in these capacities.

The prohibition strictly extends to a subordinate employee of a corporation in which the Settlor/Trustor/Grantor is an executive. Upon the execution of the trust indenture and the transfer of the initial consideration, the Settlor/Trustor/Grantor possesses no further legal or equitable relationship with the trust. *Consequently, the trust is recognized as an independent taxable entity rather than an extension of the Settlor/Trustor/Grantor.*

Under standard governing non-grantor trust provisions, specific restrictions are applied directly to the escrow corpus to prevent grantor trust classification under the Internal Revenue Code:

- **Adequate Consideration:** No person (including the Settlor or Trustee) is permitted to purchase, exchange, or dispose of the escrow corpus or its income for less than adequate consideration.
- **Borrowing Prohibitions:** The Settlor is strictly prohibited from borrowing the escrow corpus or its income, directly or indirectly, without adequate interest and security.
- **Prohibition on Reacquisition:** No person possesses the administrative power to permit anyone to reacquire the escrow corpus by substituting other property of equivalent value.

Section 3: Statutory Authority for Trust Taxation and Capital Allocations

The taxation of Non-Grantor Irrevocable Complex Discretionary Spendthrift Trusts is governed strictly by the Internal Revenue Code, Treasury Regulations, and binding Supreme Court decisions.

Internal Revenue Code Section 643(b)

Under Internal Revenue Code Section 643(b), trust income is determined by the specific terms of the governing instrument and applicable local law.

When the governing instrument grants the fiduciary the discretionary power to allocate receipts between principal (corpus) and income in good faith, that contractual allocation controls.

Utilizing the term "escrow corpus" enforces the fiduciary duty under IRC § 643 by establishing a compliant, good-faith path for tax deferral. By using "escrow corpus" as a contractually defined destination:

- **Mandatory Capital Allocations:** The Trustee is contractually obligated to allocate capital gains specifically to the escrow corpus, ensuring they are legally excluded from Distributable Net Income (DNI) and preserved from distribution to any beneficiary during the taxable year.
- **Dividend Treatment:** The Trustee must allocate extraordinary dividends and taxable stock dividends to the escrow corpus to comply with the good-faith fiduciary standards of IRC § 643 and Treasury Regulation Section 1.643(b)-1.

Step	IRC SECTION 643(b) MECHANICS
1. Fiduciary Discretion	Trustee exercises contractual authority under the trust indenture.
2. Corpus Allocation	Receipts are allocated to trust corpus rather than fiduciary income.
3. DNI Exclusion	Capital additions to corpus are excluded from Distributable Net Income.
4. Deferral Mechanism	Tax liability is deferred until a distribution is made to the beneficiary.

Treasury Regulation Section 1.643(b)-1 confirms that trust provisions departing reasonably from local law definitions of income will be respected when the governing instrument grants the trustee prudent, good-faith discretion over principal and income allocations.

Section 4: Supporting Case Law Precedents

The following authorities establish the validity, asset protection boundaries, and tax planning legitimacy of private contractual spendthrift trusts.

1. Constitutional Protections and Common Law Contract Rights

- **Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810)**
 - *Holding:* The Supreme Court held that the Contract Clause of the United States Constitution applies to both public and private agreements. A state legislature cannot enact statutes that impair or nullify valid contractual rights.
 - *Application:* Confirms that a trust indenture established through the constitutional right of contract is protected against state legislative impairment.

- **Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819)**
 - *Holding:* The United States Supreme Court held that a private corporate charter constitutes a contract protected by the Contract Clause of the United States Constitution.
 - *Application:* This ruling reinforces the foundational premise that private contractual arrangements are entirely distinct from statutory entities. It guarantees that the trust operates contractually under the strict protections of Article 1, Section 10 of the United States Constitution.

- **Schumann-Heink v. Folsom, 328 Ill. 321, 159 N.E. 250 (1927)**
 - *Holding:* The Supreme Court of Illinois affirmed that common law trusts originate from the fundamental right of contract, operating independently of statutory authorization. The court ruled that trustees and beneficiaries are exempt from personal liability for trust obligations when the governing agreement so provides.
 - *Application:* Affirms that a contractual trust is not a partnership, does not depend upon statutory creation, and provides limited liability strictly through the terms of its governing contract.

- **Burnett v. Smith, 240 S.W. 1007 (Tex. Civ. App. 1922)**
 - *Holding:* The Texas Court of Civil Appeals held that a declaration of trust constitutes a binding contract that governs all parties. The court ruled that absolute legal title, management, and control are vested exclusively in the trustees, and beneficiaries cannot maintain an action for receivership or dissolution contrary to the express terms of the trust contract.
 - *Application:* Confirms that a private declaration of trust operates as an inviolable contract under common law, strictly preventing equitable interest holders from overriding the administrative powers granted to the trustees.

2. Creditor Shielding and Spendthrift Protections

- **Nichols v. Eaton, 91 U.S. 716 (1875)**
 - *Holding:* The United States Supreme Court established the validity of spendthrift provisions under American common law. The Court ruled that a property owner has the right to bestow property upon a trust with conditions that prevent the beneficiary from alienating the asset or creditors from attaching it.

- *Application:* Provides binding federal authority that spendthrift clauses fully protect trust principal and income from the creditors of the beneficiaries.
- **Hussey v. Arnold, 185 Mass. 202, 70 N.E. 87 (1904)**
 - *Holding:* The Massachusetts Supreme Judicial Court held that a trust agreement providing for the management of property by trustees without individual liability protects both certificate holders and trustees from personal debt obligations. Trust property cannot be attached or sold upon execution for the personal debts of the trustee.
 - *Application:* Affirms that trust corpus is insulated from the personal liabilities of the trustee and that beneficiaries cannot be held personally liable for debts incurred by the trust.
- **Mayo v. Moritz, 151 Mass. 481, 24 N.E. 1083 (1890)**
 - *Holding:* The court ruled that an agreement transferring property to trustees for management, where certificate holders retain no operational control, creates a pure trust relationship rather than a partnership.
 - *Application:* Protects beneficiaries from third-party contract claims and trust liabilities, provided that beneficiaries do not exercise operational control over the trust assets.
- **Burnett v. Smith, 240 S.W. 1007 (Tex. Civ. App. 1922)**
 - *Holding:* The court established that trustees acting on behalf of the trust estate constitute a separate entity from themselves as individuals, and beneficiaries who hold no operational control cannot interfere with the fiduciary management of the estate.

- *Application:* Substantiates the strict separation between the equitable title of beneficiaries and the legal authority of the trustee, ensuring that trust assets and the escrow corpus remain protected against unauthorized claims.
- **California Code of Civil Procedure Section 695.030(a)**
 - *Statutory Rule:* Property of the judgment debtor that is not assignable or transferable is not subject to the enforcement of a money judgment.
 - *Application:* Reinforces spendthrift trust provisions under state civil procedure by confirming that non-assignable beneficial interests cannot be seized by judgment creditors.
- **Blair v. Commissioner, 300 U.S. 5 (1937)**
 - **Holding:** The United States Supreme Court affirmed that federal tax liability follows the ownership of beneficial interests as determined by local property law and the governing trust instrument.
 - **Application:** This ruling establishes that federal courts must defer to local property determinations when evaluating the alienation of an equitable interest. According to *Black's Law Dictionary* (9th edition), alienation is the conveyance or transfer of property to another. In this matter, the Supreme Court validated the assignment of the beneficiary's interest because the governing instrument lacked valid spendthrift restrictions. This outcome highlights the absolute necessity of drafting strict spendthrift provisions within the private contract.

3. Legal Right to Choose Organizational Forms and Minimize Taxation

- **Weeks v. Sibley, 269 F. 155 (N.D. Tex. 1920)**
 - *Holding:* The federal district court ruled that the dissolution of a corporation and the subsequent transfer of its assets to a common law trust was valid, even though the express objective was to reduce future federal income taxes.
 - *Application:* Confirms that creating a common law trust for the purpose of reducing tax exposure is entirely lawful and does not constitute tax evasion.

- **Edwards v. Commissioner, 415 F.2d 578 (10th Cir. 1969)**
 - *Holding:* The United States Court of Appeals for the Tenth Circuit ruled that taxpayers have the full legal right to reduce their tax exposure or avoid taxes completely using legitimate structural mechanisms.
 - *Application:* Reaffirms the judicial doctrine that legitimate structuring cannot be disregarded simply because it produces a tax advantage.

- **Narragansett Mutual Fire Ins. Co. v. Burnham, 51 R.I. 371, 154 A. 909 (1931)**
 - *Holding:* The Supreme Court of Rhode Island held that choosing a specific form of business or organizational structure to minimize tax liabilities does not constitute an evasion of legal duty.
 - *Application:* Supports the freedom of contract to select a non-grantor trust structure over statutory corporate forms to achieve tax efficiency.

4. Trust Formation, Alienation, and Tax Deferral Mechanics

- **Freuler v. Helvering, 291 U.S. 35 (1934)**
 - *Holding:* The United States Supreme Court ruled that beneficiaries are only taxable on the amounts that are properly distributable to them under the governing instrument, and any income that the fiduciary properly retains or reserves is not taxable to the beneficiaries.
 - *Application:* This ruling explicitly validates the precise mechanics of Internal Revenue Code Section 643(b). When the trustee exercises the contractual authority to allocate receipts to the trust escrow corpus, this allocation legally excludes such amounts from Distributable Net Income. Consequently, the tax liability is deferred until a future distribution is made to a beneficiary.

Section 5: Professional Misinterpretations of Internal Revenue Code Section 643(b).

It is common for tax attorneys, certified public accountants, and enrolled agents to misinterpret the proper applications of the Internal Revenue Code pertaining to these trusts. This misunderstanding occurs because modern legal and financial education focuses almost exclusively on statutory entities. Professionals are trained primarily to administer corporations, limited liability companies, and statutory business trusts. Therefore, they default to applying the rules of state-enabled entities to all legal structures. They overlook the fact that a private trust operates under the fundamental right of contract and is protected by Article 1, Section 10 of the United States Constitution. When practitioners attempt to determine the tax obligations of these private structures, they frequently rely on administrative perspectives rather than binding law. For example, they often look to Internal Revenue Service Chief Counsel Memorandums, such as AM 2023-006, to guide their interpretations.

These memorandums do not possess the weight of legal precedence, and practitioners will still use or cite them as binding authority even when it clearly states, *“This memorandum may not be used or cited as precedent.”* Under a strict application of Internal Revenue Code Section 643(b), the term income is defined by the governing instrument and the good faith determinations of the fiduciary.

Because practitioners conflate statutory trusts with private contractual trusts, they incorrectly assume that local law permanently supersedes the private contract.

However, the governing instrument maintains the ultimate authority. The trustee possesses the explicit authority to allocate receipts to the trust escrow corpus. This allocation excludes such amounts from Distributable Net Income. Consequently, the tax liability is deferred until a future distribution is made to a beneficiary. Treasury Regulation Section 1.643(b)-1 confirms that allocations made pursuant to the terms of the governing instrument and applicable local law will be respected.

Professionals fail to apply these deferral mechanisms because they fail to recognize the escrow nature of the trust corpus. They attempt to force a private contractual arrangement into the rigid framework of a statutory entity. By adhering strictly to the statutory text of the Internal Revenue Code and the constitutional protections of private contracts, the proper legal and tax administration of the trust remains perfectly clear.

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