

ADVANCED FIDUCIARY INCOME TAX UPDATE

By

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I. Introduction

While creative estate planners are busy designing new and more complex strategies to maximize their clients' transfer of wealth, they are often creating numerous income tax issues that trustees and tax preparers must deal with during the administration. Many of these strategies involve the creation of new entities, some of which are disregarded for income tax purposes, the merger, division, or termination of these entities, or the need for special tax elections. On top of that, a family settlement agreement can add further income tax complexities to the mix. This outline addresses some of the emerging income tax issues that fiduciaries and tax return preparers need to be aware of.

II. Income Tax Issues Involving Grantor Trusts

Grantor trusts have become immensely popular over the last several years to enhance wealth transfer strategies. This is primarily because they allow the grantor to make a completed gift for gift and estate tax purposes, while the grantor continues to be treated as the owner of the trust property for income tax purposes. This feature allows the grantor to make an additional gift to the trust beneficiary of the income tax on the gifted property without it being treated as a taxable gift.

The hybrid nature of grantor trusts has sparked several questions about the income tax consequences of transactions involving them. Some of these questions have been answered in various revenue rulings, cases, and regulations. But other questions remain unanswered. We address some of these questions below and suggest some practical answers based on existing guidance.

A. The Income Tax Nature of a Grantor Trust

It is necessary to first review the income tax nature of a grantor trust before discussing the tax impact of transactions involving it. The grantor trust rules under Subpart E of Subchapter J of the Internal Revenue Code were enacted in 1954 to prevent high bracket taxpayers from shifting taxable income to lower bracket taxpayers while the grantor retained control of the trust.¹

1. Income, Deductions, and Credits

Thus, a grantor (or another person) is treated as the owner of any portion of a trust if they meet any of the conditions described in IRC §§ 671-679. In that case, the grantor (or other person) must include the income, deductions, and credits attributable to the trust (or portion thereof) to the same extent they would be taken into account in computing his own tax.² Thus, the existence of the trust is ignored for purposes of its income, deductions, and credits. Such income, deductions, and credits are reported on the grantor's federal income tax return on the appropriate schedules as if he or she were the owner of the property.

¹ See H.R. Rep. No. 83-1337, at 63-64, app. at 211-17 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4089-90, 4530-57; S. Rep. No. 83-1622, at 86-87, 364-72 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4718-19, 5005-13.

² IRC § 671.

This treatment of trust property as owned directly by the grantor can be good or bad. It can be good for deducting passive activity losses if a grantor materially participates in a rental or business activity owned by the trust, which would otherwise be disallowed if the trustee did not materially participate.³ In addition, the grantor may be able to reduce the 3.8 percent Medicare tax by reporting the trust's investment income on his or her own return, given that the grantor has a \$200,000/\$250,000 Medicare threshold compared to the trust's \$11,950 Medicare threshold for 2013.

On the other hand, the grantor would be subject to self-employment tax on any trade or business income generated by a business activity owned by the trust, whereas a nongrantor trust is exempt from self-employment tax.⁴ And finally, all of the grantor trust's administrative deductions would be subject to the alternative minimum tax (AMT) and the 2-percent floor on miscellaneous itemized deductions because the exception under IRC § 67(e) does not apply to grantor trusts.⁵

2. Transactions Between the Grantor and the Trust

The IRS interprets IRC § 671 more broadly and holds that a grantor trust is also ignored as a separate taxable entity for income tax purposes in dealings between the grantor and the trust. Prop. Reg. § 1.671-1(f) states: "For purposes of subtitle A of the Internal Revenue Code, a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion for all purposes."

This view was also maintained in Rev. Rul. 85-13, which held that a grantor's purchase of corporate stock from his trust with an unsecured promissory note was not a purchase for federal income tax purposes. Rather it was the economic equivalent of borrowing the trust corpus, which under IRC § 675(3) made the grantor the owner of the trust for income tax purposes. Having concluded that the grantor was now the owner of the trust assets, he was viewed as "both the maker and the owner of the promissory note."⁶ Such a transaction where "the same person is treated as owning the purported consideration both before and after the transaction" cannot be recognized for income tax purposes.

Notice that the same transaction that changed the trust's tax status to a grantor trust was viewed as occurring *after* the conversion. Thus, the "sale" became a "non-sale" because it was viewed as occurring between the grantor and himself in his *post*-conversion status. This view of a transaction or event that causes a conversion as occurring between the

³ Ltr. Rul. 201317010, 201029014; TAM 200733023 (Aug. 17, 2007); *But see* Carter v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

⁴ Reg. § 1.1402(a)-2(b) (The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.)

⁵ Reg § 1.67-2T(b)(1) ; Bay v. Comm'r, T.C. Memo 1998-411; *see also* Conference Rep. No. 99-841, 99th CONGRESS, 2nd Session, H.R. 3838 (Sept. 18, 1986), p. 34; General Explanation of the Tax Reform Act of 1986 H.R. 3838, JCS-10-87, 99th Cong. P.L. No. 99-514 (May 4, 1987), p. 81.; IRC § 56(b)(1)(A)(i) (no deduction is allowed for miscellaneous itemized deductions as defined in section 67(b) for purposes of the AMT).

⁶ Rev. Rul. 85-13, 1985-1 C.B. 184.

parties in their *post*-conversion status is consistent with Example 5 in Reg. § 1.1001-2(c). In the example, the moment the grantor renounced his grantor powers, converting the trust to a nongrantor trust, the grantor and the trust were treated as separate taxpayers. Because the grantor transferred his partnership interest to the trust in exchange for consideration in the form of debt relief, it was taxable to him.

3. Gift Tax Consequences of the Grantor's Payment of the Income Tax

And to further sweeten the pie, the IRS held in Rev. Rul. 2004-64 that the grantor's payment of the income tax attributable to the inclusion of trust income in his or her taxable income was not a gift to the trust beneficiaries because the grantor, not the beneficiaries, is liable for the tax.

4. Partial Grantor Trusts

A grantor can be taxed as the owner of all or "any portion of a trust" if the grantor holds a prohibited interest or power.⁷ A person who owns only a portion of a trust includes in his or her income only the income, deductions, and credits attributable to that portion. Determining what specific portion of the trust the grantor owns can be one of the most difficult problems in applying the grantor trust rules. Normally, a grantor can own a portion of a trust divided in three ways:

- Ownership of the income or principal only;
- Ownership of a fractional or pecuniary share of trust income and principal; or
- Ownership of all items attributable to specific trust assets.

Wealth transfer techniques usually involve trusts that are treated as wholly owned by the grantor rather than only partially owned. This enhances the gift by causing more of the trust income to be taxed to the grantor. It also simplifies the accounting for transactions with the trust. But other than that, there is no hard and fast rule against using partial grantor trusts for estate planning.

5. Reporting Requirements

Perhaps one of the most popular aspects of a grantor trust is the minimal reporting requirements. The trustee is not required to calculate distributable net income (DNI), but merely states on page 1 of Form 1041 that the trust is a grantor trust and that its income, deductions, and credits are shown on a separate statement attached to the form and provided to the grantor. Wholly owned grantor trusts may even opt out of filing Form 1041 altogether.⁸ Instead, they may provide the *grantor's* social security number to the payors, who will then issue the Forms 1099 directly to the grantor. Alternatively, the trustee may provide the *trust's* federal ID number to the payors, who will issue Forms 1099 to the trustee, who then issues Forms 1099 to the grantor. If the trustee changes

⁷ IRC § 671; Prop. Reg. § 1.671-2(f).

⁸ Reg. § 1.671-4(b)(2); Reg. § 1.671-4(b)(8) (Husband and wife are treated as one taxpayer if they file jointly.).

from filing Forms 1041 to filing Forms 1099, the trustee must file a final Form 1041 for the year before the switch.⁹

Despite the alternative reporting options, many trustees prefer to obtain a federal ID number for the trust and file annual Forms 1041. First it functions as a reminder that the grantor trust is a distinct legal entity. And second, the trust will eventually need a separate ID number when its grantor trust status ends, as it inevitably will.¹⁰

But using the trust's separate ID number instead of the grantor's social security can make it more confusing to brokers, who must report a transfer of securities by gift and apply the loss limitation rules under IRC § 1015(a) to a sale of those securities. Under IRC § 6045A, a broker who transfers securities purchased after January 1, 2011 to the account of another by gift must report the basis on a sale of those securities on Form 1099-B as the lesser of cost or fair market value if the value of the securities exceeded the donor's basis on the date of the gift.¹¹ Application of these rules could prevent the recognition of a loss on the sale of these securities. But because the gift to a grantor trust is ignored for income tax purposes, and IRC § 1015(a) is an *income* tax rule, the grantor should instruct the broker that the gift-related basis adjustments are inapplicable, and that the transfer should be reported as if it were *not* a gift for Form 1099-B reporting purposes.¹²

Interestingly, the number of Forms 1041 filed by grantor trusts has sharply declined since 2007.¹³ According to the IRS Statistics of Income, the number of grantor trust returns declined from 1,266,080 in 2007 to 559,312 in 2010. Grantor trusts accounted for 34 percent of all Form 1041 filings in 2007 compared to 19 percent in 2010. While this might indicate that the number of grantor trusts is on the decline, judging from their recent popularity among the estate planning community, it more likely indicates that more new trusts are opting for grantor trust status and opting out of the Form 1041 filing requirements.

B. Transactions Between the Grantor and the Grantor Trust

Because the grantor is treated as the owner of trust property for income tax purposes, we disregard any transfers of property between the grantor and the trust.¹⁴ They are treated as transfers of property by the grantor to himself, which are not recognized for income tax purposes. Thus, if the grantor sells an appreciated asset to the trust, the grantor recognizes no gain under IRC § 1001 because the sale is ignored for income tax purposes.

For the same reason, if the grantor gifts a built-in loss asset to the grantor trust who sells it to a third party, the full amount of the loss can be recognized. If we had recognized the trust as a separate taxpayer, the trust's basis for purposes of determining a loss would have been limited to its fair market value on the date of the gift under IRC § 1015(a). But

⁹ Reg. § 1.671-4(g)(1).

¹⁰ Reg. § 1.671-4(h)(2).

¹¹ Reg. §§ 1.6045A-1(b)(6)(i); 1.6045-1(d)(6)(ii)(B)(2).

¹² *Id.*

¹³ "Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Type of Entity," Table 2, available at www.irs.gov.

¹⁴ Prop. Reg. § 1.671-2(f); Rev. Rul. 85-13, 1985-1 C.B. 184.

because we can ignore the gift for income tax purposes, the grantor is entitled to deduct the full amount of the loss.

Similarly, the IRS has ruled that a gift of an installment note to a grantor trust is not a “disposition” of the note that causes the grantor to recognize gain under IRC § 453B because the transfer is not recognized for income tax purposes.¹⁵ Ordinarily a gift of an installment obligation is a taxable disposition of the note that results in gain recognition to the donor to the extent the fair market value of the note exceeds the basis.¹⁶

C. Tax Elections With Respect to Grantor Trust Property

The grantor is responsible for making any tax elections with respect to trust property or transactions between the trust and third parties. For example, if the trust sells property on the installment sale to a third-party and wishes to opt-out of installment sale treatment, the grantor, not the trust must make the election. Likewise, the grantor must make the election to engage in a tax-free exchange, reinvest the proceeds of an involuntary conversion,¹⁷ capitalize holding costs on nonproduction investment property, elect S corporation status, and the like.

D. Transactions Between the Grantor Trust and Entities Owned by It

When a grantor trust engages in transactions with entities owned by it, such as partnerships and corporations, we may not ignore the transactions because other taxpayers are involved. However, we ignore the trust and treat the transaction as occurring directly between the grantor and the entity.

1. Transactions With C Corporations

If a grantor trust owns a C corporation that redeems its interest, we ignore the trust and treat the redemption as occurring between the corporation and the grantor.¹⁸ Thus, the grantor’s interest is being redeemed, not the trust’s, and the grantor reports the gain or loss on the redemption rather than the trust. The grantor, rather than the trust, is also treated as the shareholder for purposes of the family attribution rules under IRC § 318, which determine whether there has been a complete redemption that qualifies for long-term capital gain treatment under IRC § 302(a).

2. Transactions With S Corporations

The same rules apply if the grantor trust is redeemed by an S corporation. The redemption is treated as occurring between the grantor and the S corporation. However, this is not the case where the trust is treated as a grantor trust solely because of the QSST election and would not otherwise qualify as a grantor trust. In that case, the redemption terminates the QSST election. Thus the trust is no longer treated as a grantor trust, the redemption is treated as occurring between the trust and the S corporation, and the trust,

¹⁵ Rev. Rul. 81-98, 1981-1 CB 40; Rev. Rul. 74-613, 1974-2 CB 153.

¹⁶ IRC § 453B(a)(2).

¹⁷ Rev. Rul. 70-376, 1970-2 C.B. 164.

¹⁸ Rev. Rul. 72-471, 1972-2 C.B. 201.

not the beneficiary, reports the gain or loss on redemption.¹⁹ Note that the disposition is viewed as occurring between the entities in their post-termination status. Thus, the very same transaction that terminates the grantor status is viewed as occurring between the taxpayers in their post-termination status. This view under Subchapter S that events causing a termination of grantor status are viewed as occurring between taxpayers in their post-termination status is consistent with the view under Subchapter J for events terminating grantor trust status as discussed below.

3. Transactions with Partnerships

Where a grantor trust owns a partnership interest, we ignore the trust and treat the grantor as the partner for income tax purposes. This is illustrated in Example 5 of Regulation 1.1001-2(c) and in Revenue Ruling 77-402 where an individual created an irrevocable grantor trust, which purchased an interest in a partnership. Because the grantor was treated as the owner of the partnership interest, the grantor (not the trust) deducted the trust's share of partnership income and deductions. The grantor would also report any gain or loss on disposition of the partnership interest. In short, the trust is simply ignored during the term of the grantor trust until the day it terminates.

E. Transactions Between the Grantor Trust and Its Beneficiaries

The authorities discussed above suggest that we should also ignore the trust in dealings between the grantor trust and its beneficiaries, although no authority directly addresses this point. In other words, we would treat the transaction as occurring directly between the grantor and the trust beneficiaries. For example, a distribution from the trust would be treated for income tax purposes as a gift directly from the grantor. Likewise, if the trust sells property to the beneficiary, the sale would be treated as occurring directly between the grantor and the beneficiary. In most cases we would also need to apply the related party rules under IRC § 267 to limit any losses because the grantor and the beneficiary.

On the other hand, maybe we should view distributions from the trust to the beneficiary differently than other transactions. This is because distributions terminate the grantor's powers over that portion of the trust property. If viewed that way, the distribution creates a separate trust that exists just long enough to make a distribution to the beneficiary. The distribution should be tax-free to the beneficiary because the trust did not exist long enough to accumulate any distributable net income (DNI).

If the distribution is made in property rather than cash, the beneficiary inherits the trust's basis in the property under IRC § 643(e)(1).²⁰ Contrast this to a gift made directly by the grantor, in which the beneficiary's basis is the same as the grantor's (or last preceding owner by whom it was not acquired by gift), but is limited to the lesser of the property's cost or fair market value at the time of the gift for purposes of determining a loss on sale under IRC § 1015(a).

Query: Can we avoid the loss limitation rules under IRC § 1015(a) by treating distributions of depreciated property from a grantor trust to a beneficiary as being made

¹⁹ Reg. § 1.1361-1(j)(8).

²⁰ IRC § 643(e)(1).

by a separate trust rather than by the grantor?

Example. Grandma creates an irrevocable grantor trust for her grandson. She is treated as the owner of the trust property. The trust invests \$100,000 in an asset that is now worth \$1 (practically worthless). The trustee proposes to distribute the asset to the grandson, who would like to sell the property and claim the capital loss. Can the grandson claim the loss?

If we view the transfer as a gift by Grandma to her grandson, his basis would be \$1 for determining a loss on sale of the property under § 1015(a). Thus, he would not be able to deduct a capital loss on sale of the asset. On the other hand, if we view the distribution as made by a separate trust, the grandson takes a carryover basis from the trust under IRC § 643(e)(1). But the trust's basis is also limited to \$1 under IRC § 1015 because it acquired the property by gift from the grantor. Therefore, the beneficiary takes the same basis as the trust's (or last preceding owner by whom it was not acquired by gift), which is the lesser of \$100,000 or \$1 for purposes of determining a loss under IRC § 1015(a).²¹

Based on the foregoing discussion, the beneficiary has a carryover basis, subject to the loss limitation rules regardless of whether we treat distributions from a grantor trust as made directly by the grantor or by the trust as a separate entity.

F. Toggling Grantor Trust Status During Lifetime

“Toggling” has been used to describe an event, voluntary or not, that changes the status of a trust from grantor to nongrantor, or vice-versa. For example, a renunciation of powers by the grantor will immediately convert a grantor trust to a nongrantor trust.²² Likewise, a borrowing of trust corpus by the grantor without adequate interest or security will convert a nongrantor trust to a grantor trust.²³ In both of these cases, a “trigger event” occurred that changed the status of the trust. In both cases, the IRS treated the change as occurring at the moment the trigger event occurred and viewed the transaction as occurring between the trust and the grantor as separate taxpayers.

1. Abusive Toggling

There is no official limit on the number of times a trust can toggle back and forth between grantor and nongrantor status. In Notice 2007-73, the IRS identified two types of toggling transactions that must be disclosed to the IRS on Form 8886, Reportable Transaction Disclosure Statement, as “transactions of interest” because of their potential for abuse.²⁴ The IRS noted that these transactions usually occur within a short period of time during the taxable year (typically within 30 days), and that in each case, the termination and subsequent reestablishment of grantor status, combined with a series of events regarding trust's assets, resulted in tax consequences that “could not be achieved without both the toggling off and on of grantor status.” The Notice expressly states that it

²¹ *Id.*; see also Ltr. Rul. 9035046 in which the IRS treated a distribution by the trust of depreciated property to the beneficiaries as a gift for purposes of avoiding recapture under § 1245 on the distribution.

²² Reg. § 1.1001-2(c), Ex. 5.

²³ Rev. Rul. 85-13, 1985-1 C.B. 184.

²⁴ Notice 2007-73, 2007-2 C.B. 545; Reg. § 1.6011-4(b)(6).

does not apply to transactions in which grantor status was terminated, unless there was also a subsequent toggling back to the trust's original status for income tax purposes.

One of the examples in the Notice involved a contribution of high basis liquid assets to a nongrantor trust. The trust gave the grantor a power of substitution under § 675(4) effective on a specified future date – a “springing” power. After the substitution power became effective, the grantor swapped low basis assets of equivalent value for the trust's high-basis assets. The swap was ignored for income tax purposes because it was a grantor trust. A Buyer then purchases the Beneficiary's interest in the trust at fair market value, terminating the trust (and toggling grantor status off). As a result of these transactions, the Buyer acquires a basis in the trust assets equal to his purchase price, the Beneficiary reports no gain or loss because he received proceeds equal to his basis in the trust, and the grantor avoids recognizing gain when he eventually disposes of the high basis assets acquired from the trust in the swap.

The Notice essentially finds this result too good to be true. However, it neither expresses nor implies an opinion concerning the tax consequences of the transaction. It simply states that the Service has not yet gathered enough information to make an informed decision about whether the transaction is a “tax avoidance type of transaction” and that transactions similar to the ones described in the Notice should be disclosed on Form 8886.

The IRS identified another potentially abusive toggling situation in CCA 200923024. There the grantor contributed low basis pre-IPO stock to a partnership. He then sold the partnership units to a nongrantor trust on the installment basis for close to the IPO price. When the stock was sold on the public market shortly thereafter, the trust had very little gain to report because it had made a Section 754 election stepping up the inside basis of the stock as to the trust. After the trust made a couple of installment payments to the grantor, the trust converted to a grantor trust because of a change of trustees and the grantor no longer had to report gain on the installment payments from the trust.

Even though the IRS found the transaction potentially abusive, it noted that none of the existing authorities was sufficient to immediately tax either the grantor or the trust on the conversion. That is because they do not treat the conversion from nongrantor to grantor status as a deemed transfer of assets like they do a conversion from grantor status to nongrantor status.

However, the day of reckoning will come. Either the partnership will liquidate causing gain to its owner because it distributes cash and marketable securities in excess of its outside basis reduced by the note between the grantor and the trust, which we ignore.²⁵ Or the trust will convert back to a nongrantor trust before a liquidation and while the note is still outstanding. This will cause the grantor to recognize gain to the extent the note balance exceeds the grantor's low basis in the partnership units.²⁶ And even if the note is paid off at this point, the trust will then inherit low basis partnership units, which will eventually liquidate causing gain to the trust. Thus, there is no free lunch.

²⁵ IRC 731(a), (c).

²⁶ Reg. § 1.1001-2(c), Ex. 5.

2. Grantor to Nongrantor Status

Existing guidance tells us that at the moment a trust converts from grantor to nongrantor status, the grantor is deemed to transfer the trust property to the trust, a separate taxable entity.²⁷ If the property is a passive activity, any suspended passive losses would be added to the basis of the activity.²⁸ Because the grantor does not usually receive any consideration on the transfer of assets to a trust, there is generally no gain recognized on the conversion of a grantor to nongrantor trust. The grantor is simply deemed to have transferred property to the trust for no consideration and the trust receives a carryover basis from the grantor.²⁹ Nor does the trust recognize any gain because the transfer is gratuitous.

However, gain could be recognized by the grantor if he receives consideration in the transfer. For example, in *Diedrich v. Commissioner* the Supreme Court held that a donor can realize income on a gift in a variety of ways, including relief from his obligation to pay gift taxes.³⁰ To the extent that the gift taxes paid by the donee exceed the donor's basis in the property transferred to trust, the donor received an "immediate economic benefit," which was taxable to the extent it exceeded the donor's basis in the gifted property. The amount gifted was the excess of the property's fair market over the gift tax liability assumed by the donee. Such transactions are referred to as a "part sale-part gift" and are taxed in the same manner whether made in or outside of trust where the donor receives an economic benefit in connection with a gift.³¹

Although the economic benefit realized in these authorities involves reduction of the grantor's debt to third parties, their holdings are equally applicable to economic benefit realized in any form, including a note payable to the grantor.³² For example, assume the grantor sold property to the trust on the installment basis and the note remains unpaid when the trust converts from grantor to nongrantor status. In that case, when the grantor status ends, the grantor is deemed to have transferred the property to the trust and the trust is deemed to transfer the note to the grantor. If the value of the note exceeds the grantor's adjusted basis in the property on the date of the conversion, the grantor should recognize gain.³³

Example. Joe sold Blackacre on the installment basis to a grantor trust for \$60,000. A few years later when the note balance was down to \$30,000, Joe renounced his grantor powers. At that time, his basis in Blackacre was

²⁷ Reg. § 1.1001-2(c), Ex. 5.

²⁸ IRC § 469(j)(6).

²⁹ IRC § 1015(b).

³⁰ *Diedrich v. Comm'r*, 457 U.S. 191 (1982) (grantor was taxable to the extent the donee paid the donor's gift tax liability in a net gift arrangement.); see also Ltr. Rul. 7752001 (gift conditioned on the payment of the donor's gift taxes by the donee is a part sale-part gift in which the donor's basis is determined under Reg. § 1.1015-4.)

³¹ *Id.*; see also Reg. § 1.1001-1(e), Ex. 1 (income recognized by the transferor on sale for less than adequate consideration with the intent to make a gift is a part sale-part gift).

³² *Diedrich*, 457 U.S. at 195 ("Gross income" means income from whatever source derived and may be realized by a variety of indirect means, including income from discharge of indebtedness, payment of a donor's gift taxes, payment of an employee's income taxes, etc. The substance rather than the form of the economic benefit controls. The form of the economic benefit is immaterial as long as the taxpayer realizes an economic benefit.)

³³ Reg. §§ 1.1001-1(e), Ex. 1 ; 1.1001-2(c), Ex. 5.

\$20,000. Joe is treated as having transferred Blackacre to the trust. He receives a \$30,000 note in the exchange. Thus he realizes a \$10,000 gain on the difference between the note he received and his basis in the property. Because the exchange qualifies as an installment sale, Joe can recognize the gain as he collects the remaining payments from the trust.

The trust's basis in the property is \$30,000 because property acquired by a trust *other than* by gift, bequest or devise is the same as it was in the hands of the grantor, increased by any gain or decreased by any loss recognized by the grantor in the transfer.³⁴ Thus, the trust's basis Joe's basis of \$20,000 plus his \$10,000 gain, or \$30,000.

3. Nongrantor to Grantor Status

It is less common for a trust to convert from nongrantor to grantor status. Nonetheless, this can occur in a variety of situations. For example, if the grantor borrows money from the trust for less than adequate interest or security, the trust becomes a grantor trust.³⁵ A change of beneficiaries or trustees can convert a nongrantor trust to a grantor trust.³⁶ A special trustee can confer powers on the grantor causing the trust to become a grantor trust. Or a nongrantor trust can simply decant to a grantor trust.

The IRS treats the conversion of a nongrantor trust to a grantor trust as tax-free.³⁷ At the moment of conversion, the grantor and the trust are viewed as the same taxpayer. Any transactions between them, even the one that triggered the conversion, are ignored for income tax purposes. Thereafter, the grantor reports the income and deductions attributable to the trust property and transactions between the grantor and the trust are ignored for income tax purposes.

A recent illustration of this is CCA 200923024 in which a grantor sold appreciated property to a nongrantor trust for an installment note. Shortly thereafter the trust converted to a grantor trust when a nonadverse party replaced the corporate trustee. As a result of the conversion to grantor status, the grantor was no longer required to report any gain on the installment notes. The CCA concluded that neither the grantor nor the trust recognized any gain on the conversion because no authority holds so. Although not mentioned in the CCA, the trust would have been required to reduce its basis in the property by the amount of the outstanding installment note because the note would be ignored for income tax purposes.

Also unanswered by the CCA was the treatment of carryovers of the nongrantor trust after the conversion to grantor status. These might include passive losses under IRC § 469, capital losses under IRC § 1212, disallowed investment interest under IRC § 163, AMT credits under § 53, charitable contributions under IRC § 170, net operating losses (NOLs) under IRC § 172, and other carryovers. Carryover periods for charitable contributions and NOLs are limited to 5 and 15 years. Do we count the intervening years

³⁴ IRC § 1015(b).

³⁵ Rev. Rul. 85-13, 1985-1 C.B. 184.

³⁶ CCA 200923024.

³⁷ *Id.*; Rev. Rul. 85-13, 1985-1 C.B. 184.

while the trust is a grantor trust for purposes of the carryover period? If so, some carryovers may expire while the trust is a grantor trust.

By comparison, if a C corporation converts to an S corporation, the S corporation is not entitled to any carryovers or carrybacks arising during the C corporation years. What is worse is that the intervening years during the S corporation status are counted in determining any carryover or carryback period limitations.³⁸ However, there is no counterpart in Subchapter J to determine what happens to carryover items when a nongrantor trust converts to a grantor trust. By analogy, carryovers from a nongrantor trust are probably suspended while the trust is a grantor trust.

Another unresolved issue is what happens if the trust is in the process of a tax-free exchange under IRC § 1031 when it converts from nongrantor to grantor status. Would a timely replacement of the exchanged property, while a grantor trust, satisfy the exchange requirements and avoid gain recognition by the nongrantor trust? These and many more questions remain unanswered when a nongrantor trust converts to a grantor trust.

G. Death of the Grantor

While the tax consequences of terminating grantor trust status during the grantor's lifetime are fairly well-settled, commentators sharply disagree on whether terminations of grantor trust status caused by death are treated in the same manner.³⁹ This disagreement is caused, in part, by the fact that existing authorities deal only with lifetime terminations. They hold that at the moment grantor trust status ceases, the grantor is deemed to transfer the trust property to the trust, now a separate taxable entity, and the grantor is taxed on consideration the grantor receives in excess of his basis in the property transferred.⁴⁰ If an event or transaction causes the termination of grantor trust status, the event or transaction is deemed to occur between separate entities. So far the only consideration involved in the authorities has been debt relief. No authority directly addresses other types of consideration or termination of grantor trust status caused by the death of the grantor.

³⁸ IRC § 1371(b)(3).

³⁹ Carol A. Cantrell, "Gain is Realized at Death," *Trusts & Estates* (February 2010), p. 20; Deborah V. Dunn & David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," *J. Tax'n.* (July 2001), p. 49; Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," *Trusts & Estates* (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," *J. Tax'n.* (Sept. 2002).

⁴⁰ Reg. § 1.1001-2(c), Ex. 5 (Grantor recognized gain upon termination of grantor trust status equal to the excess of his relief from partnership debt over the basis in his partnership interest.); *Madorin v. Comm'r*, 84 T.C. 667 (1985) (upholds Example 5 in § Reg. 1.1001-2(c) on similar facts where the grantor realized gain from debt relief on disposition of trust assets at moment when grantor trust status ceased and trusts became separate taxable entities); Rev. Rul. 77-402, 1977-2 C.B. 222 (Grantor recognized gain on cessation of grantor trust status as a taxable disposition of partnership interest measured by the difference between the basis in the partnership and his share of the partnership liabilities.) TAM 200011005 (debt incurred by grantor trust which was secured by property of trust is included in founder's amount realized when trust terminates and assets and liabilities of trust are transferred to remainder trusts); GCM 37228 (grantor must recognize gain when the trust ceases to be a grantor trust and becomes the owner of grantor's assets subject to liabilities).

1. Failed GRATs

It seems odd that no authority has addressed the income tax consequences of a GRAT termination by reason of death, given that many GRAT owners must have died before the end of the GRAT term. Applying the authorities we have, when a GRAT owner dies, the grantor is deemed to transfer the GRAT property to the trust in exchange for the remaining annuity payments. The grantor would report gain to the extent that the value of the remaining annuity payments exceeds his basis in the GRAT property. However, the GRAT property receives a stepped-up basis under IRC § 1014(b)(9) on the grantor's death due to its inclusion in the grantor's estate under IRC § 2036. Therefore, it is unlikely that the grantor would have any gain on the exchange, unless the value of the annuity payments exceeds the basis of the GRAT property. Thus, the exchange will generally not result in any taxable gain to the grantor.⁴¹ The trust, now a separate taxable entity, acquires a basis in the GRAT property equal to the grantor's stepped-up basis.⁴²

Example. D transferred \$100,000 of property to a GRAT when the § 7520 rate was 3.2 percent. The GRAT pays a qualified annuity of \$12,000 a year for 10 years. D died in year 8 when the § 7520 rate was 6 percent and the GRAT property was worth \$300,000. The amount includible in the grantor's estate is \$200,000, which is the lesser of the value of the GRAT property (\$300,000) or the principal necessary to pay a \$12,000 annuity at 6 percent. [$\$12,000 / .06 = \$200,000$]⁴³ The basis of the GRAT property is \$200,000 and two annuity payments of \$12,000 each are still due the estate.

Because the \$24,000 of remaining annuity payments does not exceed the stepped-up basis in the GRAT property, there should be no income tax consequences to the grantor or the estate when the grantor dies during the term of the GRAT. The trust takes a carryover basis of \$200,000 in the property under IRC § 1015(b).

2. Installment Obligations and Other Consideration

But what a situation where the grantor sold appreciated property during his life to the grantor trust for an installment note, and dies before the installment note is paid off? The note is included in the grantor's estate, but the property is not because the grantor did not own it. What happens to the unreported installment gain embedded in the note? Is it income in respect of a decedent, or does the gain somehow "disappear" because we ignored the installment sale while he was alive? What is the basis of the installment note in the decedent's estate and what is the basis of the property in the hands of the trust, now a separate taxable entity? These are all unanswered questions.

a. The Case for Gain at Death

There appears no logical reason to treat a termination of grantor trust status caused by death any differently than a termination during his lifetime. This is particularly true considering that transactions occurring on the last day of a person's life are deemed to

⁴¹ Reg. § 20.2036-1(c)(2)(i); Prop. Reg. § 20.2036-1(c)(3) (Apr. 30, 2009).

⁴² IRC § 1015(b).

⁴³ Example based on Reg. § 20.2036-1(c)(2)(iii), Ex. 2.

occur during their lifetime.⁴⁴ A taxpayer's taxable year ends on his death and includes all income received up to the end of that day. Because death causes the grantor's powers to lapse on the last day of the grantor's life, the termination should be treated as occurring on the last day of the grantor's life.

Revenue Ruling 77-402 seems to draw no distinction on what causes a grantor's powers to cease. The ruling held that gain was recognized when a grantor renounced his powers over a grantor trust and was relieved of debt in the transaction. It further held that "the result would be the same if the trust ceases to be a grantor trust by reason of the expiration or lapse of the powers." In other words, gain recognition is not limited to terminations by renunciation, but applies to any expiration or lapse of grantor powers, even those caused by the grantor's death.

Example 5 in Reg. § 1.1001-2(c) describes what happens when a grantor trust terminates:

C, an individual, creates T, an irrevocable grantor trust. Therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts his distributive share of partnership losses attributable to T's partnership interest. When the adjusted basis of T's partnership interest is \$1,200, C renounces his grantor trust powers. Consequently, T ceases to be a grantor trust and is no longer considered the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is \$11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. **Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C.** On the transfer, C's share of partnership liabilities (\$11,000) is treated as money received. Accordingly, C's amount realized is \$11,000 and C's gain realized is \$9,800 (\$11,000 – \$1,200).

If we apply the authorities on lifetime terminations to a termination caused by death of the grantor with an outstanding installment obligation due from the trust, the decedent (or his estate) is deemed to transfer the property to the trust in exchange for the installment note. If the note balance exceeds the basis of the property transferred to the trust, the decedent (or his estate) has a gain, which is income in respect of a decedent (IRD) under IRC § 691. If the transaction qualifies for installment sale reporting, the decedent's estate may report the gain as it collects the remaining installment payments.

We also need to determine the basis of the property in the hands of the trust, now a separate taxable entity. Section 1015(b) governs the basis of property transferred to a trust *other than by gift, devise, or bequest*. It provides that the basis to the trust is the "same as it would be in the hands of the grantor, increased by the amount of gain or

⁴⁴ Reg. § 1.451-1(b)(1).

decreased in the amount of loss recognized by the grantor on such transfer.” Thus, the trust’s basis will be the note balance in most cases if the grantor has a gain. But if the grantor’s basis exceeds the note, the trust’s basis will be the grantor’s basis.

Change the facts and assume that the grantor trust had sold property to an unrelated third party on the installment method. During the grantor’s life, he reports the installment gain as the note payments are collected because we ignore the trust. When the grantor dies, he is deemed to transfer the note to the trust, now a separate taxable entity. Is the unreported installment gain of the trust IRD to the decedent? It would have been IRD if the grantor had owned the note directly. Is it still IRD to the decedent if the trust owned the note instead? Yes, indeed, said the Court of Claims in *Sun First National Bank of Orlando v. United States*.⁴⁵ The issue was important there because the grantor trust was included in the decedent’s taxable estate under IRC § 2036 and the IRD recipients wished to claim a deduction for the estate taxes paid under IRC § 691(c).

b. The Case for No Gain at Death

Proponents of the theory that termination of grantor status on death of the grantor has no income tax implications point to CCA 200923024, which commented that the existing authorities only affect “inter vivos lapses of grantor trust status, not that caused by the death of the owner, which is generally not treated as an income tax event.” Although chief counsel advice are considered authorities under IRC § 6662 for purposes of avoiding substantial understatement penalties, it is hard to see how dictum in a chief counsel advice could be considered *substantial* authority.

While it is true that death is not *generally* an income tax event, that does not mean it is *never* an income tax event. Quite the contrary, a Roth IRA owner who elected to defer the income on a conversion over time recognizes gain on his final income tax return if he dies before the end of the deferral period.⁴⁶ Death is also an income tax recognition event if a U.S. grantor of an irrevocable foreign grantor trust dies.⁴⁷ And finally, IRC § 1022(f) (dealing with carryover basis property for 2010 decedents) specially excepts from gain recognition a transfer of encumbered property by a decedent to his estate where liabilities exceed the basis. If death is not generally an income tax event, there would be no need for this special exception.

Some proponents of the “no gain on death” theory also rely on the 1947 decision in *Crane v. Commissioner* where a beneficiary inherited property encumbered by a liability equal to the decedent’s basis under IRC § 1014.⁴⁸ Because the Supreme Court did not treat the inheritance as a “sale,” they conclude that a transfer of property to the trust at death in exchange for a promissory note should likewise not be a sale. The flaws in that analysis are that *Crane* involved an inheritance rather than a sale, the debt did not exceed the property’s basis and thus the transfer would not have been taxable under any circumstances, and the issue of whether the testamentary transfer from the estate to the

⁴⁵ *Sun First National Bank of Orlando v. United States*, 607 F.2d 1347 (Ct. Cl. 1979).

⁴⁶ IRC § 408A(d)(3)(E)(ii).

⁴⁷ IRC § 684.

⁴⁸ Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, “Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death,” *J. Tax’n*. (Sept. 2002).

beneficiary was a sale was never before the court. Consequently, it is difficult to see how *Crane* stands for the proposition that transfers of property to a grantor trust in exchange for consideration in excess of the property's basis are tax-free to the grantor on death.

H. Impact of Swapping Assets On the Trust

So far, much has been said about the income tax consequences to the grantor on conversion to and from grantor trust status. However, no attention has been paid to the income tax consequences to the trust on termination of its grantor status. This is probably because the trust usually receives a gratuitous transfer, which is not taxable. Or the trust is purchasing property from the grantor, which is not taxable to the trust either. But the trust *could* have income tax consequences on termination of its grantor status if it receives money or property in a nongratuitous transfer, such as a sale or exchange of its property.

Creative taxpayers have suggested that a grantor with a substitution power under IRC § 675(4)(C) can swap high basis assets for the trust's low basis assets (even those the grantor previously sold to the trust) shortly before the grantor's death and obtain a stepped-up basis in those assets when the grantor dies.

Example. Joe sold partnership units with a basis of \$10,000 to his grantor trust several years ago for \$100,000. The transaction was ignored for income tax purposes. The partnership units have now appreciated to \$200,000. They still have a basis of \$10,000 because the sale was ignored. Joe wishes to get a stepped-up basis in the partnership units on his death. So he repurchases them from the grantor trust for \$200,000 cash. The purchase is ignored for income tax purposes because Joe and the trust are treated as the same taxpayer. Therefore the partnership basis remains at \$10,000 until Joe dies, at which time Joe's estate obtains a stepped-up basis of \$200,000. What are the tax consequences to the trust?

At the moment the grantor trust status ceases, the exchange is recognized for income tax purposes as occurring between two separate taxpayers.⁴⁹ Joe is treated as transferring \$200,000 cash to the trust, now a separate taxable entity, and the trust is treated as transferring its property to Joe.⁵⁰ Joe's estate is entitled to a stepped-up basis under IRC § 1014(a). Joe has no income tax consequences because he has merely purchased an asset. However, the trust receives \$200,000 in exchange for its low basis property, which should be taxable to the trust, absent some clear exception.

As illustrated in Example 5 of Reg. § 1.1001-2(c), a taxable exchange occurs at the moment a grantor trust becomes a separate taxable entity. The grantor exchanges his partnership interest for relief of debt by the trust, now a separate taxable entity. The transfer is taxable to the grantor under IRC § 1001(a) because he exchanged an asset for consideration. The transfer is not taxable to the trust in that example because the trust is merely purchasing an asset by assumption of the debt on it. But if we reverse the roles

⁴⁹ Regs. § 1.1001-2(c), Example 5.

⁵⁰ Regs. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200011005; GCM 37228.

and the trust was selling or exchanging an asset in the example, the trust might have been the one with the gain to report.

Query: Would the tax consequences to the trust depend on whether the trust had originally acquired its property by gift from the grantor? In other words, would the exchange be viewed as a gratuitous transfer, rather than a taxable sale or exchange and thereby be tax free to the trust? Or would the exchange be viewed as a taxable disposition of gifted property under IRC § 1001(a)?

While there are no authorities directly on point, it is unlikely that the Service would find the exchange tax-free to the trust, regardless of how the trust acquired the property. No matter how the trust acquired its property, the sale of an asset is taxable under IRC §§ 1001(a) and 61(a)(3). If that is the result, the family may be worse off for exchanging the asset if it causes immediate gain recognition to the trust.

Query: Should an exchange by the grantor of high basis property for the trust's low basis property shortly before the grantor's death be reported as a "transaction of interest" on Form 8886, Reportable Transaction Disclosure Statement, because of its similarity to the transactions described in Notice 2007-73?⁵¹

I. The Administration's Budget Proposals on Grantor Trusts

For the second year in a row, the Administration's Greenbook has included a proposal to tax the assets in an irrevocable grantor trust as part of the estate of the deemed owner.⁵² The latest proposal is a much sounder approach than the first proposal, which many commentators passed off as unworkable and hence unlikely to gain any traction. The tax would apply if a deemed owner under the grantor trust rules engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes. The tax would apply to the portion of the trust attributable to the property received in the transaction, including all retained income, appreciation, and reinvestments thereof, less any consideration received by the grantor in that transaction.

In addition, the deemed owner would be subject to gift tax if the grantor status is terminated during his or her lifetime or the trust assets are distributed to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner. The amount subject to transfer tax would be reduced by any amount that was treated as a prior taxable gift by the deemed owner. The transfer tax would be payable from the trust.

The proposal would not apply to grantor retained annuity trusts (GRATs), personal residence trusts, and qualified personal residence trusts (QPRTs) or any such trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code. Nor would it apply to trusts that are part of a nonqualified deferred compensation plan if the trust assets are subject to the grantor's general creditors or to

⁵¹ Notice 2007-73, 2007-2 C.B. 545.

⁵² General Explanation of the Administration's Fiscal Year 2014 Revenue Proposals, U.S. Dept. of the Treasury (Feb. 2013), p. 145; General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals, U.S. Dept. of the Treasury (Feb. 2012), p. 83.

trusts that are a grantor trust solely by reason of IRC § 677(a)(3) (insurance trusts). The proposal is estimated to raise about \$1 billion over the next ten years.⁵³

III. QSSTs and ESBTs

In order for a trust to be an eligible S shareholder after the two-year period allowed for a decedent's grantor trust or a testamentary trust discussed above, the trust must either be a qualified subchapter S trust (QSST) or an electing small business trust (ESBT).⁵⁴

A. Qualified Subchapter S Trust (QSST)

In order to be a QSST, the trust terms must provide:

- During the life of the current income beneficiary, there is only one income beneficiary of the trust who is a U.S. citizen or resident. However, a QSST may have multiple income beneficiaries if they have separate shares under IRC § 663(c).⁵⁵
- Any corpus distributed during the life of the current income beneficiary must be distributed only to that beneficiary;
- The income interest of the current beneficiary in the trust must terminate on the earlier of such beneficiary's death or the termination of the trust;
- if the trust terminates before the current income beneficiary dies, the trust must distribute all of its assets to that beneficiary;

In addition, the trust income must be distributed each year directly to the beneficiary, or to a custodial account for the benefit of a minor beneficiary, who is a resident or citizen of the United States.⁵⁶ Distributions within the first 65 days after the trust's year end for which the trustee makes a 65-day election to treat them as made on the last day of the preceding year are considered distributions of the prior year income for purposes of the QSST requirements.⁵⁷

A QTIP trust will automatically meet the requirements of a QSST. A minor's trust under IRC § 2503(c) will qualify as long as it has only one current income beneficiary and distributes all its income each year. However, a GRAT will not qualify as a QSST because it distributes its assets to the remainder beneficiary upon termination during the grantor's life rather than to the grantor, who is the current income beneficiary.⁵⁸ Nonetheless, a GRAT is still eligible to own S corporation stock because it is a wholly owned grantor trust. Nor will a special needs trust qualify as a QSST because it usually withholds rather than distributes income to the beneficiary in order to maintain their eligibility for government aid. But, in several private letter rulings, the IRS has created an exception for special disability trusts. The rulings allow a special needs trust to be a beneficiary of a QSST, where the QSST distributes all its income to the special needs

⁵³ *Id.* at p. 244.

⁵⁴ IRC § 1361(c)(2)(A)(v); IRC § 1361(d).

⁵⁵ IRC § 1361(d)(3); Ltr. Rul. 201119005, 201122003.

⁵⁶ Reg. § 1.1361-1(e)(1); IRC § 1361(d)(3)(B).

⁵⁷ Ltr. Rul. 8717024 (Jan. 17, 1987).

⁵⁸ Note however, that a GRAT will qualify to hold S stock because it is a wholly owned grantor trust.

trust, but the trust makes only limited distributions to or for the benefit of the beneficiary.⁵⁹

1. Making the QSST Election

The beneficiary of the trust (or separate share) must affirmatively elect to be taxed as a QSST.⁶⁰ If a trust has multiple shares, the election is made on a share by share basis. Not all shares need to make the election. Moreover some shares may elect QSST and other shares may elect ESBT.⁶¹ The beneficiary does so by signing and filing a statement with the service center where the S corporation files its income tax return within 2 months and 15 days after the election is to be effective.⁶² The trustee is not required to consent to this election. The QSST election is revocable only with the Commissioner's consent.⁶³

The failure to meet any of these requirements will disqualify the trust as an eligible S shareholder as of the date it ceases to meet the requirements.⁶⁴ However, the Service has been extremely generous in granting relief for failure to distribute QSST income⁶⁵ or make a timely QSST election as long as the failure is "inadvertent" and not an attempt at retroactive tax planning.⁶⁶ The IRS has even allowed trustees to amend the trust agreement to satisfy the QSST requirements after the time when the S election would have terminated. In a couple of recent private letter rulings the trustee of a trust that qualified as an ESBT, but did not wish to make an ESBT election, was allowed to amend the trust document to create separate subtrusts that were eligible and did make a late QSST election.⁶⁷ The IRS receives so many requests for relief from inadvertent failure to properly elect S status each year, that it has included guidance under § 1362 and § 9100 on its 2012-2013 Priority Guidance Plan.⁶⁸

2. Reporting Requirements

⁵⁹ Ltr. Ruls. 9444059, 9444024, 9444022, 9442036.

⁶⁰ IRC § 1361(d)(2)(A).

⁶¹ Ltr. Rul. 201122003.

⁶² IRC § 1361(d)(2)(D); Reg. § 1.1361-1(j)(6).

⁶³ Reg. § 1.1361-1(j)(11).

⁶⁴ IRC § 1361(d)(4).

⁶⁵ Ltr. Rul. 201228009, 201047018, 200932031, 200932022, 200932001, 200931036, 200905014, 200839008, 200726029 (failure to distribute QSST income).

⁶⁶ IRC § 1362(f); Rev. Proc. 2003-43, 2003-1 C.B. 998 (procedures for relief without a user fee for failure of an S corporation Q-Sub, QSST, or ESBT to make a proper election); Ltr. Ruls. 201306015-16, 201302004-6, 201301004, 201246002, 201245014, 201242009, 201208023, 201206009, 201203011, 201201005, 201151004, 201147016, 201146002, 201146001, 201117008, 201123023, 201117016, 201114002, 201128021, 201127005, 201106002, 201102034, 201103028, 201050019, 201050021, 201048020, 201047018, 201045016, 201042022, 201041025-28, 201037001; 201036005; 201034016; 201032020; 201029005; 201020007; 201017041; 201017020; 201016046; 201016016; 201016015; 200929002, 200917024, 200909024, 200906037, 200906027, 200903066, 200901024, 200843006, 200843007, 200841030, 200840029, 200840027, 200840026, 200820014, 200807004, 200806005, 200805004, 200804009, 200801004.

⁶⁷ Ltr. Rul. 200934007, 200932031.

⁶⁸ Department of the Treasury 2012-2013 Priority Guidance Plan, Third Quarter update, May 2, 2013, *available at* http://www.irs.gov/pub/irs-utl/2012-2013_pgp_3rd_quarter_update.pdf.

A QSST beneficiary is treated as if he or she is the direct owner of the portion of the QSST that owns the S corporation stock under Section 678(a).⁶⁹ As such, the beneficiary is taxed on the entire amount shown on the trust's Schedule K-1 received from the S corporation. But when the QSST disposes of the stock, the trust rather than the beneficiary of the QSST recognizes gain or loss.⁷⁰

A QSST must file a Form 1041 regardless of whether its only asset is the S corporation stock or not.⁷¹ If the QSST only owns the S stock, the QSST files a Form 1041 with a plain paper statement reflecting the separately stated S items, which it furnishes to the income beneficiary to report on his or her own Form 1040. If the QSST owns other assets in addition to the S stock, the QSST's other income and deductions are reflected on page 1 of the Form 1041 and taxed according to the general rules of Subchapter J.⁷²

3. Death of the Income Beneficiary

If the income beneficiary dies and the trust continues to hold S corporation stock, but does not qualify as a QSST, grantor trust, or ESBT, then for two years after the income beneficiary's death, the estate is treated as the S shareholder for eligibility purposes.⁷³ Within that two year period the trust must qualify as a permitted shareholder or dispose of the stock, or else the S election will be terminated. While the estate is treated as the shareholder for eligibility purposes, the trust is the shareholder for purposes of reporting income and deductions, basis, and distributions.⁷⁴ If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the S election will terminate. If the termination is inadvertent, the corporation may request relief under § 1362(f).

If there are multiple beneficiaries after the death of the QSST beneficiary, each new beneficiary must own a separate share of the trust in order for the trust to continue to be a qualified QSST.⁷⁵ Although the trust could probably make an ESBT election instead, that may not be desirable because it causes the trust's share of the S corporation income to be taxed at the highest marginal tax rates applicable to such income. Alternatively, the trust document could provide that the QSST divides into multiple trusts upon the death of the income beneficiary. In that case, each new trust must make a separate QSST election.⁷⁶

4. Refusal to Consent to the QSST Election

If the trust continues to meet the QSST requirements after the income beneficiary's death, then the QSST election continues in place without any further action required by the trust

⁶⁹ IRC § 1361(d)(1)(B).

⁷⁰ Reg. § 1.1361-1(j)(8); Ltr. Rul. 9721020.

⁷¹ Reg. § 1.671-4(b)(6)(iii).

⁷² Reg. § 1.1361-1(j)(8).

⁷³ Reg. § 1.1361-1(j)(7)(ii).

⁷⁴ *Id.*

⁷⁵ Ltr. Rul. 201119005 (QSST divided into separate shares after the death of the QSST income beneficiary continued to qualify as a QSST. The successive income beneficiaries were not required to make a new QSST election.)

⁷⁶ Reg. § 1.1361-1(j)(9).

or the beneficiaries.⁷⁷ However, a successor income beneficiary may affirmatively refuse to consent to the QSST election within the 2-month-and-15-day period after becoming the successor income beneficiary. If the affirmative refusal is filed, the trust generally becomes an ineligible shareholder.⁷⁸ The beneficiary may refuse to consent to the S election because, for example, the corporation is passing through income but not making distributions, and he or she does not want to pay tax currently on the trust's share of the corporation's income.

EXAMPLE

Sue is the income beneficiary of a QSST. She dies on August 15, 2012 and the trust names Annie as the successor income beneficiary. For the 2 ½ month period after Sue's death, Annie can file an affirmative refusal to consent to the QSST election. Annie's refusal to consent is due October 30, 2012 (2 ½ months after she becomes the current income beneficiary) and is effective as of August 15, 2012, the day Annie became a beneficiary. If Annie refuses to consent, the trust becomes an ineligible shareholder on August 15, 2012 and must dispose of its stock or make an ESBT election within two years of August 15, 2012.

A new beneficiary's ability to terminate the S election is in sharp contrast with the general procedure for terminating an S election, which requires the consent of more than 50 percent of the shareholders.⁷⁹

5. Crummey Withdrawal Rights

The terms of a QSST must require that any corpus distributed during the life of the current income beneficiary be distributed only to that beneficiary.⁸⁰ Crummey withdrawal rights are rights to withdraw corpus. Therefore, attorneys drafting trusts intended to qualify as a QSST should avoid multiple Crummey power holders. However, if multiple Crummey withdrawal rights are important to the planning objective, the trust could provide for separate shares. Alternatively, the trust could make an ESBT election because an ESBT allows multiple beneficiaries. However, ESBT beneficiaries who have withdrawal rights must be individuals, estates, or certain charitable organizations.⁸¹ Even so, ESBT status may not be desirable because its share of the S corporation income is taxed at the maximum individual tax rate (39.6% in 2013 and after) and is also subject to the 3.8 percent Medicare surtax starting in 2013.

B. Electing Small Business Trust (ESBT)

The Small Business Job Protection Act of 1996 introduced a new, more flexible form of trust eligible to hold S stock called an "electing small business trust," or ESBT. An ESBT may have more than one current beneficiary and may accumulate its income.⁸² For

⁷⁷ Reg. § 1.1361-1(j)(9)(i).

⁷⁸ Reg. 1.1361-1(j)(9) and (10).

⁷⁹ IRC § 1361(d)(1)(B).

⁸⁰ IRC § 1361(d)(3)(A)(ii).

⁸¹ IRC § 1361(e)(1)(A)

⁸² IRC §§ 1361(c)(2)(A)(v); 1361(e).

example, a special needs (disability) trust is an ideal candidate for an ESBT because it generally does not distribute its income to avoid disqualifying the beneficiary from government aid. Crummey trusts with power holders who are not current income beneficiaries are also ideal candidates for an ESBT. They are not eligible to make a QSST election because they may distribute corpus to someone other than a current income beneficiary.⁸³ Charitable remainder annuity and unitrusts (CRATS and CRUTs) defined in IRC § 664(d) are ineligible ESBT shareholders by statute.⁸⁴ But charitable lead annuity trusts (CLATs) may be S shareholders and elect ESBT treatment.⁸⁵

The price paid for an ESBT's flexibility in distributing or accumulating income for multiple beneficiaries is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate (39.6% for 2013), except for long-term capital gains which are taxed at the capital gain rate that applies (20% in 2013).⁸⁶ The taxable income of an ESBT consisting solely of stock in one or more S corporations includes:⁸⁷

1. The S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder.
2. Gain or loss from the sale of the S corporation stock, but not the interest income on an installment sale of the S stock.⁸⁸
3. State and local income taxes and administrative costs directly related to the S portion.⁸⁹
4. Interest expense on indebtedness incurred to acquire S corporation stock.⁹⁰
5. Capital losses, but only to the extent of capital gains.⁹¹
6. The ESBT is *not* entitled to an income distribution deduction or the \$100/\$300 personal exemption unless it has taxable income from sources other than the S corporation.⁹²
7. The ESBT is *not* entitled to an alternative minimum tax exemption.⁹³

⁸³ IRC § 1361(d)(3)(A)(ii).

⁸⁴ IRC § 1361(e)(1)(B)(iii); Ltr. Rul. 200703023 (Jan. 19, 2007) (S status terminated on transfer of stock to a CRUT. But the IRS held that the S corporation's election could remain valid because the termination was inadvertent. The shareholders were required to transfer the stock back to the original owners and treat them as if they had continued to own the stock for federal income tax purposes.).

⁸⁵ Reg § 1.641(c)-1(l), Ex. 4.

⁸⁶ IRC § 641(c)(2)(A).

⁸⁷ IRC § 641(c)(2).

⁸⁸ Reg. § 1.1361-1(j)(8).

⁸⁹ Reg. § 1.641-1(d)(4); Reg. § 1.641(c)-1(l), Example 1.

⁹⁰ IRC § 641(c)(2)(C)(iv) (added by the Small Business and Work Opportunity Tax Act of 2007 effective for taxable years beginning after December 31, 2006).

⁹¹ IRC § 641(c)(2)(D); IRC § 1211(b).

⁹² *Id.*

⁹³ IRC § 641(c)(2)(B).

8. The ESBT is subject to the 3.8 percent Medicare tax on its undistributed net investment income.⁹⁴ The S portion of the ESBT shares a single \$11,950 Medicare exemption with the non-S portion of the trust.

The tax on these items of income, deduction, gains or losses is calculated separately on a plain paper schedule attached to the Form 1041 and entered on line 7 of Form 1041, Schedule G. The ESBT is also required to make estimated tax payment under the same rules as individuals.⁹⁵ When an ESBT holds other property in addition to S corporation stock, the trust consists of two portions, the “S” portion and the “Other” (non-S) portion.⁹⁶ The S portion items are disregarded when figuring the tax liability of the “Other” portion, which is taxed under the normal trust taxation rules. Distributions from the “Other” portion and the “S” portion are deductible (limited to the DNI of the “Other” portion) in computing the taxable income of the “Other” portion.

An ESBT must meet all of the following criteria:

- All beneficiaries must be individuals, estates, charitable organizations described in IRC §§ 170(c)(2)-(5), or a government organization described in § 170(c)(1) that holds a contingent interest in the trust.⁹⁷ A government organization may not be a potential current beneficiary (PCB), as described below. A beneficiary generally includes any person who has a present, remainder, or reversionary interest in the trust. However, it does not include a person whose interest is so remote as to be negligible. Nor does it include a person in whose favor a power of appointment can be exercised until the power is actually exercised in favor of that person.⁹⁸ Nonresident aliens may be ESBT beneficiaries as long as they are not potential current beneficiaries.⁹⁹ The rules regarding eligible beneficiaries of an ESBT apply to the entire trust even if only a portion of the trust is treated as an ESBT.
- No interest in the trust can be acquired by purchase.¹⁰⁰ The interest must be acquired by gift, bequest, or transfer in trust. If any portion of the basis in the acquired interest in the trust is determined under § 1012, such interest has been acquired by purchase.¹⁰¹ For example, if a donee pays the gift tax on the net gift of a beneficial interest in the trust, the donee is deemed to have purchased an interest in the trust.¹⁰² Purchasing an interest in the trust should not be confused with the trust itself purchasing S corporation shares to hold in the trust, which is perfectly permissible without disqualifying the ESBT.¹⁰³

⁹⁴ Prop. Reg. § 1.1411-3(c)(1).

⁹⁵ IRC § 6654(l).

⁹⁶ IRC § 641(c)(1).

⁹⁷ IRC § 1361(e)(1)(A)(i).

⁹⁸ Reg. § 1.1361-1(m)(1)(ii)(C).

⁹⁹ Reg. § 1.1361-1(m)(1)(ii)(D).

¹⁰⁰ IRC § 1361(e)(1)(A)(ii).

¹⁰¹ Reg. § 1.1361-1(m)(1)(iii).

¹⁰² *Id.*

¹⁰³ Reg. § 1.1361-1(m)(1)(iii).

- The trustee, not the beneficiary, makes an ESBT election.¹⁰⁴ He does so by signing and filing with the Service Center where the S corporation files its income tax return, a statement containing the name, address, and taxpayer ID number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock. It must also disclose any powers of appointment, but need not provide any detailed information about it. The election must be identified as an ESBT election made under § 1361(e)(3), indicate the first date on which the trust owned the S stock, the date the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed), and represent that the trust meets the statutory requirements of an ESBT.¹⁰⁵

The ESBT election can be revoked only with IRS's consent.¹⁰⁶ Rev. Proc. 2003-43 provides relief from failure to make a timely ESBT election.¹⁰⁷ Although the relief is not automatic, no user fees apply. The IRS has granted relief from S corporation termination where the trust's failure to make the ESBT election was inadvertent and the trustee makes a late retroactive ESBT election.¹⁰⁸ In Letter Ruling 200927012, the IRS allowed the trust to make a late ESBT election even though the S corporation was dissolved by the time it made the election. In Letter Ruling 201209005, the IRS allowed the trustee to correct a deficient ESBT election. The ruling doesn't say, but the trustee probably sent the election to the wrong IRS Service Center.

In some cases, a trust may satisfy the requirements for an ESBT, but would rather be a QSST. In that case, the trustee might consider creating a separate subtrust that meets the QSST requirements. In Letter Ruling 200932031 the trustee that did not wish to make an ESBT election, was allowed to amend the trust document to create a separate subtrust that was eligible to and did make a late QSST election.¹⁰⁹ Each subtrust beneficiary must affirmatively elect to be a QSST where the trust is converting from an ESBT to a QSST. Similarly, in Letter Ruling 201122003, an ESBT divided into separate shares under IRC § 663(c), allowing each income beneficiary of a separate share to revoke the ESBT election as to his or her separate share and treat it as a QSST.¹¹⁰ That is, each separate share of an ESBT can make a QSST election with no effect on the ESBT election for the nonelecting shares.

An ESBT can meet all of these qualifications and still cause the S election to terminate if it has a "potential current beneficiary" (PCB) that is an ineligible shareholder or the

¹⁰⁴ IRC § 1361(e)(3).

¹⁰⁵ Reg. § 1.1361-1(m)(2).

¹⁰⁶ IRC § 1361(d)(2)(C); Ltr. Rul. 201114002.

¹⁰⁷ Rev. Proc. 2003-43, 2001-1 C.B. 998.

¹⁰⁸ Ltr. Rul. 201308022, 201252007, 201247008, 201244002, 201243009, 201205006, 201201006, 201147012, 201144018, 201129001, 201140010, 201128023, 201117004, 201118008, 201117016, 201114002, 201103015, 201108028, 201108012, 201106002, 201051010, 201042002, 201041025-28, 201035009; 201034003; 201032030; 201032020; 201032018; 201015013; 201015001; 201011005; 201010008; 201010007; 201006010, 200941002, 200934003, 200927012.

¹⁰⁹ Ltr. Rul. 201119005, 200932031.

¹¹⁰ Ltr. Rul. 201122003.

number of shareholders exceeds 100.¹¹¹ In that case, the trust has one year from the terminating event to dispose of its interest in the S corporation to avoid loss of its S status.¹¹²

A potential current beneficiary is any beneficiary who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.¹¹³ It does not include a person who only holds a future interest in the trust.¹¹⁴ Nor does it include a person who is only entitled to receive a distribution after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment), until the time arrives or event occurs.¹¹⁵ For tax years after December 31, 2004, it does not include a person in whose favor an unexercised power of appointment can be exercised.¹¹⁶

IV. Qualified Revocable Trusts and the § 645 Election

A qualified revocable trust (QRT) may elect to be treated as part of the estate by making an election under IRC § 645. The election is made on Form 8855 – Election to Treat a Qualified Revocable Trust as Part of an Estate. It must be filed not later than the due date (including extensions) of the Form 1041 for the estate’s first taxable year.¹¹⁷ The executor should file a timely Form 1041 for the combined estate and QRT for each taxable year during the election period. The trustee of the QRT must timely provide the executor of the estate with all the trust information necessary to file the Form 1041.¹¹⁸ The trustee need not file a Form 1041 for the short taxable year of the QRT beginning with the decedent’s death and ending December 31 of that year.¹¹⁹

To qualify as a QRT, the grantor must have had the power to revest title to property in himself or herself.¹²⁰ The period of time that a QRT qualifies to own S corporation stock is two years if no estate tax return is required.¹²¹ Estate tax return refers to the “return of tax imposed by Chapter 11,” which is Form 706. Thus if no estate tax return is required or the grantor died in 2010 and opted out of the estate tax, the § 645 election does not afford any additional time for the QRT to own S corporation stock than it would have otherwise.

However, if the estate is required to file an estate tax return, the qualification period ends six months after the determination of the final estate tax liability, which is the earliest of:

¹¹¹ IRC §§ 1361(b)(1)(A) (100 shareholder limit), 1361(c)(2)(B)(v) (who counts as a shareholder with an ESBT); Reg. § 1.1361-1(m)(4)(i) (each potential current beneficiary counts as a shareholder).

¹¹² IRC § 1361(e)(2); Reg. §§ 1.1361-1(m)(4)(iii); (m)(8), Ex. 2.

¹¹³ IRC § 1361(e)(2) (potential current beneficiary defined).

¹¹⁴ IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(i).

¹¹⁵ Reg. § 1.1361-1(m)(4)(v).

¹¹⁶ IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(vi) (Sept. 28, 2007).

¹¹⁷ Reg. § 1.645-1(c)(1)(i).

¹¹⁸ Reg. § 1.645-1(c)(1)(ii).

¹¹⁹ Reg. § 1.645-1(d)(2).

¹²⁰ IRC §§ 645(b)(1) and 676(a).

¹²¹ IRC § 645(b)(2)(A).

- (a) The date that is 6 months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 12 months after the issuance of a letter;
- (b) The date of a final disposition of the claim for refund, as defined in Reg. § 1.645-1(f)(2)(iii), that resolves the liability for the estate tax, unless suit is instituted within 6 months after a final disposition of the claim;
- (c) The date of execution of the settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;
- (d) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or petition for a certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of court; or
- (e) The date of expiration of the period of limitations for assessment of the estate tax provided in § 6501.¹²²

In addition to extending the normal two-year period of time that a QRT may own S corporation stock, other potential benefits of the § 645 election are:

- (a) A non-calendar fiscal year is allowed, unlike a trust, which must use a calendar year end. A fiscal year allows the fiduciary and the beneficiaries to defer income taxes.¹²³
- (b) The tax items of one fiduciary, such as passive activity losses, net operating losses, capital losses or investment interest, which may otherwise be nondeductible, may be offset by the other entity's passive income, taxable regular income, capital gains or investment income.
- (c) The fiduciary is exempt from making estimated tax payments for its first two years.¹²⁴
- (d) Losses may be recognized on the satisfaction of a pecuniary bequest with assets that have fair market value less than basis pursuant to § 267(b)(13).
- (e) The availability of the charitable set aside deduction under § 642(c).
- (f) The special \$25,000 deduction for passive losses from rental real estate activities under § 469(i)(4).¹²⁵

A possible detriment of making the § 645 election is the uncertainty about how to allocate the tax benefits from using the combined entity between the estate and the QRT. It may be a good idea to prepare a tax allocation agreement between the fiduciaries. Neither the preamble nor the final regulations provide any rules for allocating the tax liability between the QRT(s) and the estate. However, the trustee(s) and the executor

¹²² Reg. § 1.645-1(f)(2).

¹²³ Reg. § 1.441-1(c)(1).

¹²⁴ IRC § 6654(1)(2).

¹²⁵ Reg. § 1.645-1(e)(2).

might consider allocating the combined tax liability of the fiduciaries in the same ratio that each fiduciary's separate income tax would bear to the total tax if both fiduciaries had filed separately.

<u>QRT's separate tax</u>	X	Tax of the combined entity
Separate tax of the QRT and estate		

The IRS approves a similar formula for computing the separate income tax liability of a decedent when he and the surviving spouse file a joint return in the year of death.¹²⁶ The failure to prorate fairly may result in unintended income tax consequences among the beneficiaries.

Upon termination of the § 645 election period, the assets in the combined estate and QRT attributable to the QRT are deemed to be distributed to a new trust.¹²⁷ A distribution deduction under § 661 is allowed and the new trust must include all items of gross income, including capital gains, attributable to the trust in income under § 662.¹²⁸ If the combined estate and QRT terminates with the deemed distribution, then its unused capital losses, net operating losses, and excess itemized deductions may be carried out under IRC § 642(h). If it does not terminate, its capital losses, net operating losses, and excess itemized deductions stay in the estate along with its other carryover items such as tax credits, investment interest, and charitable contributions. The estate would maintain the same federal ID number as before, but the QRT must obtain a new ID number.¹²⁹

If there is no estate, the assets in the QRT are deemed to be distributed to a new trust, the old QRT terminates, and the new trust obtains a new ID number

V. Trust Mergers and Divisions

The Internal Revenue Code has extensive provisions regarding mergers and divisions of corporations and partnerships that allow for tax-free combinations or divisions and the carryover of tax attributes if certain requirements are met.¹³⁰ But there are no similar Code provisions for mergers and divisions of trusts. Instead there are hundreds of private letter rulings, a handful of cases, and no Revenue Rulings directly addressing these issues.¹³¹ Even though it is generally only the favorable private letter rulings that are published, they still provide an enormous amount of guidance.¹³²

Decanting also involves a form of merger or a division that is generally done pursuant to authority in the governing instrument or a state decanting statute.¹³³ A complete transfer

¹²⁶ Reg. § 20.2053-6(f).

¹²⁷ Reg. § 1.645-1(h).

¹²⁸ Reg. § 1.645-1(h)(1).

¹²⁹ Reg. § 1.645-1(h)(3).

¹³⁰ IRC §§ 368, 708.

¹³¹ As of November 17, there were 510 private letter rulings since 1986 addressing the federal income, estate, gift, and GST consequences of trust mergers and divisions.

¹³² Rev. Proc. 2012-1, 2012-1 IRB 1, Sec. 7.07(1) (A taxpayer may withdraw a request for a letter ruling or determination letter at any time before the letter ruling or determination letter is signed by the Service.).

¹³³ Approximately sixteen states have enacted decanting statutes, which give the trustee authority to modify the trust's terms and conditions by pouring its assets into a new trust with different provisions. These include

of trust assets from one trust to another is a merger.¹³⁴ And a partial transfer is a division. The Treasury Department and the IRS are studying the tax implications of such transfers when there is a change in the beneficial interests in the trust and are considering approaches to addressing some or all of the relevant tax issues in published guidance.¹³⁵ While these issues are under study, the IRS will not issue private letter rulings with respect to such transfers that result in a change in beneficial interests.¹³⁶

However, the IRS will continue to issue private letter rulings with respect to transfers that do not result in a change to any beneficial interests or the rule against perpetuities period. Therefore, this outline examines several of the recent letter rulings that have been published in order to see what criteria the Service uses to determine whether there has been a change of beneficial interest. A discussion of the various issues and state statutes involving decanting is beyond the scope of this outline.

A. General Tax Issues on Trust Mergers and Divisions

The private letter rulings seeking advice on trust mergers and division generally ask the following six basic questions about the proposed merger or division. A negative ruling on any one of these can be a tax disaster for the trust.

1. Will the transaction cause the trusts to lose their GST exempt grandfather status and cause a distribution from or termination of any interest in the trusts to be subject to GST tax under § 2601.
2. Will the transaction result in the realization by the trust or beneficiary gain or loss under § 661, 61, or 1001.
3. Will the transaction result in each trust being treated as a separate trust under § 643(f).
4. Will the transaction result in each trust having the same basis and holding period in trust property as it had before the transaction under § 1015 and § 1223.
5. Will the transaction cause any portion of the assets of the trusts to be includible in the gross estate of any beneficiary of the trusts under §§ 2036 through 2038.
6. Will the transaction be a transfer by any beneficiary subject to gift tax under § 2501.

With respect to the generation-skipping issues, the IRS generally compares the merger or division to one of the examples in Reg. § 26.2601-1(b)(4)(i)(E). Example 5 deals with divisions and Example 6 deals with mergers. As long as the proposed division or merger does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the persons holding the interests prior to the division or merger and will not extend the time for vesting of any beneficial interest in the trusts beyond the period

Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Missouri, Nevada, New Hampshire, North Carolina, Ohio, Rhode Island, South Dakota, Tennessee, and Virginia.

¹³⁴ Ltr. Rul. 201134017.

¹³⁵ Notice 2011-101, 2011-52 I.R.B. 932 (Dec. 20, 2011);

¹³⁶ Rev. Proc. 2011-3, 2011-1 I.R.B. 111, Sections 5.09, 5.16, and 5.17.

provided in the original trust, the merger or division will not adversely affect the original or resulting trusts' GST status.

Regarding the gift tax implications, the IRS generally holds that as long as the beneficial interests, rights, and expectancies of the beneficiaries are substantially similar, both before and after the merger or division, no transfer of property will be deemed to occur.¹³⁷ Similarly, where the provisions of the resulting trusts are substantially similar to those of the resulting trust(s) with respect to distribution, management, and termination, the merger or division, does not constitute a transfer within the meaning of IRC §§ 2036 through 2038.¹³⁸ Nor does it cause the exercise or release of a general power of appointment under IRC § 2041.¹³⁹

An additional question arises in trust divisions about whether the divided trusts will be respected as separate trusts under IRC § 643(f). If so, this allows them to each have their separate tax brackets and exemptions.¹⁴⁰ Under IRC § 643(f), two or more trusts will be treated as one trust if (1) they have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of the trusts is to avoid income tax under Chapter 1 of the Internal Revenue Code. In cases where a trust is divided down a family line, it is fairly clear that the separate trusts will be respected. Although they have the same grantor, they have different primary beneficiaries.¹⁴¹ But where the divided trusts have the same beneficiaries, but different property, the IRS will generally respect the separate trusts if they are separately managed and administered.¹⁴²

The rest of this discussion focuses on the income tax issue of whether a taxable exchange has occurred that causes the trust or the beneficiaries to recognize gain. If so, it could be a disaster for a beneficiary with a term interest whose basis is *zero* for purposes of determining gain or loss on a sale or exchange of the interest.¹⁴³ Thus, the beneficiary must report gain on the merger or division equal to the entire value of the trust interest that is deemed to be exchanged, even though no cash has changed hands.¹⁴⁴

B. Mergers

A trust merger occurs when two or more trusts are combined into a single trust. The Uniform Trust Code, and many state trust codes patterned after it, refers to a merger as a “combination.”¹⁴⁵ This is perhaps to avoid any notion that a combination may be accomplished tax free like a corporate and partnership merger. It may also be to avoid

¹³⁷ See Ltr. Rul. 201245007 (division) and Ltr. Rul. 20105008 (merger).

¹³⁸ Ltr. Rul. 201245007 (Nov. 9, 2012) and Ltr. Rul. 201042004 (Oct. 22, 2010).

¹³⁹ Ltr. Rul. 201245007 (Nov. 9, 2012).

¹⁴⁰ Note that IRC § 643(f) was originally enacted to prevent taxpayers from forming multiple trusts on substantially the same terms in order to avail themselves of multiple lower tax brackets. But this subsection was effectively rendered obsolete when the Tax Reform Act of 1986 substantially compressed the brackets for estates and trusts. Now there is no longer any tax advantage to forming multiple trusts with the same terms and beneficiaries.

¹⁴¹ Ltr. Rul. 199912034 (Dec. 28, 1998).

¹⁴² Ltr. Rul. 201245007 (Nov. 9, 2012), 201109004 (Mar. 4, 2011).

¹⁴³ Reg. § 1.1001-1(f); Reg. § 1.1014-5.

¹⁴⁴ Reg. § 1.1001-1(f); Ltr. Rul. 200231011 (Aug. 2, 2002).

¹⁴⁵ UNIF. TRUST CODE § 417.

confusion with the “doctrine of merger” by which a trust terminates if all beneficial interests, both life and remainder, are vested in the same person.¹⁴⁶

Most state trust codes authorize the trustee to merge a trust without the consent of the beneficiaries if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust and there is no contrary provision in the trust instrument.¹⁴⁷ In addition, many trust instruments expressly authorize combinations and divisions of the trust. The Uniform Trust Code (UTC) comments state that the trustee may have a “responsibility to pursue a combination” if the administrative economies suggest it.

The Uniform Trust Code does not require the terms of merged trusts to be identical.¹⁴⁸ They may differ on insignificant details such as having different perpetuities savings periods, trustee selection, compensation, and the like. But the more the dispositive terms of the trusts to be combined differ from each other, the more likely it is that the combination would impair a beneficiary’s interest, require approval of the court or the beneficiaries, and cause tax adverse tax consequences. While the beneficiaries’ consent is not necessary if the result does not impair their rights or adversely affect the settlor’s purposes, advance notice to them is required under the Uniform Trust Code.¹⁴⁹

Trusts merge for any number of reasons. One very common reason is for cost efficiency and administrative convenience.¹⁵⁰ In Ltr. Rul. 200544007 cited the “costs, complexities, and inefficiencies arising from the use of multiple trusts.”¹⁵¹ Ltr. Rul. 200449020 stated that “separate administration has proved to be costly and cumbersome resulting in frequent duplication in connection with investment oversight, court filing requirements, annual accounting statements and tax reporting matters.”¹⁵² Another reason was provided in Ltr. Rul. 9613014 involving two identical charitable lead trusts (CLATs) that merged.¹⁵³ The two CLATs owned, as tenants in common, two parcels of real property and various liquid assets. Trust 2 had substantially more liquid assets than Trust 1. Combining the trusts would allow them collectively to meet the required annuity payments without selling the illiquid assets of Trust 1.

A trustee may also wish to merge with a trust that has more favorable terms such as a unitrust conversion option, a different trustee, a spendthrift provision, a discretionary distribution standard, or a different investment standard. When trusts with different durations or perpetuities periods wish to merge without forfeiting their GST exempt status, they often provide in the Merger Agreement that their original perpetuities period will be retained on a separate share basis. In Ltr. Rul. 20105008, the Merger Agreement provided that at the time of consolidation, the individual values of each of the trusts will be established in order to determine each trust's proportionate fraction of the entire

¹⁴⁶ UNIF. TRUST CODE § 402(a)(5), Cmt.; Restatement (Third) of Trusts § 69.

¹⁴⁷ UNIF. TRUST CODE § 417.

¹⁴⁸ UNIF. TRUST CODE § 417, Cmt.

¹⁴⁹ *Id.*

¹⁵⁰ Ltr. Rul. 201024044.

¹⁵¹ Ltr. Rul. 200544007 (Nov. 4, 2005)

¹⁵² Ltr. Rul. 200449020 (Dec. 3, 2004)

¹⁵³ Ltr. Rul. 9613014 (Dec. 27, 1995).

combined trust's initial value. This fraction would be used in the event the combined trust is subsequently separated, either pursuant to an election by the trustees, or because part of the combined trust terminates. If it becomes necessary to separate one of the combined trusts, the amount separated will be determined under the following formula:¹⁵⁴

$$\frac{\text{Initial Value of the Separate Trust}}{\text{Initial Value of the Combined Trusts}} \times \text{Value of the Combined Trust on Separation Date}$$

A very simple example of when it makes sense to merge nearly identical trusts is in the case of a qualified personal residence trust (QPRT) that continues in trust after the end of the initial QPRT term.

Example. Bob and Sue Smith partitioned their home in 2005 and each transferred their one-half interest to a separate qualified personal residence trust (QPRT). The trusts were to last 7 years and then terminate in favor of a separate trust for each of their four children for life with the remainder to grandchildren. When the QPRTs terminated in 2012, eight trusts were created with each child having two identical trusts, each owning a one-fourth interest in half the house. The house was sold and the proceeds invested in securities. The trustees executed a merger agreement to combine the two identical trusts for each child into a single trust for the child, reducing the number of trusts from eight to four and significantly reducing the administrative costs.

A will or trust instrument also might direct that trusts be merged on the death of the surviving spouse. For example, the decedent could provide that the QTIP and Bypass Trusts created in his will be merged when his surviving spouse dies. This prevents the family from having to deal with multiple trusts after both spouses are gone and there is no longer any reason, tax or otherwise, to keep the trusts separate.

C. Divisions

The vast majority of trust divisions occur because the beneficiaries have different investment goals and financial needs.¹⁵⁵ The Uniform Trust Code allows a trust to divide, even if the resulting trusts are dissimilar.¹⁵⁶ Trusts may also divide in order to allow each trust to appoint different trustees,¹⁵⁷ to separate assets that require unique management such as closely-held company stock,¹⁵⁸ or to avoid sprinkle provisions in the existing trust. Dividing a trust with sprinkle provisions along family lines would allow the trustee to make unequal distributions within a family line while ensuring that the distributions between family lines are equitable.¹⁵⁹ Trusts may also divide as part of a family

¹⁵⁴ Ltr. Rul. 201050008 (Dec. 17, 2010); see also Ltr. Rul. 201024044 (The Merger Agreement provided that certain distributions will be made according to the terms of the original trust as if the merger had not occurred.)

¹⁵⁵ Ltr. Rul. 201245007, 201223012, 201238004, 201204005, 201131014, 200552009, 200314007.

¹⁵⁶ UNIF. TRUST CODE § 417, Cmt.

¹⁵⁷ Ltr. Rul. 201109004 (Mar. 4, 2011).

¹⁵⁸ Ltr. Rul. 200723014 (June 8, 2007).

¹⁵⁹ Ltr. Rul. 201131014 (Aug. 5, 2011); see also Ltr. Rul. 201223012, 201131014, 201133007, 201033025.

settlement agreement following a dispute over management of the trusts.¹⁶⁰

Another common reason to divide a trust is to separate the GST exempt and non-exempt portions. While the terms of the severed GST trusts will be identical, the division will permit differing investment objectives to be pursued and allow for discretionary distributions to be made from one trust and not the other. This allows the trustee to deplete the non-exempt trust and preserve the exempt trust. Comments to the Uniform Trust Code state that the failure of the fiduciary to pursue a division in this case might be a breach of fiduciary duty.¹⁶¹ The opposite could be true if the trustee divides in order to fit within the small trust termination provisions.

As with merged trusts, the more the dispositive terms of the resulting trusts differ, the more likely the terms of the divided trusts will not meet the settlor's purposes and the trustee should obtain the approval of the court or the beneficiaries. While the consent of the beneficiaries is not necessary where the beneficiaries' rights are not impaired and the division will not adversely affect the settlor's purposes, advance notice to the beneficiaries is required for a division.¹⁶²

Many times a trust will divide pursuant to its own terms. For example, a bypass trust might provide that on the death of the surviving spouse, it will merge into the marital trust and divide into separate trusts for each child.¹⁶³ These resulting trusts should be considered a continuation of the original trust rather than a termination of the old trust and the creation of new trusts. By necessity, only one of the resulting trusts can keep the federal ID number of the old trust and the others will need new ID numbers.

D. Income Tax Consequences

Regardless of how or why a trust merger or division might occur, the income tax questions are a) whether the transaction will result in the realization of gain or loss by the trust or a beneficiary b) whether the basis and holding periods of trust property carryover to the resulting trust, and c) what happens to the trust's income tax carryovers from net operating losses, capital losses, passive losses, charitable deductions, investment interest limitations, foreign tax credits, AMT credits, and the like?

1. The Beneficiaries

Nearly all private letter rulings analyze the income tax consequences of a trust merger or division by applying *Cottage Savings v. Commissioner*.¹⁶⁴ In *Cottage Savings*, the Supreme Court held that an exchange of mortgages was a taxable exchange under IRC § 1001 because the mortgages were "materially different." Even though they were of equal value and all of them were secured by single family homes, the Court found that they embodied legally distinct entitlements because the loans were made to different obligors and were secured by different homes.

¹⁶⁰ Ltr. Rul. 201104001, 201023006, 200507002 (Feb. 18, 2005) (The IRS declined to rule on the income tax consequences of a division following a family dispute.)

¹⁶¹ UNIF. TRUST CODE § 417, Cmt.

¹⁶² *Id.*

¹⁶³ Ltr. Rul. 200723014 (June 8, 2007).

¹⁶⁴ *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991).

Applying *Cottage Savings* in the context of a trust merger or division, the IRS looks at whether the interest of the beneficiaries before and after the proposed merger or division differs materially. If the interests before and after are substantially identical, the merger or division does not result in the realization of gain or loss to the trust or the beneficiaries under IRC § 1001.¹⁶⁵

Some private letter rulings do not even reach the question of whether the interests are materially different because they find that no exchange has occurred at all.¹⁶⁶ Therefore, it is unnecessary to determine whether the interests are materially different under *Cottage Savings*. In Ltr. Rul. 201042004, the Service found that where state law authorized the merger of trusts with “substantially similar terms,” the merging trusts were “substantially similar,” no beneficiaries acquired new or additional interests in the surviving trust, and there did not appear to be any reciprocal exchange of legal rights or entitlements among the beneficiaries, no “exchange” occurred under IRC § 1001.¹⁶⁷ Letter Ruling 201134017 similarly found that where a merger was made under the authority granted to the trustee under the express terms of the trust document, the beneficiaries did not acquire their interests as a result of an exchange, but instead by reason of the exercise of the trustee's existing authority to make distributions in further trust.¹⁶⁸

A few private letter rulings also rely on *Silverstein v. United States* for the proposition that no sale or exchange has occurred in a trust merger.¹⁶⁹ In *Silverstein*, the Seventh Circuit held that no realization event occurs when, despite the form of the transaction, in substance the taxpayer holds the same property interest after a transaction as before, is as secure with respect to the interest after the transaction as before, and there is no realistic difference in the value of the property interest held as a result of the transaction. The income beneficiary had exchanged her right to annual installments of \$12,000 for life from the trust for annuity-like payments of similar amount from the remainderman. She contended that a sale occurred and that she was entitled to report the payments as capital gain. However, the Court found that no disposition of property occurred because the beneficiary was “in virtually the same economic position as she was before.” “What she gave up with her right hand, she got back with her left.” There was “simply a change in administration of the trust funds.”

Nearly all of the rulings pertaining to divisions hold that the division of a trust into nearly identical trusts is analogous to a partition, which the IRS has held to be tax-free in Rev. Rul. 56-437.¹⁷⁰ The ruling found that the severance of a joint tenancy in corporate stock under a partition action instituted under Colorado law to eliminate a survivorship feature was not a sale or exchange within the meaning of the income tax law.

¹⁶⁵ Ltr. Rul. 201204005, 201243004, 201109004, 201133007, 201024044, 200801036, 200736002, 200607015, 200552009, 200544007, 200527007, 200449020.

¹⁶⁶ Ltr. Rul. 201243004, 201216010, 201134017, 201042004, 201050008, 201033025, 200743022, 200723014, 9613014, 200314007.

¹⁶⁷ Ltr. Rul. 201042004 (Oct. 22, 2010).

¹⁶⁸ Ltr. Rul. 201134017 (Aug. 26, 2011).

¹⁶⁹ *Silverstein v. United States*, 419 F.2d 999 (7 Cir. 1969), *aff'g* 293 F. Supp. 1106 (N.D. Ill. 1968), *cert. denied*, 397 U.S. 1041 (1970); Ltr. Rul. 200924018, 200923012-18, 200231011, 200012074.

¹⁷⁰ Rev. Rul. 56-437, 1956-2 C.B. 507.

And more recently, a few rulings have cited Reg. § 1.1001-1(h), which was published in 2007 and expressly provides that a division (or severance) of any trust pursuant to authority under the governing instrument or local law is not an exchange or property differing materially either in kind or extent.¹⁷¹ In addition, the division may be nonprorata if the governing instrument or local law authorizes it.¹⁷² Most well-drafted trust instruments authorize the trustee to make nonprorata distributions. And even if they don't, many states have adopted Uniform Trust Code § 816(22), which authorizes the trustee to make nonprorata distributions and allocate particular assets in proportionate or disproportionate shares. This power was specifically added to provide needed flexibility and lessen the risk that a non-pro-rata distribution will be treated as a taxable sale.¹⁷³

Collectively, all of the rulings rely on some combination of *Cottage Savings*, *Silverstein*, Rev. Rul. 56-437, and Reg. § 1.1001-1(h) to hold that there was no exchange of properties that were materially different because the beneficiaries did not acquire legal entitlements that were different in kind or conferred different rights and powers than they had before. Once that conclusion is reached, it is axiomatic that no gain is recognized on the transaction and the beneficiaries succeed to the trust's basis under IRC § 1015(b) and holding periods under IRC § 1223(b).

2. The Trust

The trust may also have income tax consequences if it is deemed to have made a distribution to the beneficiaries in connection with a merger or division. First, the trust may claim a distribution deduction under IRC § 661 if there has been a deemed distribution. Second, the trust may be required to recognize gain on the distribution under Reg. § 1.661(a)-2(f) if it distributes appreciated property to a beneficiary in satisfaction of a right to receive a specific dollar amount, specific property other than that distributed, or income of the trust.¹⁷⁴ Third, the trust may elect to recognize gain on a distribution under IRC § 643(e)(3). And finally, the trust may lose some of its valuable tax attributes if the distribution is considered to terminate the trust, because only certain tax attributes may carry over to the beneficiaries on termination of a trust under IRC § 642(h).¹⁷⁵

a. Is There a Distribution?

The threshold question for the trust is whether there has been a distribution (deemed or otherwise) in connection with the merger or division. If so, the IRS might argue that the merger or division should be treated as a distribution of trust assets followed by an exchange of interests among the beneficiaries, resulting in recognize gain for income tax purposes.¹⁷⁶ The question generally comes up in connection with divisions rather than mergers. However, Ltr. Rul. 200801036, involving a merger, concluded that there was a "deemed distribution" of the assets of two merging trusts to the resulting trust, but that it

¹⁷¹ Reg. § 1.1001-1(h); T.D. 9348 (Aug. 1, 2007).

¹⁷² Ltr. Rul. 201204001-5, 201133007, 201026018, 201024027-9, 201023001-6, 201021003-11.

¹⁷³ UNIF. TRUST CODE § 816(22), Cmt.

¹⁷⁴ IRC § 1.661(a)-2(f); Reg. § 1.1014-4(a)(3).

¹⁷⁵ IRC § 642(h); Reg. § 1.642(h)-4.

¹⁷⁶ Rev. Rul. 69-486, 1969-2 C.B. 159.

would not result in gain or loss realization to the trust or the beneficiaries. However, the ruling did not directly refer to IRC § 661. Although oddly worded, the ruling seems to say that the deemed distribution will not be treated as an *actual* distribution. Otherwise it would have had tax consequences, at a minimum resulting in a deduction to the trust and income to the beneficiaries under IRC §§ 661 and 662.¹⁷⁷

Letter rulings involving trust divisions address distributions much more frequently, although not routinely. The Service generally concludes that where there has been no exchange of materially different interests, there is no realization event and no distribution. In other words, nothing changed hands or left the trust. All that has happened is that the trust has partitioned its property. And under Rev. Rul. 56-437 a state law partition is not a sale or exchange.¹⁷⁸ The rulings almost unanimously conclude that a trust division is essentially equivalent to a partition of the trust assets. Thus, no distribution under IRC § 661 or Reg. § 1.661(a)-2(f) has occurred.

However, Letter Ruling 200723014 did involve a terminating distribution and a separate discussion of Reg. § 1.661(a)-2(f). In, a marital trust was divided into Trust A and Trust B. Trust A received closely-held company stock and Trust B received marketable securities and cash. Trust B then terminated as part of the overall plan and distributed the securities to the beneficiaries. The IRS could hardly say that this was not a distribution under IRC § 661. But the Service concluded that it was not taxable under Reg. § 1.661(a)-2(f) because the governing instrument authorized non-prorata distributions and thus it was not a distribution made in satisfaction of a right to receive a specific dollar amount, specific property other than that distributed, or income of the trust as described in Reg. § 1.661(a)-2(f). Therefore it did not cause gain recognition to the trust. Rather the distribution would simply carry out any DNI under the normal distribution rules and the basis of the securities would carry over to the beneficiaries under IRC § 643(e)(1).

b. Do the Trust's Tax Attributes Carryover?

A trust may only carry out certain tax attributes under IRC § 642(h) to the beneficiaries on termination of the trust. These include its net operating losses, capital loss carryovers, and deductions in excess of gross income.¹⁷⁹ However, IRC § 642(h) does not allow a carryout of passive losses, charitable deductions, investment interest limitations, foreign tax credits, AMT credits, or any other kind of credits, deductions, or carryovers.

Two private letter rulings have addressed the tax attributes in trust mergers and divisions and concluded that *all* of the trust's tax attributes, not just those expressly allowed by IRC § 642(h), carry over to the resulting trusts in both a merger and a division.¹⁸⁰ Letter Rulings 200552009 and 200544007 state:

All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts immediately before the mergers will survive and remain available to the

¹⁷⁷ IRC § 662(a).

¹⁷⁸ Rev. Rul. 56-437, 1956-2 C.B. 507.

¹⁷⁹ IRC § 642(h); Reg. § 1.642(h)-4.

¹⁸⁰ Ltr. Rul. 200552009 (Dec. 30, 2005), 200544007 (Nov. 4, 2005).

merged Trust 4 after the mergers and no limitation will be imposed as a result of the proposed mergers on the merged Trust 4's use of such tax attributes.

All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4 immediately before the division will survive and remain available to the divided New Trusts after the division and no limitation will be imposed as a result of the proposed division on the New Trusts' use of such tax attributes.

Although the rulings are favorable, they offer no guidance on how the tax attributes would be allocated among the shares or divided trusts. Some tax attributes are specific to a particular asset, such as passive losses and thus it follows that the losses would go to the share or trust that received the asset. Indeed, IRC § 469(j)(12) specifically provides that when a passive activity is distributed to an estate or trust beneficiary, unused passive losses are added to the basis of the passive activity and are not deductible in any year.¹⁸¹

But other losses are not specific to a particular trust asset. Rather, they belong to the trust as a whole. The regulations offer limited guidance on how to allocate losses and deductions under IRC § 642(h) among the beneficiaries. They provide that the attributes are “allocated among the beneficiaries succeeding to the property of the estate or trust proportionately according to the share of each in the burden of the loss or deductions.”¹⁸² The regulations provide the following example:

Example. A decedent's will leaves \$100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only \$90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of \$5,000, and a capital loss carryover of \$15,000. A is a beneficiary succeeding to the property of the estate to the extent of \$10,000, and since the total of the excess of deductions and the loss carryover is \$20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.¹⁸³

In the example above, A succeeds to estate property to the extent of \$10,000, the portion of the loss he actually (economically) sustained because there were insufficient assets to satisfy his bequest. Therefore, A is entitled to \$10,000 of the loss carryovers. Because the total carryovers are \$20,000, A is entitled to half of each item. Thus, A succeeds to \$2,500 of excess deductions and \$7,500 of net operating losses. The remainder is divided equally between B and C.

VI. Family Settlement Agreements

A. General Tax Principals on Settlements

¹⁸¹ IRC §469(j)(12).

¹⁸² Reg. § 1.642(h)-4.

¹⁸³ *Id.*

The general rule under IRC § 102(a) is that “gross income does not include the value of property acquired by gift, devise, or inheritance.”¹⁸⁴ The same is true for property acquired in settlement or compromise of a will contest or genuine dispute by an heir. This principle was established by the Supreme Court in *Lyeth v. Hoey* in 1938 and has been routinely followed.¹⁸⁵ Whether a claim is resolved through litigation or settlement, the nature of the underlying action determines the tax consequences of the proceeds.¹⁸⁶ In characterizing the settlement payment for tax purposes, the court asks “In lieu of what were the damages awarded?”¹⁸⁷ Thus, settlement proceeds are treated as if they had been received in satisfaction of the bequest.¹⁸⁸ For example, in FSA 90, the IRS found that settlement proceeds from a beneficiary’s action against the trustee to restore depleted trust assets and recover income that would have been earned had prudent practices been observed was not taxable income to the extent the proceeds represented corpus in excess of the beneficiary’s basis.¹⁸⁹ The basis question was deferred to a supplemental response in coordination with the Passthroughs and Special Industries Branch.

However, to the extent that settlement proceeds are received in lieu of income, they represent taxable income to the beneficiary.¹⁹⁰ Section 102 does not apply to amounts required by a settlement to be paid from income. When the settlement amount is in lieu of an income interest, the courts have generally held that the settlement is taxable income.¹⁹¹ In *Garrett v. Commissioner*, an income beneficiary filed suit against the bank, as trustee, to recover diminution of his income interest in trust and not to challenge the validity of the will or his share of the estate under its provisions.¹⁹² Therefore, the Court found that the proceeds were not property acquired in lieu of an inheritance, but taxable income.

Another exception to the rule that inheritances are tax-free is for bequests in lieu of services rendered. Bequests made to compensate for services to the decedent are not excluded from income.¹⁹³ Moreover, if part of a settlement involves dissolving partnerships and corporations to reach assets held by those entities, the dissolution would be taxed under the normal income tax rules of Subchapter K and C.

¹⁸⁴ IRC § 102(a).

¹⁸⁵ *Lyeth v. Hoey*, 59 S.Ct. 155 (1938).

¹⁸⁶ *Tribune Publishing Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988).

¹⁸⁷ *Id.* at 1178 (quoting *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.) cert. denied, 323 U.S. 779 (1944)); *see also Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963) (question was what the taxpayer would have received had sums wrongfully withheld been paid when due); *Victor E. Gidwitz Family Trust v. Commissioner*, 61 T.C. 664, 673-74 (1974) (question was what the taxpayer would have received in a merger had the consideration for the taxpayer's shares been adequate).

¹⁸⁸ *Tribune*, 836 F.2d at 1179.

¹⁸⁹ FSA 90, Vaughn # 90 (1999).

¹⁹⁰ IRC § 102(b).

¹⁹¹ *Getty v. Comm’r*, 913 F.2d 1486, 1492 n. 7 (9th Cir. 1990).

¹⁹² *Garrett v. Comm’r*, T.C.M. 1994-70.

¹⁹³ *Cotnam v. Comm’r*, 263 F.2d 119 (5th Cir. 1959); *Wolder v. Comm’r*, 493 F.2d 608 (2nd Cir. 1974), cert. denied 419 U.S. 828 (1974) (bequest to lawyer to compensate for his services was taxable income); Rev. Rul. 67-375, 1967-2 CB 60 (A distribution of property under the terms of a will in satisfaction of a written agreement under which the taxpayers were required to perform services for the testator is compensation for services includible in their gross income in the taxable year of receipt.)

1. Settlements Involving Spouses or Charities

Special care is required for settlements involving a surviving spouse or charity to make sure that the amounts qualify for the marital or charitable deduction. In *Ahmanson Foundation v. United States*, the court considered whether a marital deduction was allowable under IRC § 2056 for property distributed to the decedent's spouse pursuant to a settlement agreement.¹⁹⁴ Relying on *Commissioner v. Estate of Bosch*, the court concluded that a good faith settlement must be based upon an enforceable right, under state law properly interpreted, in order to qualify the property distribution as “passing” from the decedent for purposes of the federal estate tax marital deduction under IRC § 2056.¹⁹⁵

This principal has been found equally applicable in determining whether an amount passing to charity pursuant to a settlement agreement is deductible under IRC § 2055.¹⁹⁶ The IRS recently addressed this issue in Ltr. Rul. 201236022 and held that a charitable deduction is allowable under IRC § 2055(a) to the decedent's estate for the amounts paid to charity pursuant to the settlement agreement if:¹⁹⁷

- (1) The settlement agreement was negotiated, and is in settlement of a bona fide will contest;
- (2) The charities have an enforceable right to the residue of the Decedent's estate under State law, and the payments are in recognition of that right;
- (3) The payments do not exceed what the charities would have received if they had pursued their rights in litigation; and
- (4) The form of the payments passing to the charities under the settlement agreement resembles the form of the benefits that the charities could have received under the terms of Decedent's will.

Similarly, in Letter Ruling 201316004 shortly after a decedent executed her will, she became incapacitated, but did not die until several years later. Her will left her property to her surviving spouse, children, grandchildren, and charity.¹⁹⁸ However, the beneficiaries disagreed on its proper interpretation under state law. As a result, her executor petitioned the court for construction and reformation of her will to determine the amount each beneficiary was to receive. All parties were represented by separate counsel. They agreed that each other's position had merit, and wished to avoid the uncertainty and cost of litigation. Accordingly, they entered into a court-approved settlement. The IRS held that the estate was entitled to a charitable deduction for amounts passing to the charity under the settlement agreement because the settlement was the product of arm's length negotiations, resolved a legitimate will contest among the beneficiaries, reflected their assessments of the relative strengths of their positions, and was within the range of reasonable outcomes under the will and applicable state law.

¹⁹⁴ *Ahmanson Foundation v. United States*, 674 F.2d 761(9 Cir. 1981).

¹⁹⁵ *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

¹⁹⁶ *Terre Haute First Nat'l Bank v. United States*, 67 AFTR 2d 91-1217 (1991).

¹⁹⁷ Ltr. Rul. 201236022 (Sept. 7, 2012).

¹⁹⁸ Ltr. Rul 201316004 (Apr. 19, 2013).

Given the scrutiny applied to amounts paid to a spouse or charity pursuant to a settlement agreement, it may not be possible to obtain an estate tax marital or charitable deduction by negotiating a “friendly” settlement. For example, it has been suggested that a family could agree to waive funding a bypass trust in order to pass the assets directly to the surviving spouse who would then be able to use the decedent’s full unused exemption amount (DSUEA) under IRC § 2010(c)(4), unreduced by the amount that would have gone to the bypass trust. However, if a marital deduction is unavailable in the first estate because the amount passing to the surviving spouse was negotiated in a friendly settlement, that amount would necessarily reduce the DSUEA available to the surviving spouse on her death.

Example. Joe and Sue have joint property worth \$2 million. Joe dies in 2012 and leaves his \$1 million to a bypass trust. Sue and the children decide the bypass trust is too much trouble and draft a friendly settlement agreement whereby they waive funding the bypass trust and the entire \$1 million in Joe’s estate passes to Sue. If the \$1 million passing to Sue is not eligible for the marital deduction because it did not pass to her from Joe under IRC § 2056, it reduces the DSUEA available to Sue on her death to only \$4,120,000 [\$5,120,000 - \$1,000,000].

2. Litigation Costs

Estates are allowed a deduction for litigation costs if they are actually and necessarily incurred in the proper administration and settlement of a decedent’s estate and are allowable under applicable state law.¹⁹⁹ However, settlement payments to beneficiaries are not deductible as administration expenses. In *Bates v. Commissioner*, the estate paid a caretaker \$575,000 to settle a will contest in lieu of \$100,000, which was left to the caretaker in a will that was contested, but ultimately validated.²⁰⁰ The executors claimed that the excess over \$100,000 was not attributable to the testator’s intended bequest and thus was deductible as an administration expense under IRC § 2053(a) because it was necessary to preserve the estate assets.

The Tax Court denied the deduction because the caretaker was a legitimate beneficiary delineated in both of the contested wills. It distinguished the situation from *Pitner v. Commissioner*, where the Fifth Circuit allowed an estate to deduct litigation costs as administration expenses in a challenge by individuals “with no legitimate interest in the estate whatsoever.”²⁰¹ The Court held that administrative costs are deductible under IRC § 2053 “where beneficiaries are suing to determine their share in the estate as against other beneficiaries, not, as here, where parties have sued to have their interest in the estate in general—the total estate—recognized as opposed to others with no legitimate interest in the estate whatsoever.”²⁰² A closer call may be the deductibility of costs incurred by the estate to defend a will contest filed by an heir who was purposely omitted from the testator’s will.

¹⁹⁹ Reg. § 20.2053-3(a)

²⁰⁰ *Bates v. Comm’r*, Docket No. 1193-10 (Nov. 7, 2012).

²⁰¹ *Pitner v. Comm’r*, 388 F.2d 651 (5th Cir. 1967).

²⁰² *Id.* at 660.

An estate may not deduct attorneys' fees paid on behalf of the beneficiaries in litigation over their own interests, even if approved by the probate court, if it is not essential to the proper settlement of the estate.²⁰³ In *Bates v. Commissioner*, the Tax Court disallowed as an estate administrative deduction expenses paid to a private investigator to "monitor the trust litigation" on behalf of one of the beneficiaries, who was incarcerated at the time of the litigation.²⁰⁴

A trust may also deduct administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration.²⁰⁵ However, expenses paid or incurred by an heir in protecting or asserting their right to a decedent's property as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.²⁰⁶

B. Cashing Out a Trust Beneficiary

A common means of settling disputes among the beneficiaries of a trust involves the sale of one or more of their interests in the trust. Because the sale will generally be to a related party, certain related party rules must be applied as discussed below. But in general, beneficiaries who sell their interest in a trust are entitled to a capital gain or loss based on the difference between the sale price and their basis. The IRS has held that a sale of an interest in a testamentary trust is a sale of a capital asset.²⁰⁷

Beneficiaries have a basis in a trust interest that is acquired by gift or inheritance. The basis of an income beneficiary is the beneficiary's life expectancy factor multiplied by the basis of the entire trust property. The basis of the remainder beneficiary is the remainder factor multiplied by the basis of the trust property. The remainder factor is one minus the life expectancy factor.

1. Income Beneficiary

For purposes of determining a gain or loss on sale of an income interest, a life interest, or a term interest, the beneficiary's basis is *zero* to the extent the basis of the interest was determined by reference to IRC § 1014 (property acquired from a decedent) or § 1015 (property acquired by gift or transfer in trust).²⁰⁸ Thus, an income beneficiary who cashes out his or her interest in a trust acquired by gift or inheritance is taxable on the full amount of the proceeds.

Example. Securities worth \$500,000 on the decedent's death are bequeathed to his wife, W, for life, with remainder to his son, S. W is 48 years old. By reference to § 20.2031-7A(c), the life estate factor for a 48 year old female in 1971 is 0.77488 and the remainder factor for such age is 0.22512. The portion

²⁰³ *Id.*; Reg. § 20.2053-3(b); *but see* *Sussman v. United States*, 236 F. Supp. 507 (1962, DC NY).

²⁰⁴ *Bates v. Comm'r*, Docket No. 1193-10 (Nov. 7, 2012).

²⁰⁵ Reg. § 1.212-1(i).

²⁰⁶ Reg. § 1.212-1(k).

²⁰⁷ Rev. Rul. 72-243, 1972-1 C.B. 233 (life tenant's sale of her entire interest in a testamentary trust to the remainderman is a sale of a capital asset).

²⁰⁸ Reg. § 1.1014-5(b).

of the uniform basis assigned to W's life interest is \$387,440 ($\$500,000 \times 0.77488$) and the basis of S's remainder interest is \$112,560 ($\$500,000 \times 0.22512$). W sells her life interest to her nephew A for \$370,000 when she is still 48 years old. W's gain is \$370,000, the full amount realized from the sale because her basis is zero.²⁰⁹ A has a basis of \$370,000, which he can recover by amortization deductions over W's life expectancy.

Example. The facts are the same as above except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to \$650,000. By reference to §20.2031-7A(c), the life estate factor for a 60 year old female in 1983 is 0.63226 and the remainder factor for such age is 0.36774. Therefore, the portion of the uniform basis assigned to W's life interest is \$316,130 ($\$500,000 \times 0.63226$) and the basis of S's remainder interest is \$183,870 ($\$500,000 \times 0.36774$). W sells her life interest for \$410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($\$650,000 \times 0.63226$). W's gain is \$410,969, the amount realized, because her basis is zero. A has a basis of \$410,969 which he can recover by amortization deductions over W's life expectancy.²¹⁰

The purchaser in each of the two examples above can amortize his purchase price over W's life expectancy because he is not related to the remainder beneficiary. The amortization deduction, however, is an itemized deduction subject to the two-percent floor under IRC § 67(a).

But if the purchaser of an income interest is related to the remainder beneficiary, as defined in IRC § 267(b) or (e), the purchaser may not amortize the purchase price.²¹¹ Instead, the disallowed amortization deductions are added to the basis of the trust property.²¹² Thus, in the first example above, if W had sold her interest to her daughter for \$370,000, her daughter would not be entitled to amortize the purchase price because her daughter is related to the son who is the remainder beneficiary.²¹³ Assuming W's remaining life expectancy was 30 years, the basis in the securities owned by the trust would be increased by \$12,333 per year, representing the daughter's foregone amortization deductions. [$\$370,000/30$ years]²¹⁴

There is an exception to the zero basis rule when, as a part of a single transaction, the entire interest in the property is transferred to a third person or to two or more other persons.²¹⁵ Thus, where a life tenant and a remainderman simultaneously sell their

²⁰⁹ Reg. § 1.1014-5(c), Ex. 1.

²¹⁰ Reg. § 1.1014-5(c), Ex. 2.

²¹¹ IRC § 167(e).

²¹² IRC § 167(e)(3)(B).

²¹³ IRC § 267(c)(4) (members of an individual's family include brothers and sisters, whether by whole or half-blood, spouse, ancestors, and lineal descendants)

²¹⁴ H. Rept. No. 101-247 (P.L. 101-239), p. 1362.

²¹⁵ IRC § 1001(e)(3); Reg. § 1.1001-1(f)(3).

interests in a single transaction, the life tenant's gain would be the excess of the sales price of his interest over his regular basis, as would be the remainderman's.²¹⁶

An income beneficiary who wants to sell his or her interest in the trust has a strong incentive to find a buyer who wants to buy the entire trust property. In that way, the beneficiary has basis to offset part of the gain. However, failing that, it may still make sense for the income beneficiary to sell an income interest because the beneficiary is effectively able to convert what would have been ordinary income into capital gain.²¹⁷

2. Remainder Beneficiary

The zero basis rule does not apply to a remainder beneficiary. Thus, the basis of a remainder beneficiary's interest in a trust acquired by gift or inheritance is the remainder factor times the basis of the trust property at the time the interest is sold. This is generally the basis of the entire trust property minus the basis attributable to the income beneficiary.

Example. Unimproved land having a value of \$18,800 at the date of the decedent's death in 1970, is devised to A, a male, for life, with remainder over to B, a female. B sells her remainder interest to S for \$12,500. At the time of the sale, B is 39 years old. By reference to § 20.2031-7A(c), the remainder factor for an age 39 female is .20146. Therefore, the portion of the uniform basis assigned to B's remainder interest is \$3,787.40 ($\$18,800 \times 0.20146$). B's gain on the sale is \$8,712.55 ($\$12,500$ less $\$3,787.45$). S has a basis in the remainder interest of \$12,500, which he can recover by amortization deductions over A's life expectancy.²¹⁸

Even though remainder beneficiaries are not subject to the zero basis rule, they could still have significant gains if the property in the trust has a very low basis. This can be quite a surprise to the beneficiary who expects to receive the property as a tax free inheritance.

C. Terminating the Trust

An alternative to cashing out one or more beneficiaries is to terminate the trust prior to its natural expiration date. This might be advisable if the trust is considered too small to administer economically or the remainder beneficiaries have financial needs that cannot wait until the income beneficiary dies. It might also be appropriate if none of the beneficiaries get along and the trust property is liquid or easily divisible.

Assuming the trustee can obtain the consent of all the beneficiaries, the question arises how to divide the trust property between the income beneficiary and the remainder beneficiaries if the trust instrument is silent. It makes sense to value the income beneficiary's interest based on the commuted value of the income beneficiary's remaining life interest in the property at its fair market value on the date of the division.

²¹⁶ S. Rept. No. 91-552 (P.L. 91-172) p. 204.

²¹⁷ Rev. Rul. 72-243, 1972-1 C.B. 233 (life tenant's sale of her entire interest in a testamentary trust to the remainderman is a sale of a capital asset).

²¹⁸ Reg. § 1.1014-5(c), Ex. 3.

This could be done by using the IRS valuation tables in Reg. § 20.2031-7 or other standard mortality tables and interest rates.

Once the values are determined and property is distributed to the beneficiaries on termination, the trust's distributable net income carries out to the beneficiaries according to the amount distributed. Each beneficiary would also be allocated a prorata share of the trust's unused loss carryovers and excess deductions under IRC § 642(h). However, the trust would lose any carryovers attributable to passive losses, charitable contributions, investment interest limitations, or tax credits, which are not expressly provided for under IRC § 642(h).

VII. Planning For the 3.8% Medicare Surtax

Starting in 2013, estates and trusts will be subject to the new 3.8 percent Medicare surtax on investment income.²¹⁹ IRC § 1411 imposes a surtax of 3.8 percent on the unearned income of an estate or trust in addition to all other taxes imposed by Subtitle A (Income Taxes), including the alternative minimum tax.²²⁰ The surtax applies to the lesser of a) adjusted gross income under § 67(e) in excess of a threshold equal to the dollar amount at which the highest income tax bracket begins for the year (\$11,950 for 2013) or b) undistributed net investment income.²²¹ The threshold is indexed for inflation each year, unlike the threshold for individuals, which is fixed at \$250,000 for married individuals, \$125,000 for married individuals filing separately, and \$200,000 for other individuals.²²²

The IRS issued proposed regulations under IRC § 1411 on December 5, 2012 fleshing out many details of its application.²²³ The proposed regulations explain how section 1411 interacts with many other code sections such as the 2 and 3 percent floors under IRC §§ 67 and 68, the passive and at risk rules under IRC §§ 465 and 469, net operating losses, investment interest limitations, and others. They do not, however, attempt to update or clarify these other areas, even where it is sorely needed, such as passive losses and administrative expenses for estates and trusts. The proposed regulations apply to tax years beginning after December 31, 2013 even though the statute is effective January 1, 2013. In the meantime, taxpayers may rely on the regulations.

A. Adjusted Gross Income

The proposed regulations clarify that the adjusted gross income (AGI) of an estate or trust is determined under § 67(e) for purposes of the Medicare tax.²²⁴ Thus, an estate or trust's AGI is computed in the same manner as for an individual, except that deductions are allowed for charitable contributions, the personal exemption, distributions to beneficiaries, and costs "which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." This last category has been interpreted by the Supreme Court

²¹⁹ IRC § 1411.

²²⁰ IRC § 1411(a)(1).

²²¹ IRC § 1411(a)(2).

²²² IRC § 1(f); IRC § 1411(b).

²²³ Notice of Proposed Rulemaking, Fed. Reg. Vol. 77, No. 234, p. 72611. 12/05/2012.

²²⁴ Reg. § 1.1411-3(a)(1)(ii)(B).

and in Proposed Regulation 1.67-4.²²⁵ Unfortunately, there is still a great deal of confusion over what this means.

B. Undistributed Net Investment Income

“Undistributed net investment income” means net investment income minus distributions of net investment income to beneficiaries.²²⁶ Distributions reduce both AGI and net investment income. Therefore, the trustee may want to make distributions to beneficiaries if their AGI is below the \$250,000/\$125,000 threshold that applies to individuals.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities, and trading activities less “properly allocable” expenses.²²⁷ Properly allocable deductions means deductions described in IRC § 62(a) allocable to passive activities, rents and royalties, and penalties on early withdrawal of savings.²²⁸ It also means the allowable portion of investment interest expenses under IRC § 163(d), investment expenses that are directly connected with the production of investment income under IRC § 163(d)(4)(C), and state, local, and foreign income taxes on investment income. In addition, investment expenses must be further reduced by the 2 and 3 percent haircuts under IRC § 67 and 68.²²⁹ Casualty, theft, abandonment, and worthlessness deductions under IRC § 165 are not allowed as investment expenses at all. Rather they are treated as losses from the disposition of property.²³⁰ The effect of this is to disallow losses in excess of gains.

Several types of income are excluded from net investment income. The statute expressly excludes distributions from IRAs and qualified plans.²³¹ It also excludes nonpassive trade or business income.²³² Net investment income also excludes tax exempt income and the internal build-up of annuities because they are excluded from gross income. It also excludes guaranteed payments from partnerships, first because § 1411(c)(6) specifically excludes any item subject to self-employment tax. And second because guaranteed payments that are not subject to self-employment tax, such as those from investment partnerships, are simply not on the list of items that constitute investment income under § 1411(c)(1)(A).

C. Allocating Expenses

The trustee’s classification of expenses will impact the amount of the surtax in two ways. First, expenses classified as miscellaneous itemized deductions subject to the 2 percent floor are not deductible in computing AGI. Therefore, the trustee may want to consider allocating as many expenses as it can to “above the line” deductions not subject to the 2

²²⁵ Knight v. CIR, 552 U.S. 181 (2008).

²²⁶ Prop. Reg. § 1.1411-3(d)(2).

²²⁷ IRC § 1411(c)(1).

²²⁸ Prop. Reg. § 1.1411-4(f).

²²⁹ Prop. Reg. § 1.1411-4(f)(3)(ii).

²³⁰ Prop. Reg. § 1.1411-4(f)(4).

²³¹ IRC § 1411(c)(5).

²³² IRC § 1411(c)(1)(A)(ii).

percent floor to minimize the surtax.

Second, in determining the character of income distributed to beneficiaries, the regulations require that expenses deducted in determining DNI be allocated to various classes of income included in DNI, including tax exempt income.²³³ Direct expenses must be allocated to the class of income to which they relate. Indirect expenses may be allocated to any category as long as a portion is allocated to tax exempt income.²³⁴ The regulations list trustee fees, safe deposit box rental, and state income and personal property taxes as examples of indirect expenses.²³⁵ Thus to the extent that expenses are allocated to income excluded from the surtax base, such as tax-exempt income, these deductions are wasted for purposes of the surtax. Therefore, the trustee may want to allocate as few expenses as reasonably possible to tax exempt and other classes of income that are not subject to the surtax.

D. Capital Gains

Net capital gains are part of both AGI and undistributed net investment income in computing the surtax. Capital losses can only reduce AGI up to the \$3,000 annual limit, but do not reduce net investment income. Capital gains that are part of corpus are trapped in the trust and subject to the surtax. However, not all capital gains are part of corpus as discussed below.

The IRS regulations describe the circumstances under which capital gains can be included in DNI.²³⁶ These circumstances include a) where the trust instrument provides that capital gains are included in trust income (rare), b) the distributions are in full or partial liquidation of the trust, c) the trustee has the power to adjust and consistently designates principal distributions as capital gains, or d) the gains are included in a unitrust distribution. In addition to these specified circumstances, capital gains flowing from a partnership K-1 are included in DNI. Therefore, the trustee may want to consider investing through a partnership so that capital gains can be distributed and escape the surtax.

E. IRA Distributions

IRA distributions are included in AGI, but not net investment income.²³⁷ Therefore, if a trust is receiving IRA distributions, its undistributed net investment income will likely be lower than its AGI in excess of the threshold. Therefore, because IRA distributions will likely escape the surtax, it may be good planning to name a trust as an IRA beneficiary. To the extent that the trust distributes the IRA distribution to the beneficiary, the distribution retains the same character in the hands of the beneficiary as it had in the

²³³ IRC § 652(b); Reg. § 1.652(b)-3.

²³⁴ *Id.*

²³⁵ Reg. § 1.652(b)-3(c).

²³⁶ Reg. § 1.643(a)-3.

²³⁷ IRC § 1411(c)(5).

hands of the trust.²³⁸ Thus, IRA distributions from an estate or trust should be exempt from the net investment income of the individual.

F. Passive Income

Passive income is included in both AGI and net investment income. Passive income is trade or business income in which the taxpayer does not materially participate.²³⁹ In the case of an estate or trust, the IRS has ruled that the trustee himself needs to meet the material participation test.²⁴⁰ Rental income is, however, per se passive regardless of the owner's level of participation.²⁴¹ A trust with passive income might consider investing in passive loss activities to shelter its passive income.

VIII. Administrative Deductions Under IRC § 67(e)

Estates and trusts incur a significant amount of administrative costs each year in carrying out their fiduciary duties. Most of these expenses can be deducted on either Form 706 or Form 1041, but not both places.²⁴² Examples of administrative costs include:

- Trustee fees
- Accounting fees
- Legal fees
- Costs related to decanting
- Costs related to mergers, divisions, and terminations of trusts
- Cost of obtaining a private letter ruling
- Litigation costs for breach of fiduciary duty or family disputes
- Cost of defending an IRS audit
- Investment advice
- Specialized investment managers
- Consultants
- Bank charges
- Safe deposit box and storage fees
- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)
- Tax advice and preparation
- Property maintenance
- Costs from passthrough entities

Many of these costs are “miscellaneous itemized deductions” under § 67(b) and subject to the 2-percent “floor” under IRC § 67(a). This means that they are deductible to the estate or trust only to the extent that they exceed two percent of the estate or trust's adjusted gross income (AGI).

²³⁸ IRC § 652(b).

²³⁹ IRC § 469(c).

²⁴⁰ TAM 201317010, 200733023.

²⁴¹ IRC § 469(b)(2).

²⁴² IRC § 642(g); Reg. § 20.2053-3.

Adjusted gross income of an estate or trust is determined in the same manner as for an individual, except that the estate or trust may deduct from AGI its \$100/300/600 personal exemption, charitable contributions, distributions to beneficiaries, and certain other costs that are exempt from the floor under IRC § 67(e).

An estate or trust can minimize the impact of the 2-percent floor by making distributions to beneficiaries to reduce its AGI against which the two-percent floor is applied. The miscellaneous itemized deductions are then deducted from the estate or trust's DNI and carried out "net" to the beneficiary rather than passed through as a separate line item on the Schedule K-1. However, the estate or trust is generally not able to distribute capital gains because they are considered corpus. Therefore, it will not be easy for an estate or trust with significant capital gains to reduce its AGI for purposes of the two-percent floor.

The fiduciary must parse through each of its costs and determine which of them is fully deductible and which are subject to the two percent floor. Section 67(e) provides that administrative costs are not subject to the two-percent floor if they "would not have been incurred if the property were not held in such trust or estate." The Supreme Court attempted to clarify the meaning of this phrase in *Knight v. Commissioner*, and held that IRC § 67(e)(1) means that estates and trusts may claim a full deduction only for costs that hypothetical individuals do not "commonly" incur.²⁴³

A. The AMT Impact

Subjecting costs to the 2-percent floor also implicates the alternative minimum tax, because costs classified as "miscellaneous itemized deductions" are an AMT adjustment that must be added to the estate or trust's taxable income in determining its alternative minimum taxable income (AMTI). After applying a \$22,500 exemption and a 26 or 28 percent AMT tax rate to the estate's AMTI, if the fiduciary's tentative minimum tax exceeds its regular tax, it will owe the greater of the two.

The fiduciary can reduce or eliminate its alternative minimum tax by making distributions to the beneficiaries. However, because of the structure of the DNI carryout rules for AMT, the AMT adjustment items are the last items to be carried out. Therefore, the fiduciary must distribute nearly all of its DNI before it carries out the AMT preferences and adjustments.²⁴⁴ The AMT adjustments are carried out to the beneficiary on Schedule K-1. Although this exposes the beneficiary to additional AMT taxes, the impact can be lessened if there are multiple beneficiaries. To the extent the AMT adjustment is divided among multiple beneficiaries, the amount allocated to any single beneficiary is likely to be too small to cause the beneficiary to incur an AMT.

B. Medicare Tax Impact

Because adjusted gross income (AGI) of an estate or trust for the Medicare tax is determined under § 67(e), expenses that are subject to the two-percent floor on miscellaneous itemized deductions will have a triple negative impact. They will be subject to the two-percent floor, expose the fiduciary and its beneficiaries to additional AMT taxes, and cause the estate or trust to incur additional Medicare taxes.

²⁴³ *Knight v. Comm'r*, 552 U.S. 181 (2008).

²⁴⁴ IRC § 59(c); IRC § 661(a); IRC § 662(b).

The fiduciary can lessen the impact of its Medicare tax by making distributions to the beneficiaries. This reduces both its AGI and its undistributed net investment income against which the 3.8 percent Medicare tax is applied. While a distribution carries out the investment income to the beneficiaries, they will be able to apply the higher individual Medicare tax thresholds of \$250,000 for married individuals, \$125,000 for married individuals filing separately, and \$200,000 for other individuals, compared to the fiduciary's meager threshold of \$11,950 for 2013.

C. Revised Proposed Regulations

Prior to the Supreme Court's decision in *Knight*, the IRS had issued proposed regulations allowing costs to be fully deductible only if they were "unique" to an estate or trust.²⁴⁵ If a cost is not unique to an estate or trust, meaning that an individual could have incurred the cost, then that cost is subject to the 2-percent floor. The proposed regulations clarified that it is the type of product or service provided to the estate or trust rather than its description that is tested to determine its uniqueness. The proposed regulations also required costs that are included as part of a comprehensive commission or fee paid to the trustee or executor ("Bundled Fiduciary Fee") to be separated between those subject to the floor and those not.

But because the Supreme Court found that the IRS's interpretation of IRC § 67(e) "flies in the face" of the statute, the IRS issued a series of announcements waiving any requirement for fiduciaries to unbundle their fees until final regulations are published in the federal register.²⁴⁶ They also issued a new set of proposed regulations on September 7, 2011 to replace the ones invalidated by the Supreme Court. The new proposed regulations are intended to reflect the reasoning and holding in *Knight*.²⁴⁷

1. "Commonly" or "Customarily" Incurred

Prop. Reg. § 1.67-4 provides that a cost is "commonly" or "customarily" incurred if a hypothetical individual owning the *same property* would have incurred the same cost. It provides examples of such commonly or customarily incurred costs as those incurred in defending a claim against the estate, the decedent, or the non-grantor trust that is *not* related to the existence, validity, or administration of the estate or trust.²⁴⁸ Although this sounds like a "but for" test, it is not. The Supreme Court rejected any interpretation of IRC § 67(e) that allows a full deduction for costs that would not have been incurred "but for" the existence of the trust because all administrative costs would pass that test, according to the Court. Therefore, the regulations focus on whether the cost is related to the existence, validity, or administration of the estate or trust.

The good news is that the proposed regulations would appear to allow a full deduction for costs incurred to decant, merge, or divide a trust or to resolve litigation involving the existence, validity, or administration of the estate or trust. The bad news is that grantor

²⁴⁵ Prop. Reg. § 1.67-4, REG-128224-06, 2007-36 IRB 551, 72 FR 41243 (July 27, 2007).

²⁴⁶ Notice 2010-32, 2010-16 I.R.B. 594 (Apr. 1, 2010); Notice 2008-116, 2008-2 C.B. 1372 (Dec. 11, 2008); Notice 2008-32, 2008-1 C.B. 593 (Feb. 27, 2008).

²⁴⁷ Preamble to Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 173, p. 55322 (09/07/2011).

²⁴⁸ Prop. Reg. § 1.67-4(b)(1).

trusts will not be allowed a full deduction under IRC § 67(e) because it does not apply to grantor trusts.²⁴⁹ Thus, the grantor will be treated as incurring those expenses individually and will be subject to the two-percent floor and the AMT adjustment.²⁵⁰

a. Ownership Costs

The regulation also creates a new class of costs called “ownership costs” which are subject to the floor. Ownership costs are those chargeable to or incurred by an owner of property simply by reason of being the owner of the property.²⁵¹ It gives the following examples: condominium fees, real estate taxes, insurance premiums, maintenance and lawn services, automobile registration and insurance costs, and partnership costs deemed to be passed through to and reportable by a partner. However, it has been pointed out to the IRS that the examples are problematic because real estate taxes are statutorily exempt from the floor under IRC § 67(b)(2).²⁵²

b. Tax Preparation Fees

The proposed regulations allow a full deduction for the cost of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax return.²⁵³ The costs of preparing other individual income tax returns, gift tax returns, and tax returns for a sole proprietorship or a retirement plan, for example, are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

c. Investment Advisory Fees

To the extent an investment advisory fee *exceeds* the fee generally charged to an individual investor, *and* that excess is attributable to an unusual investment objective of the trust or estate or to a specialized balancing of the beneficiaries' interests such that a reasonable comparison with individual investors would be improper, that excess is not subject to the 2-percent floor.²⁵⁴ In other words, the investment fees incurred by the fiduciary must exceed those charged to an individual investor or they will be subject to the 2-percent floor. The IRS rationalizes its approach by noting that individual investors commonly have investment objectives that may require a balance between investing for income and investing for growth and/or a specialized approach for particular assets.²⁵⁵

2. “Bundled” Fees

²⁴⁹ Conference Rep. No. 99-841, 99th CONGRESS, 2nd Session, H.R. 3838 (Sept. 18, 1986), p. 34; General Explanation of the Tax Reform Act of 1986 H.R. 3838, JCS-10-87, 99th Cong. P.L. No. 99-514 (May 4, 1987), p. 81.; IRC § 56(b)(1)(A)(i) (no deduction is allowed for miscellaneous itemized deductions as defined in section 67(b) for purposes of the AMT).

²⁵⁰ Reg § 1.67-2T(b)(1) ; Bay v. Comm’r, T.C. Memo 1998-411.

²⁵¹ Prop. Reg. § 1.67-4(b)(2).

²⁵² Comments by ABA RPTE Section on IRS REG-128224-06 (Dec. 7, 2011), *available at* [http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67(e)%257Cestates).

²⁵³ Prop. Reg. § 1.67-4(b)(3).

²⁵⁴ Prop. Reg. § 1.67-4(b)(4).

²⁵⁵ *Id.*

The proposed regulations also address “bundled fees,” which are defined as a “single fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's fee) for both costs that are subject to the 2-percent floor and costs (in more than a de minimus amount) that are not.”²⁵⁶ It is difficult to think of attorneys’ and accountants’ fees as bundled fees, especially if they are computed hourly. Nonetheless, the regulations provide three basic rules for bundled fees.

First, the portion of a bundled fee attributable to investment advice must be identified and subjected to the two-percent floor.²⁵⁷ The rest is fully deductible. This is a hard and fast rule, requiring no analysis of the nature of the investment services. The only exception is for fees computed on an hourly basis, which do not require unbundling.

Second, payments to a third party that are paid out of a bundled fee are subject to the two-percent floor if they would have been subject to the floor if paid directly by the estate or trust.²⁵⁸ And third, any fee separately assessed by the fiduciary or other service provider to the estate or trust that are commonly or customarily incurred by an individual owner of such property are subject to the floor. The regulations provide as an example of a separately assessed expense subject to the floor as a fee charged by the fiduciary for managing rental real estate owned by the trust or estate. However, it has been pointed out to the Service that fees for managing real estate would be deductible above the line under IRC § 62(a)(4) as an expense attributable to the production of rents and royalties.²⁵⁹

3. Any Reasonable Method

Finally, the proposed regulations allow the fiduciary to use any reasonable method to allocate a bundled fee between costs that are subject to the 2-percent floor and those that are not, including the portion of a fiduciary commission attributable to investment advice.²⁶⁰ The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.

4. Comments on the Proposed Regulations

The IRS received four comment letters in response to the September 2011 proposed regulations and dozens of comment letters in response to its earlier proposed regulations.²⁶¹ The comments were nearly unanimous that fiduciary fees should not be unbundled. They pointed out the impossibility of parsing fiduciary fees into the myriad of duties fiduciaries carry out on a daily basis. They also noted that fiduciaries are already

²⁵⁶ Prop. Reg. § 1.67-4(c)(1).

²⁵⁷ *Id.*

²⁵⁸ Prop. Reg. § 1.67-4(c)(2).

²⁵⁹ Comments by ABA RPTE Section on IRS REG-128224-06 (Dec. 7, 2011), available at [http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67(e)%257Cestates).

²⁶⁰ Prop. Reg. § 1.67-4(c)(3).

²⁶¹ [http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67\(e\)%257Cestates](http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=67(e)%257Cestates) (See comments from The American Bar Association RPTE Section, the Texas Society of CPAs, the New York City Bar and Northern Trust Co.).

heavily regulated by various state and federal agencies and their duties cannot be compared to that of an agent or investment advisor for an individual.

If the IRS decides not to require trustees to unbundle their fees based on the comment letters it received, all that would be subject to the floor are investment advisory fees and numerous other insignificant deductions. In that case, smaller trusts would be disadvantaged because nearly all of their costs would be subject to the floor. Nonetheless, the status of the IRC § 67(e) regulations has been upgraded to “final” on the Treasury Department’s 2012-2013 Priority Guidance Plan.²⁶²

D. Distributing Capital Gains to Reduce AGI

One way to reduce the fiduciary’s exposure to the two-percent floor *and* the Medicare is by making distributions to the beneficiaries. However, it can be difficult to reduce the fiduciary’s AGI to zero because capital gains are generally not able to be distributed. Thus, they keep the estate or trust’s AGI high for purposes of the two-percent floor and the Medicare tax, which are both based on AGI.

Capital gains are no small amount for estates and trusts. Historically, they account for about 50 percent of an estate or trust’s gross income.²⁶³ If these gains are not “income” under the governing instrument or local law, they cannot be distributed to the beneficiary.²⁶⁴ Hence the gains are trapped in the fiduciary causing the fiduciary’s adjusted gross income to be high for purposes of the two-percent floor and the Medicare tax. If they could be distributed, the trustee may be able to significantly reduce its tax. While the capital gains would then be included in the beneficiary’s AGI, much of it might be below the beneficiary’s Medicare tax threshold, particularly if the distribution is spread among several beneficiaries.

The regulations, however, describe certain circumstances under which capital gains can be distributed.

1. Capital Gain Distributions Under the Regulations

IRS regulations provide that a trustee may include capital gains in DNI and distribute it to the beneficiaries only when:²⁶⁵

- a) capital gains are allocated to income by the governing instrument or local law;²⁶⁶
- b) the fiduciary has discretion to allocate capital gains to income under the governing instrument or local law;²⁶⁷
- c) the fiduciary *consistently* distributes capital gains to the beneficiary;²⁶⁸

²⁶² Department of the Treasury 2012-2013 Priority Guidance Plan, Third Quarter update, May 2, 2013, available at http://www.irs.gov/pub/irs-utl/2012-2013_pgp_3rd_quarter_update.pdf.

²⁶³ <http://www.irs.gov/uac/SOI-Tax-Stats---Fiduciary>Returns---Sources-of-Income,-Deductions,-and-Tax-Liability-Type-of-Entity>.

²⁶⁴ IRC § 643(a)(3).

²⁶⁵ Reg. § 1.643(a)-3.

²⁶⁶ Reg. § 1.643(a)-3(b)(1).

²⁶⁷ *Id.*

d) the fiduciary actually distributes the capital gains to the beneficiary or utilizes the capital gains to determine an amount distributed or required to be distributed to a beneficiary.²⁶⁹

Nearly all state unitrust statutes provide the needed authority to distribute capital gains by providing an ordering rule. These ordering rules generally carry out ordinary and tax-exempt income first, then short-term capital gains, then long term capital gains, and then principal. This order follows the examples in the regulations.²⁷⁰ However, these examples in the regulations are safe harbors only.²⁷¹ They do not preclude other means of distributing capital gains in a unitrust, especially if the trust instrument provides a different method.

For example, the trust instrument could direct that capital gains are allocated to a unitrust distribution in the same proportion the trust's total capital gains bear to its total taxable income for the year. Thus, unitrust distributions would carryout a cross section of the trust's capital gains and other classes of income. It is not clear whether the IRS will recognize this as a valid means of distributing capital gains. Regardless, it should not adversely affect the trust's qualification as a marital trust because the § 2056 regulations require only that the trustee's power to adjust meet the requirements of Reg. § 1.643(b)-1, which addresses the *amount* and not the character of the income distributed.²⁷²

However, only two states grant the trustee with a power to adjust the discretion to characterize all or part of the adjustment as capital gain.²⁷³ The drafters in these states believe that the regulations require the fiduciary to have express authority over capital gains in the governing instrument or local law in order to distribute those gains as part of a power to adjust. A plain reading of the regulations suggests that this is correct. If that is the case, the power to adjust alone does not provide the trustee authority to include capital gains in that adjustment. Consequently, drafters of new trust instruments should consider granting express authority to allocate capital gains as part of a power to adjust in the governing instrument. If the governing instrument grants the trustee discretion to determine what is income and principal, it should state that the power includes the discretion over capital gains.

²⁶⁸ Reg. § 1.643(a)-3(b)(2).

²⁶⁹ Reg. § 1.643(a)-3(b)(3).

²⁷⁰ Reg. § 1.643(a)-3(e), Examples 11 and 13.

²⁷¹ Reg. § 1.643(a)-3(e), Examples 11 and 13.

²⁷² Reg. § 1.2056(b)-7(d)(1).

²⁷³ S.D. CODIFIED LAWS § 55-13A-104.

2. Including Partnership Capital Gains in DNI

The question often arises whether capital gains from a partnership are includible in DNI. The regulations do not address this issue, despite that the AICPA asked the IRS to address it in comments on the proposed regulations under IRC § 643 in 2001.²⁷⁴ In response, the Preamble to the final regulations simply states:

“One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.”²⁷⁵

Despite the IRS’s silence on the issue, it seems relatively clear that partnership capital gains should be included in DNI based on a plain reading of IRC § 643(a). The statute defines DNI as taxable income minus “gains from the sale or exchange of capital assets...to the extent that such gains are allocated to corpus and are not ...paid, credited, or required to be distributed to any beneficiary during the taxable year” or permanently set aside for charity. Note that partnership capital gains are not “gains from the sale or exchange of capital assets...allocated to corpus.” They are capital gains of a separate legal entity over which the trustee has no power to allocate to corpus. The trustee can only allocate *receipts* from the entity to corpus if they meet the definition of principal under the governing instrument or local law.²⁷⁶

The United States Court of Federal Claims addressed this very issue in *Crisp v. United States*.²⁷⁷ In *Crisp*, the Hunt Trust invested \$5 million for a 2/3 limited partnership interest in ZH Associates, a Texas limited partnership. ZH generated a large amount of capital gains from sophisticated trading activities such as arbitrage and hedging. The trustee, Don Crisp, included the trust’s share of the partnership capital gains in DNI and carried them out to the income beneficiary, Caroline Hunt. The IRS challenged the inclusion of the partnership’s capital gains in the trust’s DNI as contrary to the Texas Trust Code, the trust instrument, and IRC § 643(a).

First the IRS argued that partnerships are not separate taxpayers under §§ 701 and 702, but mere conduits through which tax items flow through to their partners. As a conduit, the partnership capital gains are corpus and should not be included in DNI. However, the Court noted that the Internal Revenue Code does not control the allocation between income and principal. Second, the IRS analogized partnership profits to capital gains from regulated investment companies (RICs) and mutual funds, which the Texas Trust Code allocates to corpus even though the trust does not hold title to the underlying securities. However, the Court was not persuaded by this argument either because ZH was neither a RIC nor a mutual fund.

Third, the IRS pointed out that the partnership capital gains fit squarely the definition of capital gains in the tax code and therefore they should be excluded from DNI under IRC

²⁷⁴ Tax Notes Today, 2001 TNT 97-26 (May 17, 2001) (Comments by the AICPA to Treasury regarding the proposed regulations to revise the definition of trust income under Section 643(b)).

²⁷⁵ T.D. 9102.

²⁷⁶ See also E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).

²⁷⁷ *Crisp v. United States*, 34 Fed. Cl. 112 (1995).

§ 643(a)(3). However, the Court reminded the IRS again that although the Internal Revenue Code affects the rate of tax on capital gains, it does not control whether they are income or principal. Finally, the IRS argued that allowing the trustee to treat partnership capital gains as income permitted him to use the partnership form to convert corpus into income. However, the Court pointed out that trustees can do this anyway simply by choosing whether to invest in income or growth assets. Further, the trustee was merely exercising the discretion granted him in the trust instrument to choose among various business structures.

In sum, the Court held that the partnership profits are not corpus under either the trust agreement or state law because the trust did not acquire the securities. Rather, the partnership, a distinct legal entity acquired the securities.²⁷⁸ It also gave weight to the fact that the trustee hired a national accounting firm to audit the trust and they determined that its partnership profits were income. The Court also found that allocating partnership capital gains to income did not jeopardize the interests of the remaindermen. Even if the trustee's allocation favored the income beneficiary, the facts indicate that the settlors intended that result. Therefore, the capital gains from the partnership constituted trust income.

Even though *Crisp* was decided before the final § 643 regulations and the adoption of the Uniform Principal and Income Act (1997), its holding is still sound because partnership capital gains are not “gains from the sale or exchange of capital assets...allocated to corpus” under either state law, the governing instrument, or IRC § 643(a).

E. Legislative Proposals to Amend § 67(e)

The AICPA has made IRC § 67(e) reform a top legislative priority over the last several years. It has written members of Congress several letters since 2008 when Knight was decided urging it to allow estates and trusts a full deduction for all ordinary and necessary administrative costs. However, given the divided Congress and the attack on loopholes for the wealthy, a legislative fix to IRC § 67(e) is not likely to pass any time soon.

IX. Conclusion

Sophisticated estate planners are constantly designing new structures and planning opportunities for their trust clients. Fiduciaries and their tax return preparers must keep up with these transactions and their possible income tax consequences, not all of which are obvious to the naked eye. The fiduciary's decisions have a significant impact on beneficiaries for generations to come. Therefore, it is imperative that the fiduciary stay on top of the transactions that their clients are engaging in and communicate regularly with their CPA and other advisors.

²⁷⁸ *Crisp v. United States*, 34 Fed. Cl. 112 at 118-120.