2010 ESTATE TAX CHANGES AFFECTING TRUST ADMINISTRATION

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I. INTRODUCTION

IRS statistics show that 3.1 million fiduciary income tax returns were filed in 2008 compared to 3.7 million during 2007.[1] This drop in fiduciary returns may be due to shrinking estate values and the increasing exemption. This would, in turn, reduce the need for multiple trusts. However, this trend may be reversing as property values rebound and Congress takes some action on estate tax reform.

Congress's failure to prevent the automatic repeal of the estate tax and the application of the carryover basis rules made the trustee's job harder than ever in 2009 and 2010. The IRS kept trustees and their advisors in the dark on many fronts, namely which administrative expenses would be subject to the 2-percent floor, whether trustees' fees should be unbundled, how long discounts on family partnerships would survive, the income tax consequences of sales to an intentionally defective grantor trust (IDGT) on death of the grantor, whether discounts are dead o alive, and how trustees can "materially participate" for passive activity purposes.

On top of all this, estates and trusts have been called upon to help fund health care by paying a 3.8 percent surtax on virtually all of their gross income. This environment demands that trustees be more than good investment advisers. They must take an active role in planning, strategizing, and documenting their decisions in order to protect the beneficiaries from excessive tax burdens and to protect themselves from claims for breach of fiduciary duty.

II. TEXAS LEGISLATIVE DEVELOPMENTS

A. 2010 Margin Tax Changes Affecting Estates and Trusts

Estates and trusts are subject to the Texas margin tax just like any other entity if they have business or rental income. But there are several ways to minimize or eliminate the franchise tax for entities with less than $1 million of gross receipts, passive entities, and entities with non-Texas gross receipts.[2] Grantor trusts are also exempt as long as their grantors and beneficiaries are all natural persons or charitable entities under IRC § 501(c)(3).[3]

Business trusts described in Reg. § 301.7701-4(b), which are "a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code" are subject to the franchise tax.

1. Passive Entities. A trust can qualify as a passive entity if at least 90 percent of its "federal gross income" as defined in IRC § 61(a) consists of dividends, interest, foreign exchange gains, options, royalties, bonuses or delay rentals from nonoperating mineral interests, gains from the sale of real property or securities, and distributive shares of partnership income to the extent

[1] Table 1. Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Tax Status and Size of Gross Income, Filing Year 2008, *available at* http://www.irs.gov/pub/irs-soi/08fd01.xls.
[2] Tex. Tax Code §§ 171.002(d), as amended for reports due in 2010 and 2011 (exemption for small businesses with total revenue under $1 million or total tax computed of less than $1,000); Tex. Tax Code § 171.0003(a) (passive entities); Tex. Tax Code § 171.103 (non Texas gross receipts).
[3] Tex. Tax Code § 171.0002(c)(1).

greater than zero.[4] In addition the trust may not receive more than 10 percent of its federal gross income from an active trade or business.[5]

i. Reporting Requirements. Trusts that meet the passive entity test need not file a report or register with the Secretary of State.[6] Trusts that fail the passive entity test must register with the Comptroller by completing Form AP-224 (Texas Business Questionnaire).[7] Trusts that filed reports in the past may file a final report in the year they qualify as passive.[8]

ii. Trusts with Rental Property. Trusts with rental property will fail the passive entity test if the gross rental income exceeds 10 percent of the trust's total federal gross income. Even missing the 90 percent test by a slim margin will subject all of the trust's income to the franchise tax, which could be quite costly. A trust with rental income greater than 10 percent of its federal gross income should consider transferring its rental property to a general partnership. Doing so would convert its rental income to a distributive share of partnership income, which is passive by definition.[9] In addition, the denominator of the passive income test would now contain only *net* rental income instead of gross rental income, making it easier to meet the 90 percent passive income test.

The strategy of transferring rental property to a partnership to qualify the trust as a passive entity was uncertain prior to 2010. Before its amendment in 2009, § 3.582 of the Texas Administrative Code defined federal gross income as "gross income defined by IRC § 61(a)," which includes a partner's share of *partnership gross income*.[10] As such, the denominator of the 90 percent test would contain the partner's share of *gross* partnership income, making it harder to meet the 90 percent passive income test.

EXAMPLE

A trust has $200,000 of investment income and $10,000 of income from a partnership that owns rent property. At first it appears that the trust is a passive entity because all of its income is passive. However, if its share of partnership *gross* income must be included in the denominator of the 90 percent test, the trust will not qualify as passive because only 84 percent of its income is passive. Assume that the trust's share of partnership gross income is $50,000.

$$\frac{\$200{,}000 + \$10{,}000}{\$200{,}000 + \$50{,}000} = 84\%.$$

However, to clarify the rule, the comptroller amended the definition of federal gross income in TAC § 3.582 to include "income *that is reported* on the entity's federal income tax return, to the extent the amount reported complies with federal income tax law."[11] This amendment reflects

[4] Tex. Tax Code § 171.0003(a); TAC § 3.582(c)(2).
[5] Tex. Tax Code §§ 171.1011(c)(3), 171.1011(c)(2)(A)(iv) (referencing rental income on IRS Form 8825).
[6] TAC § 3.582(g), as amended, 34 Tex. Reg. 9464; *see also* Instructions to Texas franchise Tax Report.
[7] Ibid.
[8] Ibid.
[9] Tex. Tax Code § 171.0003(a)(2)(B) (distributive shares of partnership income are passive to the extent they are greater than zero)
[10] IRC §§ 61(a)(13), 702(c).
[11] TAC § 3.582(b)(3), as amended, 34 Tex. Reg. 9464.

the Comptroller's policy of including only income that is actually reported on the federal return in the denominator of the 90 percent test. As such, transferring rental property to a partnership will help a trust meet the definition of passive entity and avoid filing a franchise tax return. Trusts that previously filed reports must file a final report in the year they first qualify as a passive entity.[12]

The Comptroller also recently addressed the issue of whether rental income from a partnership is passive or retains its character as rental income when it flows through. In June of 2008, the Comptroller maintained that rental income included in a distributive share of partnership income retains its character as rental rather than passive when it flows through to the partner.[13] Unfortunately this position contradicted the statute, which expressly states that an entity's distributive share of income from a partnership is passive.[14] It would also have eliminated the strategy of transferring rental property to a partnership to meet the passive income test. The Comptroller proposed to incorporate her position in amended rules. However, based on comments from the TSCPA and the State Bar, she withdrew her proposal. Thus, for the time being, rental income from a partnership is passive.

2. Small Business Exception. Nongrantor trusts can also avoid the margin tax if their total revenue is less than or equal to $1,000,000 or the margin tax is less than $1,000.[15] However, the $1,000,000 threshold is reduced to $600,000 for reports due in 2012 and after.

3. Little or No Texas Gross Receipts. If a trust cannot meet either the passive entity or the small business exception, it can minimize its margin tax if it has little or no Texas receipts.[16] The margin tax is reduced proportionately by the ratio of non-Texas receipts to total gross receipts. Surprisingly, the Texas Tax Code exempts many kinds of income from Texas receipts. To name a few, dividends and interest are non-Texas receipts if the payor is a national bank with a principal location outside of Texas, a state bank not organized under the Texas Banking Code, or a corporation not domiciled in Texas.[17] In addition, the Code excludes from Texas receipts 92.1 percent of the gain on sale of stock or securities if the sale is made through an exchange. It excludes 100 percent of the gain if the purchaser's legal domicile is outside Texas.[18]

Even though a trust may be required to file a franchise tax report under these rules, it may not owe any tax due to one or more of the exemptions. Moreover, estates and trusts have no penalty for failure to file because they have no state charter or liability protection to lose.

B. New Definition of "Trust Income" from an IRA

When a trust is the beneficiary of an IRA, deferred compensation plan, annuity, or other separate fund, the Texas Uniform Principal and Income Act (UPIA) § 116.172 defines trust income as 4 percent of the fair market value of the fund.[19] Amounts in excess of that are

[12] TAC § 3.582(g)(1), as amended, 34 Tex. Reg. 9464.
[13] Texas State Comptroller's website, Frequently Asked Questions, Passive Entities, Q&A 12, *available at* http://www.window.state.tx.us/taxinfo/franchise/faq_pass_ent.html#pass_ent12
[14] Tex. Tax Code § 171.0003(a); TAC § 3.582(c)(2)(B).
[15] Tex. Tax Code §§ 171.002(d), as amended for reports due in 2010 and 2011.
[16] Tex. Tax Code § 171.103.
[17] TAC §§ 3.591(e)(8)(C), (D).
[18] TAC § 3.591(e)(25).
[19] Tex. Prop. Code § 116.172(c)(1).

allocated to principal. However, Rev. Rul. 2006-26 rejected any definition of trust income for a marital trust from IRAs and similar funds that does not require either a distribution equal to a) all of the separate fund's *traditional* income (dividends, interest, etc.), b) a 3 to 5 percent unitrust, or c) income determined under a power to adjust as if the separate fund were a separate trust under state law. A marital trust must comply with this definition of trust income from an IRA or fail to qualify as a marital trust under § 2056. Even though former UPIA § 409 contained a savings clause that allowed a trustee to allocate more of an IRA payment to income if necessary to qualify a marital trust, Rev. Rul. 2006-26 rejected the savings clause as sufficient.

In order to prevent trusts from being disqualified as marital trusts under Rev. Rul. 2006-26, NCCUSL amended its definition of trust income from deferred compensation plans, annuities, IRAs, and other separate funds in UPIA § 409 to comply with Rev. Rul. 2006-26. Texas adopted NCCUSL's changes in 2009. New Texas Property Code § 116.172(h)-(k) now requires the trustee of a marital trust to determine the "internal income" of a separate fund (annuity, IRA, pension, profit sharing, stock-bonus or stock-ownership plan) as if it were a separate trust under the Texas Trust Code. On request of the surviving spouse, the trustee must demand that the internal income of the separate fund be paid to the trust. If the separate fund fails to do so, the trustee must allocate other principal to income to make up the shortfall.

These changes are effective for trusts existing on or created after September 1, 2009 and will help protect trusts from inadvertently failing to qualify for the marital deduction because of drafting deficiencies. These changes will also likely result in smaller distributions for the beneficiary of a marital trust than under the old law to the extent the IRA or other separate fund earns less than 4 percent. However, trustees with the power to adjust should be able to shift principal to income to adjust for any perceived inequities this may cause.[20]

C. Texas Declines to Adopt NCCUSL Changes for Taxes on Partnership Income

Trusts that own partnerships face special problems when the partnership fails to distribute all its taxable income. This creates "phantom income," the taxes on which must be allocated between income and principal. Texas Property Code § 116.205 provides:

> **§ 116.205(c)** A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately:
> (1) from income to the extent that receipts from the entity are allocated to income; and
> (2) from principal to the extent that:
> (A) receipts from the entity are allocated to principal; and
> (B) the trust's share of the entity's taxable income exceeds the total receipts described in Subdivisions (1) and (2)(A).
> **(d)** for purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

[20] Tex. Prop. Code § 116.005.

Applying this rule is not as easy as it seems. The simplest situation is where the entity makes no distributions at all.

1. The Partnership Makes No Distributions. If the entity makes no distributions to the trust, but issues the trust a K-1 reflecting its share of the entity's taxable income, the trustee must allocate the tax to principal.[21] Hopefully, the trustee has cash to pay the tax. If the partnership or S corporation later distributes this accumulated taxable income in a distribution that constitutes trust income, the income beneficiary may receive a tax-free distribution, depending on the trust's DNI from other sources that year. The trustee must then decide whether to reduce the income beneficiary's distribution to repay the principal for the taxes it paid in Year 1. However, this is entirely discretionary with the trustee.[22]

The matter is further complicated if the trust has DNI from other sources payable to the beneficiary in the same year it receives a K-1 with undistributed income from the entity. Distributing that other trust income may also sweep out part of the entity's K-1 taxable income under the DNI carryout scheme.[23]

EXAMPLE

> A Trust receives a K-1 from Partnership reflecting dividend and interest income of \$100,000, but makes no distributions. The Trust also receives \$100,000 of tax-exempt interest from municipal bonds it owns. The Trust distributes the \$100,000 of trust income to the income beneficiary who expects to receive it tax-free. However, the Code requires the distribution to be treated as consisting of \$50,000 of dividends and interest and \$50,000 of tax-exempt interest.[24]

If the trustee makes another distribution to compensate the beneficiary for the tax, it carries out more taxable income, requiring another reimbursement, and so forth. Although equitable adjustments are allowed, they are not mandatory under Tex. Prop. Code § 116.206(a)(3).

2. The Partnership Designates a Payment for Taxes. Another common situation occurs where the partnership designates a distribution to pay the trust's taxes on its share of the entity's taxable income. In that case, the payment should be allocated to principal because the entity does not intend that it be income payable to the beneficiaries.

EXAMPLE

> ABC Trust receives a K-1 from Partnership reflecting taxable income of \$ 1 million. Partnership distributes \$350,000 to the trust specifically to pay its tax at the 35 percent bracket. Because the partnership designated the payment for taxes, the trustee uses the \$350,000 to pay its tax on its share of undistributed partnership taxable income and the income beneficiary receives nothing.

[21] Tex. Prop. Code §§ 116.205(c); This result is also achieved under the default rule of § 116.004(a)(4) that allocates receipts and disbursements to principal unless otherwise provided for in the trust instrument or the Texas Trust Code.
[22] Tex. Prop. Code § 116.206(a)(3).
[23] IRC §§ 652(b), 662(b); Reg. §§ 1.652(b)-1, 1.662(b)-1.
[24] IRC § 643(a)(5); Reg. § 1.643(a)-5(a).

3. Partnership Distributes Enough to Pay the Tax, But Less Than its Taxable Income. Things become even more complex when the trust receives payments from a partnership in excess of the tax on the partnership's K-1 income, but less than the partnership's total taxable income. In this case, it is not clear how the tax should be allocated between income and principal. Texas Property Code § 116.205(c) is ambiguous in this regard.

EXAMPLE

> ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $500,000 to the trust. The Partnership represents that the distribution is income and so the trustee initially allocates the entire $500,000 to income. The trust is in the 35 percent tax bracket.

Practitioners have interpreted UPIA § 505(c) two ways. It can be read to require a distribution of the entire $500,000 to the income beneficiary. Or it can be read to require a distribution only to the extent that the $500,000 exceeds the trust's tax on the partnership K-1 after deducting the payment to the beneficiary. This latter interpretation requires the trustee to apply an algebraic formula to determine the amount due the beneficiary because the distribution and the trust's tax are interrelated. That is, the distribution reduces the trust's tax, which increases the amount due the beneficiary, which reduces the trust's tax, and so on. The equation to solve the amount due the beneficiary is an **"infinite series approaching a finite sum."**

D = (C-R*K)/(1-R)

D= Distribution to the income beneficiary
C= Cash paid by the partnership to the trust
R= Rate of income tax
K= the partnership's taxable income shown on Schedule K-1

Using the formula, the trustee in the above example must pay the income beneficiary $230,769 so that after the distribution, the trust has exactly enough to pay its own tax.

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[25]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	
Partnership Distribution		$ 500,000
Fiduciary's Tax Liability		(269,231)
Payable to the Beneficiary		$ 230,769

This circular calculation occurs only when the entity distributes more than enough to pay the tax on its taxable income, *but less than* its total taxable income. When the entity distributes

[25] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

less than enough to pay the tax on the trust's share of the entity's taxable income, the trust must retain the entire distribution to pay its income tax. And when the entity distributes its entire taxable income or more, the trust's tax attributable to its share of the entity's taxable income is zero because paying that amount to the beneficiary reduces the trust's share of the entity's taxable income to zero.

Alternate Interpretation

Some practitioners interpret Tex. Prop. Code § 116.205 as requiring the trustee to reduce income receipts by the amount for which the trustee receives a distribution deduction *before* allocating tax between income and principal. In the above example the trustee would reduce income receipts by $500,000 before figuring the trust's tax. Consequently, income receipts are zero and the trustee allocates no taxes to the income beneficiary.

The trustee pays the income beneficiary the entire $500,000 it received from the partnership. The trust also deducts $500,000 from its taxable income and pays tax of $175,000 on its remaining $500,000 of taxable income [35% X ($1,000,000 - $500,000)]. The income beneficiary reports the $500,000 distribution received on his or her personal income tax return and pays tax of $175,000.

The alternate interpretation seems fair because the income and principal beneficiary each bear half of the $350,000 tax in proportion to the amount they each received or retained. However, if the partnership distributes the $500,000 of undistributed taxable income next year, the trustee may want to make an equitable adjustment to reimburse the principal for the tax it paid on that amount the previous year.[26]

Critics fault the alternate interpretation because it leaves the trustee no source of cash to pay the tax. However, the UPIA does not address the trustee's liquidity problems. While the drafters of the statute may have intended to provide a source of cash for the trustee to pay the tax on undistributed income, its plain reading does not do so. Therefore, if taxes on undistributed income of a passthrough entity create liquidity problems, the trustee should consider whether the entity is a suitable investment for it.

NCCUSL's Amendments to UPIA § 505

To help clear up the confusion, NCCUSL amended UPIA § 505 to specify that the trustee must reduce the distribution from the partnership by the amount of its taxes before paying the income beneficiary. This requires an algebraic equation, which the revised comments to UPIA 505 provide along with the same example as used in this outline. The amended version of UPIA § 505(c) and (d) read:

> (c). A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid:
>
> (1) from income to the extent that receipts from the entity are allocated only to income;
>
> (2) from principal to the extent that receipts from the entity are allocated only to principal;

[26] Tex. Prop. Code § 116.206.

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal;

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) After applying subsections (a)-(c) of this section, the trustee must adjust income or principal receipts to the extent that its taxes are reduced because it receives a deduction for payments made to a beneficiary.

Texas did not adopt NCCUSL's changes in the 81st legislature, however. Maybe there is no perfect way to allocate taxes on undistributed entity income. The NCCUSL amendment seems harsh to the income beneficiary because he pays the tax on accumulated income that inures to the benefit of the principal. In addition, the trustee will not know the correct amount of tax to withhold from the income beneficiary until well after year end when he receives the K-1 from the entity. On the other hand, the alternate interpretation seems unfair to the principal leaving it with no cash to pay the tax. Both interpretations cause the trustee to consider an equitable adjustment if the partnership distributes the accumulated income in a subsequent year.

New trusts on the drawing board should anticipate these problems and draft more specific tax allocation language, if they can. But other trustees should simply be aware that taxes need to be allocated, exercise judgment, and document the basis for his decision.[27] Nonetheless, it is likely that disputes over the meaning of Texas Prop. Code § 116.206 will be resolved in favor of the UPIA version because it was amended to clarify an ambiguous statute rather than make any substantive changes.

III. 3.8 PERCENT SURTAX ON NET INVESTMENT INCOME

For taxable years beginning after December 31, 2012, new IRC § 1411 imposes a surtax of 3.8 percent on the unearned income of individuals, estates, and trusts. The surtax is in addition to all other taxes imposed by Subtitle A (Income Taxes), including the alternative minimum tax.[28] In the case of an estate or trust, 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 ($11,200 in 2010) or b) undistributed net investment income.[29] 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.[30]

A. Adjusted Gross Income

Adjusted gross income (AGI) of an estate or trust is determined under § 67(e). It 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

[27] *See also* BYRLE M. ABBIN, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES § 207.5.1 et. seq. (13th ed. CCH 2009).
[28] IRC § 1411(a)(1).
[29] IRC § 1411(a)(2).
[30] IRC § 1(f); IRC § 1411(b).

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 to mean costs that hypothetical individuals would not commonly or customarily incur if they owned the same property.[31] Unfortunately, there is a great deal of confusion over what costs this covers.

Multiple Trusts. It has been suggested grantors should create multiple trusts, where feasible, or divide an existing trust into smaller trusts, consistent with the governing instrument and local law, in order to obtain multiple surtax thresholds. Congress anticipated grantors attempting to game the system with multiple trusts and the Deficit Reduction Act of 1984 added § 643(f) to provide that two or more trusts will be treated as one if they have substantially the same grantor(s) and substantially the same beneficiaries and the principal purpose is to avoid the tax imposed by Chapter 1 (Normal Taxes and Surtaxes).[32] Therefore, if the trust can establish a legitimate non tax avoidance motive for multiple trusts, it should be able to obtain multiple surtax exemptions. In addition, § 643(f) only applies if the principal purpose is to avoid taxes imposed by Chapter 1 (Normal Taxes and Surtaxes). However, the 3.8 percent surtax is imposed under Chapter 2 (Tax on Self-Employment Income).

B. Net Investment Income

Net investment income means the sum of eight specifically enumerated categories of income less deductions that are properly allocable to such income.[33] It includes gross income from (1) interest, (2) dividends, (3) annuities, (4) royalties, and (5) rents, *other than* such income that is derived in the ordinary course of a trade or business. It also includes (6) income from passive activities under § 469, (7) income from trading financial instruments or commodities as defined in § 475(e)(2), and (8) net gain from the disposition of property other than property held in a trade or business other than passive activities.

Several types of income are excluded from net investment income. The statute expressly excludes distributions from IRAs and qualified plans.[34] It also excludes nonpassive trade or business income.[35] Other types of income are excluded simply by omission, including tax exempt income, inside build up of annuities, income from noncompete agreements, guaranteed payments from partnerships, and more. Tax exempt income and inside annuity build up are excluded because they are not included in gross income. Guaranteed payments are excluded because § 1411(c)(6) excludes any item subject to self-employment tax. Guaranteed payments that are not subject to self-employment tax, such as those from investment partnerships, are also excluded from investment income because they are not one of the eight specifically enumerated categories of investment income under § 1411(c)(1)(A).

The statute imposes the surtax on the lesser of "undistributed net investment income" or AGI in excess of the applicable threshold. Undistributed net investment income is not defined. Presumably it means net investment income minus distributions to beneficiaries, excluding

[31] Knight v. CIR, 552 U.S. 181 (2008).
[32] IRC § 643(f).
[33] IRC § 1411(c)(1).
[34] IRC § 1411(c)(5).
[35] IRC § 1411(c)(1)(A)(ii).

distributions of amounts that do not constitute net investment income. Distributions reduce both AGI and net investment income. Therefore, the trustee may want to make distributions to beneficiaries if the beneficiaries will not be subject to the surtax because their AGI is below the $250,000/$200,000 threshold that applies to individuals.

Net Gains From the Disposition of Property. Net gains from the disposition of property other than property held in a nonpassive trade or business are included in both AGI and undistributed net investment income for purposes of the surtax. Net capital losses do not reduce either. But gains from the disposition of assets are usually retained as corpus by a trust and therefore are not included in DNI available for distribution to beneficiaries. Hence they become trapped in the trust and subject to the surtax.

However, there are certain circumstances where capital gains can be included in DNI and distributed to beneficiaries. IRS regulations describe some of these circumstances under which capital gains can be included in DNI.[36] These 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, *Crisp v. United States* holds that capital gains flowing from a partnership K-1 can be included in DNI and carried out to the beneficiaries.[37] Therefore, the trustee may want to consider investing through a partnership so that capital gains can be distributed to the beneficiaries who may be under the surtax threshold.

IRA Distributions. IRA distributions are included in AGI, but excluded from net investment income.[38] 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 largely escape the surtax, it may be good planning to designate a trust as an IRA beneficiary. To the extent that the trust distributes the IRA distribution to the beneficiary, the income retains the same character in the hands of the beneficiary as it had in the hands of the trust.[39] Thus, IRA distributions from an estate or trust should be exempt from the net investment income of the individual.

Passive Income. Income from passive activities is included in both AGI and net investment income. Passive income is defined as trade or business income in which the taxpayer does not materially participate and rental income without regard to the taxpayer's participation.[40] The IRS maintains that a trustee must meet the material participation test himself and may not rely on the participation of its employees or agents.[41] However, case law suggests the opposite.[42] The regulations are silent on material participation by estates and trusts.[43] And even if the trustee

[36] Reg. § 1.643(a)-3.

[37] Crisp v. United States, 34 Fed. Cl. 112 (1995).

[38] IRC § 1411(c)(5).

[39] IRC § 652(b).

[40] IRC § 469(c); Reg. § 1.469-1T(e)(1).

[41] TAM 200733023.

[42] Carter v. United States, 256 f. Supp 2d 536 (N.D. Tex. 2003).

[43] Reg. §§ 1.469-5T(g); 1.469-8T.

materially participates in the business, the trustee's share of interest, dividends, annuities, royalties, or rents produced by the activity will be subject to the surtax unless it is derived in the ordinary course of the trade or business.[44] Examples in the regulations indicate that it is very difficult to establish that interest, dividends, annuities, royalties and rents are ever derived in the ordinary course of a trade or business.[45]

Regardless of participation, rental income is per se passive unless a) the average period of customer use is seven days or less, b) the average period of customer use is 30 days or less and significant personal services are provided in connection with making the property available for use, or c) extraordinary personal services are provided in connection with making the property available for use.[46] Nonetheless, rental income can be offset by favorable depreciation deductions. A trust with rental income or other passive income might consider investing in passive loss activities to shelter its passive income from the surtax.

Expenses. Expenses attributable to gross income or net gain are deductible in computing net investment income.[47] However, these same expenses are not necessarily deductible in arriving at AGI. Therefore, the trustee's classification of expenses will impact the amount of the surtax in at least a couple of ways. First, miscellaneous itemized deductions in excess of the 2 percent floor will reduce net investment income, but not AGI. Therefore if AGI in excess of the $11,200 threshold is less than undistributed net investment income, the miscellaneous itemized deductions will not reduce the surtax. In this case, the trustee should try to classify as many expenses as it can "above the line."

Second, the trustee's allocation of expenses to various classes of income distributed to the beneficiary may impact the beneficiary's surtax. To the extent that the trustee allocates expenses to income that is excluded from the beneficiary's surtax base, such as tax-exempt income, these deductions are wasted for purposes of the beneficiary's surtax. Therefore, the trustee should allocate as few expenses as reasonably possible to tax exempt and other such income that is excluded from the surtax. The regulations give some guidance on how the trustee should allocate expenses to various classes of income distributed.[48] They require that direct expenses be allocated to the class of income to which they relate. They allow indirect expenses to be allocated to any category of income, as long as a portion is allocated to tax exempt income.[49] The regulations list trustee fees, safe deposit box rental, and state income and personal property taxes as examples of indirect expenses that may be allocated to any category of income.[50]

C. Minimizing the Surtax

There are a number of strategies available to reduce the 3.8 percent surtax on the trustee and the beneficiary. The first strategy is to distribute trust income to beneficiaries who are below the surtax threshold. This reduces the trustee's surtax without increasing the beneficiary's surtax.

[44] IRC § 1411(c)(1)(A)(i).
[45] Reg. § 1.469-2T(c)(3)(iv), Examples 1-6.
[46] IRC § 469(b)(2); Reg. § 1.469-1T(e)(3)(ii).
[47] IRC § 1411(c)(1)(B).
[48] IRC § 652(b); Reg. § 1.652(b)-3.
[49] Id.
[50] Reg. § 1.652(b)-3(c).

Second, the trustee should consider investing in tax exempt bonds and annuities, which are not included in the surtax base. Annuities owned by a trust for the benefit of a natural person are considered owned by a natural person and continue to enjoy the inside tax deferred build up.[51] Not so for annuities owned by a partnership.[52]

Third, the trustee should consider investing through a separate legal entity such as an LLC or partnership. Capital gains produced by the entity are not trust corpus and thus may be included in DNI and distributed to beneficiaries.[53] Fourth, the trustee should carefully document how expenses it incurs are not commonly incurred by individuals in order to reduce AGI if that will reduce AGI in excess of the threshold below undistributed net investment income. Fifth, it is possible that dividing into multiple trusts will afford the trustee multiple surtax thresholds. But the administrative cost may not be worth the savings. And last, trust should be named as the beneficiary of an IRA where possible because IRA distributions are not subject to the surtax.

IV. UNBUNDLING TRUSTEE FEES AND THE 2-PERCENT FLOOR

Trusts incur a variety of administrative costs each year. Many of these costs are classified as miscellaneous itemized deductions under IRC § 67(a) and are only deductible to the extent they exceed 2 percent of the estate or trust's adjusted gross income (AGI). Individuals are also subject to this rule and its application to them has always been relatively straightforward. But there is a great deal of uncertainty about how it applies to estates and trusts. Section 67(e) provides an exception from the floor for estates and trusts for administrative costs "which would not have been incurred if the property were not held in such trust or estate…" The meaning of that phrase has been debated by nine different courts, culminating with the U.S. Supreme Court's opinion in *Knight v. Commissioner*. [54]

A. The Supreme Court's Interpretation in *Knight*

On January 16, 2008 the U.S. Supreme Court in *Knight v. Commissioner* attempted to resolve the dispute and held that the statute allows estates and trusts a full deduction only for costs that individuals do not "commonly" incur.[55] While the *Knight* opinion narrowly dealt with investment advisory fees paid by the Rudkin Trust, its interpretation of § 67(e)(1) broadly applies to every type of fiduciary administrative cost except those specifically exempted from the floor under § 67(b), such as taxes, interest, casualty losses, and a handful of other deductions. Although there is not room for a complete laundry list of the possible administrative costs of estates and trusts affected here, a few of the costs in question are:

- Trustee fees
- Accounting fees
- Legal fees
- Bank charges
- Safe deposit box

[51] Ltr. Rul. 199905015, 9752035, 9639057, 9204010, 9204014.

[52] CCA 199944020.

[53] Crisp v. United States, 34 Fed. Cl. 112 (1995).

[54] Knight v. Comm'r, 552 U.S. 181 (2008); opinion and a transcript of the oral argument available at www.supremecourtus.gov.

[55] Knight v. Comm'r, 552 U.S. 181 (2008).

- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)
- Tax advice and preparation
- Property maintenance
- Costs from passthrough entities

The Supreme Court held that in order to determine whether the trust's administrative costs are fully deductible, the trustee must predict whether a hypothetical individual with the same property would commonly incur the same cost. If they would, then the cost is subject to the floor. If they would not, the cost is fully deductible.

Based on this, it seems that lawyers and accountants should provide their trust clients detailed statements, itemizing which costs are "commonly incurred" by individuals and which are not. They might also describe in their engagement letters how their services to the estate or trust are distinct from those provided to individuals. They might also use special billing codes to code time that is unique to estates and trusts. However, this can be quite a challenge. In short, the Supreme Court created an administrative nightmare for both the IRS and the taxpayer, who must now determine whether each expenses incurred by the trust would have been "commonly" incurred by an individual holding the same property as the trust.[56]

B. Proposed Regulation § 1.67-4

Before the Supreme Court's decision in *Knight*, the IRS had issued proposed regulations under § 67(e) requiring that costs be "unique" to an estate or trust in order to be exempt from the 2-percent floor. Unique means that "an individual could not have incurred that cost in connection with property not held in an estate or trust." They also required the trustee to unbundle his or her trustee fee, allocating their fee among the various services they performed for the trust during the year, and deducting only those costs which are unique. But because these proposed regulations are contrary to the Supreme Court's holding in *Knight*, they have been rendered obsolete.

C. No Unbundling for 2007, 2008, and 2009 Returns

Since the Knight decision, the Service has issued three notices that waive the unbundling requirement for trustee fees for 2007, 2008, and 2009 returns.[57] Notice 2008-32 also stated that proposed regulation § 1.67-4 would be modified and may include safe harbors for unbundling trustee fees. It requested comments on whether safe harbors would be helpful, how they may be formulated, and what might be reasonable percentage(s) of administrative costs subject to the 2-percent floor. It also requested input on whether safe harbors should reflect the nature or value of the trust assets and/or the number of beneficiaries. This indicates that the IRS may be considering a safe harbor to exempt small trusts or those with multiple beneficiaries. The Notice

[56] Lindsay Roshkind, "Interpreting I.R.C. Section 67(e): The Supreme Court's Attempt to Nail Investment Advisory Fees to the Floor," 60 Fla. L. Rev. 961, 970-972 (2008) ("By adopting the Fourth and Federal Circuits' interpretation of the second condition of Section 67(e)(1), the Court has added to the confusion surrounding the exception, rather than clarifying its application. By focusing the inquiry on what expenses are "uncommon (or unusual, or unlikely) for . . . a hypothetical individual to incur," it is unclear which expenses will qualify for the exception and which expenses will not.").

[57] Notice 2010-32, 2010-16 I.R.B. (April 1, 2010), Notice 2008-32, 2008-11 I.R.B. (Feb. 27, 2008); Notice 2008-116, 2008-52 I.R.B 1372 (Dec. 11, 2008).

did not, however, ask for comments on the meaning of "commonly." This indicates that the Service may either draw some bright lines or leave that open as a facts and circumstances test.

The AICPA and dozens of other individuals and groups wrote comments in response to Notice 2008-32 and the proposed regulations. Not surprisingly, nearly all of the comments opposed unbundling of trustee fees because of the difficulty and because there is no basis for it in the statute's legislative for judicial history. Many commentators, including the AICPA, offered alternative safe harbors if the Service insists on unbundling. These include an exemption for small trusts (i.e. those under the applicable exclusion amount for estate tax purposes), noncorporate trustees, executors, legal, accounting, tax preparation, and appraisal fees, and de minimis fees below a certain dollar amount. Many commentators also asked the IRS to reissue the regulations in proposed form rather than final form and allow another round of comments. However, Treasury has taken no action on this matter.

D. Common Trust Funds

Neither the courts nor the IRS discuss the treatment of miscellaneous itemized deductions from passthrough entities owned by an estate or trust. But presumably, costs from these entities must also be tested under the "commonly incurred by individuals" rule in order to be exempt from the 2-percent floor. This requires the trustee to ask whether each miscellaneous itemized deduction on the K-1 from the passthrough entity would commonly have been incurred by an individual. Regarding common trust fund expenses, it seems that the answer is clearly "no," considering that individuals cannot own common trust funds.

Temporary Regulation § 1.67-2T provides an example of how a common trust fund should report miscellaneous itemized deductions (i.e. *affected* expenses) to a trust owner.[58] But it stops short of explaining how the trust should treat those expenses under § 67(e).

EXAMPLE

> During 1987, a common trust fund (CTF) had the following items: (i) $50,000 of short-term capital gains; (ii) $150,000 of long-term capital gains; (iii) $1,000,000 of dividend income; (iv) $10,000 of deductions that are not affected expenses; and (v) $60,000 of affected expenses. Trust T owned a 1-percent interest in the CTF. Therefore, T reports: (A) $500 of short-term capital gains (1-percent of $50,000); (B) $1,500 of long-term capital gains (1-percent of $150,000); (C) $9,900 of ordinary taxable income (1-percent of $1,000,000 of CTF's gross income excluding capital gains and losses over $10,000 of CTF's deductions that are not affected expenses); (D) $600 of affected expenses (1-percent of $60,000).[59]

E. Outlook for 2010

The IRS has been promising regulations under § 67(e) since the project first appeared on its Priority Guidance Plan in the summer of 2007. But considering everything else on the IRS's agenda, the 67(e) regulations are probably not on the front burner. In addition, the IRS is aware

[58] Temp. Reg. § 1.67-2T(i) (affected expenses are defined as those that would be deductible as miscellaneous itemized deductions if paid or incurred by an individual.)
[59] Temp. Reg. § 1.67-2T(d)(2), Example.

that legislative reform is being sought by a number of interest groups including the AICPA and the American Bankers Association. As we approach mid-2010, it is clear that the Service won't likely require trustees to unbundle in 2010 either, because they have stated publicly on many occasions that they are aware that trustees need significant lead time to accommodate any unbundling requirement.

Regardless of how carefully any future regulations are drafted to implement the *Knight* decision or what kind of safe harbors they provide, they are bound to be either hopelessly complex or purely arbitrary. Any one-size-fits-all allocation of a trustee's fee to investment services will be entirely arbitrary because the amount of the fee is subject to a number of different factors. Corporate fiduciaries generally use a graduated fee schedule based on a percentage of the assets in the trust, which can be adjusted for the specific needs and circumstances of the trust or estate. The fiduciary may also charge a minimum annual fee or additional fees for any extraordinary services provided to the trust or estate.

On April 1, 2010, members of the AICPA and the American Bankers Association met with the Joint Committee on Taxation to discuss what factors might influence the revenue cost of a legislative proposal to exempt administrative costs of estates and trusts from the 2-percent floor. During that meeting, the JTC requested more information on how trustees charge for their services. In response to their request, the American Bankers Association sent them a letter enumerating the following factors affecting fiduciary compensation:[60]

- Nature of the account assets
- Complexity of the family situation
- Complexity of the trust terms
- Complexity of tax issues
- Number and geographical location of beneficiaries
- Existence of charitable beneficiaries
- Degree of investment risk
- Litigation risk and need to consult counsel
- Duration of the trust
- Scope, novelty, and difficulty of the duties imposed on the trustee
- Special skills required to properly perform the duties
- Amount of discretion afforded the trustee
- Need to calculate income for a mandatory income distribution
- Need to obtain appraisals
- Application of dual situs for different purposes
- Need to serve with co-trustees or special trustees
- Whether there is a trust protector or third party power holder
- Whether there are foreign trust reporting issues

[60] Letter from the American Bankers Association to the Joint Committee on Taxation in April 2010 explaining how corporate trustees charge so that the JTC can estimate the potential revenue cost of a legislative proposal to exempt administrative costs of estates and trusts from the 2-percent floor under Sec. 67(e).

The AICPA has made Section 67(e) reform a top legislative priority. The AICPA is lobbying very hard to allow a deduction for all administrative costs of estates and trusts. But it must convince Congress that it won't cost very much. In the meantime, many CPA firms are following the AICPA's guidance issued in February 2008, right after the Supreme Court's decision in *Knight,* which suggests that preparers deduct all tax preparation fees and trustee fees in full, and that other costs be assessed on the basis of whether an ordinary individual with the same property as the trust would have incurred the cost.

V. TOGGLING GRANTOR TRUST STATUS

An installment sale to an intentionally defective grantor trust (IDGT) is a popular estate-planning tool that allows the grantor to freeze the growth of an appreciating asset by selling it to an irrevocable grantor trust in return for a promissory note. The sale is ignored for federal income tax purposes, because transactions between a grantor and a trust (all of which is deemed owned by the grantor under Subpart E of Subchapter J of the Internal Revenue Code) are not regarded as sales for federal income tax purposes.[61] But the transfer is taken into account for estate and gift tax purposes. Therefore, all future appreciation inures to the benefit of the trust and is excluded from the grantor's taxable estate. However, if the trust converts to a non-grantor trust (either because the grantor dies or because the grantor powers terminate for another reason) a host of income tax questions arise if the note is still outstanding.

The first question is whether the grantor realizes gain when the trust converts from grantor to non-grantor while the note is still outstanding. If so, who should recognize the gain — the grantor or his estate—and how should that gain be calculated? Should there be a different treatment for conversions caused by the grantor's death than those caused by other reasons? And if gain is realized, does the note qualify for installment sale reporting under IRC Section 453 and thus constitute income in respect of a decedent (IRD) under IRC Section 691 to the extent of any unrecognized gain? And finally, what are the basis and holding period of the note and the property?

No single authority answers all of these questions. Some commentators have suggested that gain is realized upon termination of grantor trust status equal to the excess of the note balance over the grantor's basis in the property on the termination date.[62] Consequently, they advise paying off the note before the grantor dies to avoid gain recognition. Others maintain that there should be no gain realized or recognized upon the conversion of a grantor to a non-grantor trust when the grantor dies—primarily because transfers at death are generally not income tax events.[63] While they concede that the Internal Revenue Service and the courts have taxed terminations of grantor trust status caused by reasons other than death, they maintain that terminations on account of the grantor's death should be exempt from gain as testamentary transfers.[64]

[61] IRC § 671; Reg. § 1.671-2(a); Rev. Rul. 85-13, 1985-1 CB 184.

[62] Carol A. Cantrell, "Gain is Realized at Death," Trusts & Estates (February 2010), p. 20; Deborah V. Dunn and David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," *J. Tax'n*. (July 2001), p. 49.

[63] Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," Trusts & Estates (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," *J. Tax'n*. (Sept. 2002).

[64] Ibid.

In 2009, the Internal Revenue Service inched closer to definitive answers with two new Chief Counsel Advice opinions. The available authorities now strongly suggest that the death of the grantor of an irrevocable grantor trust with an outstanding note balance is partly a sale and partly a gift ("part sale-part gift"), both occurring on the last day of the grantor's taxable year. The grantor realizes gain equal to the excess of the note balance over his basis in the property. That gain constitutes IRD, which the grantor's estate or successors recognize when they collect the note payments. And the trust's basis in the property is the greater of the note balance or the grantor's basis in the property on the date of death.

A. Non-Grantor to Grantor Trust - CCA 200923024

The IRS has addressed the tax consequences of the reverse situation - converting a non-grantor trust to a grantor trust on at least two occasions – Revenue Ruling 85-13 and most recently in CCA 200923024. In both instances, the IRS found that the mere conversion from a nongrantor trust to a grantor trust is not an immediately taxable event for either the grantor or the trust. Converting a non-grantor trust to a grantor trust can be accomplished in a variety of ways, including the addition of a related or subordinate trustee within the meaning of Section 672(c), which is what happened in CCA 200923024.[65]

In the CCA, the grantors contributed appreciated stock to a family partnership, then sold their partnership interests to several non-grantor trusts in exchange for unsecured private annuities payable by the trusts.[66] The trusts' basis in the partnership interests was equal to their purchase price. The partnership made a Section 754 election to increase the inside basis of the stock to the outside basis of the partnership interest. Shortly afterward, the partnership sold the stock for an amount roughly equal to its basis and recognized little or no gain because of the 754 election. The grantors recognized gain on two years of annuity payments they received until the trusts became grantor trusts due to a change of trustees.[67] But after the trusts became grantor trusts, the grantors were no longer required to recognize any gain because, as owners of the grantor trusts, they were both payors and payees of the annuities. Consequently, the grantors successfully escaped recognizing most of the gain on the sale of the stock.

Even though the IRS found the transaction potentially abusive, it determined that none of the existing authorities were sufficient to immediately tax either the grantor or the trust on the conversion.[68] First, the authorities cited by the CCA only discuss the gain or loss to the grantor, who is deemed to have transferred assets to the trust. But they are silent on the income tax consequences to the transferee of the assets, which in these authorities was the non-grantor trust rather than the grantor. Second, the Service noted that "the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the

[65] The Family Trusts became grantor trusts under § 674(a) and (c) due to the replacement of the corporate trustee with a related party within the meaning of § 672(c).

[66] CCA 200923024 (June 5, 2009); *see also* Rev. Rul. 85-13, 1985-1 C.B. 184 (A non-grantor trust ceased to be a separate taxable entity at the time the grantor became the owner of the trust. As a result, the transfer of trust assets to the grantor was not a sale for federal income tax purposes and the grantor did not acquire a new cost basis in those assets.).

[67] The transaction occurred before 2006 and was not affected by Prop. Reg. §§ 1.1001-1(j) and 1.72-6(e), which would change the taxation of private annuities after Oct. 18, 2006 (or after Apr. 18, 2007 for certain annuities issued by individuals).

[68] The CCA cited Treas. Regs. § 1.1001-2(c), Ex. 5; *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; and Rev. Rul. 85-13, 1985-1 C.B. 184.

death of the owner which is generally not treated as an income tax event."

At first, it seems odd that the CCA mentions death because the taxpayer was not dead. But it may have anticipated the application of these authorities on the grantor's ultimate death. Yet even death would not have produced the immediate tax results the IRS was looking for in the CCA, because the annuity payments ceased at the grantor's death, providing no consideration in the transfer.

Finally, the IRS considered treating the grantor as having indirectly borrowed the trust corpus at the time he sold the partnership interest to the trust for the annuity under Rev. Rul. 85-13. This approach would have ignored the trust as a separate taxpayer and thus its purchase of partnership interests, vitiating the Section 754 election. The result is that the grantor would have been taxed as the partner when the partnership sold the stock without the benefit of the Section 754 election. But the facts of the CCA were substantially dissimilar to those in Rev. Rul. 85-13, in which the grantor was buying property for a note rather than selling property for an annuity. In addition, Rev. Rul. 69-74 provides that an exchange of appreciated property for a private annuity is a sale rather than a borrowing that would cause grantor trust status.[69] Thus, the CCA ultimately concluded that it could not "take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor."

The CCA should have mentioned the basis in the partnership interest upon conversion, but did not. This omission may have been because it would have produced no immediate income tax consequences to either the grantor or the trust. Moreover, the IRS previously has stated its position on the basis of trust property returned to the grantor. Rev. Rul. 72-406 provides that the basis is equal to his basis in the property at the time the grantor transferred it to the trust, adjusted for the period during which the non-grantor trust held the property.[70]

Although Rev. Rul. 72-406 did not address basis adjustments attributable to sales between the grantor and the trust, we still can apply its holding to the facts in the CCA. Doing so, we find that the basis in the partnership interest should be the original basis of the stock transferred to the partnership on formation, adjusted for partnership income and losses during the period the non-grantor trust owned it, and increased for the principal portion of the two annuity payments the trust made before conversion. But it should not be increased for any deferred installment gain that the grantor has not recognized. The deferred gain, like receivables and payables between the grantor and the trust, is an inter-entity account that represents the deferred portion of a transaction between the grantor and the trust that is disregarded once the entities become the same taxpayer.

Thus, even though the grantor in the CCA successfully avoided recognizing any current gain on the sale of his stock, he merely postponed its recognition because the basis in the partnership interest is substantially reduced after the conversion to a grantor trust. This reduced basis will have tax consequences to the grantor, who is now treated as the partner, if the partnership makes cash distributions in excess of its basis under Section 731(a) or dissolves and sells its assets; or if the trust disposes of its partnership interest. Moreover, the grantor cannot avoid these income tax consequences by waiting until he dies. Because he does not own the partnership interest for estate and gift tax purposes, he may not adjust its basis under Section 1014(b).

[69] Rev. Rul. 69-74, 1969-1 C.B. 43.
[70] Rev. Rul. 72-406, 1972-2 C.B. 462, cited by Rev. Rul. 85-13, 1985 C.B. 184.

B. Grantor to Non-Grantor Status

Although there are no recent cases or rulings on converting a grantor trust to a non-grantor trust, the IRS and the courts have consistently maintained such a conversion is a deemed transfer of property from the grantor to the trust that is taxable to the extent that the amount realized exceeds the grantor's basis in the property.[71] The amount realized includes money plus the fair market value (FMV) of other property received.[72]

In Example 5 of Treasury Regulations Section 1.1001-2(c) and Revenue Ruling 77-402, the grantor renounced his retained powers over a trust that owned a partnership interest. These authorities hold that as a result and "at that time" the trust ceased to be a grantor trust and the grantor ceased to be considered the owner of the partnership interest. On the transfer, the grantor was relieved of his share of partnership liabilities. This debt relief was treated as money received in the transfer causing the grantor to recognize gain to the extent the money exceeded his basis in the partnership. Revenue Ruling 77-402 holds 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, the ruling is not limited to terminations by renunciation, but also applies to any expiration or lapse of grantor powers, including those occurring because the grantor dies.

Similarly, a gift in trust conditioned upon the donee paying the donor's gift tax liability is a taxable transfer to the trust in return for consideration equal to the gift taxes paid by the donee. In *Diedrich v. Commissioner,* the U.S. Supreme Court held that a donor can realize income in a variety of ways, including relief from his obligation to pay gift taxes.[73] To the extent that the gift taxes paid by the donee exceed the donor's basis in the property transferred to trust, the high court found that the donor received an "immediate economic benefit," which was taxable to the extent it exceeded his basis in the gifted property. The amount of the gift was the excess of the property's FMV 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 when the donor receives an economic benefit in connection with a gift.[74]

Although the economic benefit realized in these authorities involves reduction of the grantor's debt to third parties, these holdings are equally applicable to economic benefit realized

[71] Treas. Regs. § 1.1001-2(c), Example 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. Commissioner*, 84 T.C. 667 (1985) (upholds Example 5 in Treas. Regs. Section 1.1001-2(c) on similar facts when 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.) Technical Advice Memoranda 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); General Counsel Memoranda 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).

[72] IRC § 1001(b).

[73] 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* Private Letter Ruling 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 Treas. Regs. § 1.1015-4.)

[74] *Ibid.*; *see also* Treas. Regs. § 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).

in any form, including a note payable to a grantor.[75] If we extend these holdings to the termination of grantor trust status at death with an outstanding installment note due the grantor, the grantor is treated as having transferred property to the trust in exchange for an economic benefit equal to the note balance on the date of death. The grantor realizes gain to the extent that the note balance exceeds the basis in the property.

EXAMPLE

> Joe sold Blackacre on the installment basis to an irrevocable grantor trust, for \$60,000. Joe died when the note balance was \$30,000 and the basis of Blackacre was \$20,000. On Joe's death, his grantor powers terminate and he is treated as having sold Blackacre to the trust for the note balance on his date of death. He realizes a \$10,000 gain equal to the excess of the \$30,000 note balance over the \$20,000 basis in the property.[76]

The transfer for income tax purposes occurs the moment Joe's grantor powers terminate, which is the moment of his death, at which time he and the trust become separate taxable entities.[77] Because the transfer occurs on Joe's date of death, it occurs during his lifetime because transactions occurring on the date of a taxpayer's death are included in his final tax year.[78] It matters not for federal income tax purposes whether the deemed transfer occurs the moment before or the moment after death as long as it occurs on the same day. In either case, it occurs during his lifetime.[79] As such, the authorities addressing the grantor's tax consequences on renunciation of grantor trust status during the grantor's lifetime apply with equal force to terminations of grantor trust status caused by death.[80] However, when the amount realized includes an installment note rather than immediate debt relief, the gain may be deferred under IRC § 453.

VI. DUE DATE FOR ESTATE AND TRUST RETURNS TO CHANGE AGAIN?

An estate or trust is required to file an income tax return on Form 1041, "U.S. Income Tax Return for Estates and Trusts" by April 15 each year. For returns originally due before 2010, an automatic extension period of 6 months was allowed. But for estate and trust returns originally due on or after January 1, 2010, only a 5-month extension period temporarily

[75] Diedrich, 457 U.S. at 195 ("Gross income" means income derived from whatever source 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.)

[76] Treas. Regs. § 1.1001-1(e), Ex. 1, 1.1001-2(c), Ex. 5.

[77] Treas. Regs. § 1.1001-2(c), Ex. 5 (When the grantor (C) renounced his powers, the grantor and the trust (T) became separate taxable entities. "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."); *see also* Rev. Rul. 77-402, *supra* note 47.

[78] Treas. Regs. § 1.451-1(b)(1) (A taxpayer's taxable year ends on the date of his death); Treas. Regs. § 1.443-1(a)(2) (the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death).

[79] Ibid.

[80] Rev. Rul. 77-402 ("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.")

applies.[81] The extension period for estates and trusts was changed from 6 months to 5 months by Temporary Regulation 1.6081-6T because Forms 1040 and 1041 were due on the same day (October 15) and individuals complained that they often did not receive Schedule K-1 in time to file their returns timely.

Thus it was believed that changing the extended due date for estate and trust returns to September 15 would help individuals to meet their own filing deadline of October 15 a little easier. However, after the first year of filing estate and trust returns by September 15, members of the AICPA determined that the change may have done more harm than good. Estates and trusts themselves were waiting on K-1s from partnerships and other passthrough entities. They would often have to file their own returns on the same day as they received K-1s from these entities on September 15. Therefore, the AICPA has asked the IRS to change the extended due date for estates and trusts to September 30 when it finalizes the temporary regulation, which expires on June 30, 2011.[82]

If the IRS accommodates this request, a 5 ½ month automatic extension will apply to 2011 estate and trust returns. This would allow estates and trusts to receive partnership K-1s by September 15 and timely file their own returns by September 30. The extended due date for partnership returns is expected to remain at 5 months because the provision was published as a proposed regulation rather than a temporary one and because the change seems to have been welcome.[83]

VII. MANDATORY E-FILING FOR ESTATES AND TRUSTS FOR 2010

On November 6, President Obama signed H.R. 3548, the "Worker, Homeownership, and Business Assistance Act of 2009" (the Act) into law, which among other things, authorized the IRS to issue regulations specifying which returns must be filed electronically.[84] Even though this provision received only a negligible revenue score, it is perceived to help the IRS by freeing up personnel and making their operations more efficient. It may also help in their efforts to eventually audit more fiduciary income tax returns.

The Act maintains the current rule that the IRS may not require individuals, estates, or trusts to file electronically, but it may require persons who file at least 250 tax returns during the calendar year to file electronically.[85] However, the Act was amended for returns filed after December 31, 2010 and mandates that IRS require electronic filing by "specified tax return preparers." This includes all return preparers except those who neither prepare nor reasonably expect to prepare ten or more individual income tax returns in a calendar year. "Individual income tax return" is defined to include returns for estates and trusts as well as individuals.[86]

[81] Reg. § 1.6081-6T(a)(1).
[82] Reg. § 1.6081-6T(i).
[83] Reg. § 1.6081-2.
[84] IRC § 6011(e)(1), effective for returns filed after 12/31/2010.
[85] IRC §§ 6011(e)(1), 6011(e)(2)(A).
[86] IRC § 6011(e)(3)(C), as amended by P.L. 111-92, § 17.

However, the requirement to e-file estate and trust returns has more bark than bite. First of all, there is no penalty for failure to comply with it. Second, many types of estate and trust returns cannot be filed electronically including:[87]

- Amended returns.
- Returns with dollar and cent entries—only whole dollar amounts are accepted.
- Returns with Powers of Attorney (POA) attached, unless the IRS has a POA on file.
- Fiscal year returns with extension dates after June 30 of the current year.
- Returns with any dollar amount greater than $99,999,999,999.
- Tentative returns.
- Bankruptcy estate returns.
- Returns with refund amounts equal to or greater than $1,000,000.
- Returns with more than one Schedule D, Form 2210, 2210F, 3468, 4136, 4797, 4952, 4970, 5884, 6478, 6765, 8582, 8582-CR, 8801, 8820 or 8830
- Returns where the name of the trust is not identical to the name on file with the IRS

Therefore, it is expected that the IRS will either extend the date for complying with electronic filing for estates and trusts or waive enforcement of the provision. Nonetheless, practitioners are generally in favor of electronic filing and do so willingly if they can. Currently, about 25 percent of fiduciary returns are filed electronically.[88]

VIII. BROKER REPORTING OF COST BASIS IN 2011

The Emergency Economic Stabilization Act of 2008 (the Act), (P.L. 110-343), requires every domestic and foreign broker that is required to file a Form 1099-B information return reporting the gross proceeds of a "covered security" to now include the customer's basis in the security and whether any gain or loss is short or long term.[89] A draft of the new form 1099-B is attached as Exhibit A. The Act also requires every broker who transfers a security, whether covered or noncovered, to issue a transfer statement to the transferee broker within 15 days after the transfer. The transfer statement is not filed with the IRS. If the security is a covered security in the hands of the transferring broker, the transfer statement must report the basis and holding period information to the transferee broker.[90] In the case of a noncovered security, the broker must still file a transfer statement, but is not required to report any additional information.

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired through a sale transaction in the account in which the security is held or (2) was transferred to that account in a non-sale transaction from an account in which the security was a covered security, but only if the transferee broker received a statement under Section 6045 with respect to the transfer.[91] Thus, gifted and inherited securities that were covered securities in the account of the donor or decedent remain covered securities when transferred to the recipient's account and accompanied by a transfer statement from the donor's broker.

[87] IRS Publication No. 1437 (Nov. 2009).

[88] In 2008, the IRS received 753,386 estate and trust returns electronically out of 3,057,277 total returns filed. See 2008 IRS Data Book, Table 4, page 9.

[89] IRC § 6045(g).

[90] IRC § 6045A.

[91] Prop. Reg. § 1.6045-1(a)(15).

In response to numerous public comments, the IRS issued proposed regulations in December 2009 to explain and implement these new reporting requirements.[92] The regulations describe how to determine the basis and whether any gain or loss is long or short term. They also address the reporting requirements for brokers transferring stock and for issuers of stock in connection with organizational actions. They do not cover reporting for options, compensatory options, or other equity-based compensation arrangements. These transactions will be addressed in future regulations.

Many comment letters requested that the IRS delay implementing the gift and inheritance portion of the broker reporting requirements so that confusion over these rules do not delay finalization of the rest.[93] Commentators also asked for interim guidance in the form of notices or revenue procedure and relief from penalties for inadvertent failure to comply with the new rules.

A. New Basis Reporting Rules

Brokers who sell "applicable securities" (stocks, bonds, debentures, commodities, derivatives, mutual funds, shares acquired in a dividend reinvestment program (DRP), and noncompensatory options) acquired through a sale transaction in the broker's account after 2010 must now report the cost basis and holding period of the shares on Form 1099-B in addition to the gross sales proceeds. Cost basis reporting for mutual funds, DRP shares, and options is delayed until after 2011. Applicable securities acquired in a sale transaction after these dates are "covered securities." A broker who transfers a covered security to another broker must furnish the transferee broker a written statement of the basis and holding period of the security not later than fifteen days after the date of the transfer.[94] Transferee brokers are required to take into account information they receive from transferor brokers on a transfer statement, including shares acquired by inheritance and gift. Similar reporting requirements apply to issuers.[95]

The basis of a security is generally its cost when acquired by purchase in the broker's account. If a customer sells less than his entire holding of a security, the basis is determined using the first-in first-out (FIFO) method, unless the customer notifies the broker in writing and adequately identifies the stock sold or transferred by the settlement date.[96] An adequate identification is made if (a) at the time of the sale or transfer, the taxpayer specifies to the broker or other agent having custody of the stock the particular stock to be sold or transferred, and (b) within a reasonable time thereafter, the broker or agent confirms the specification in writing.[97] Trustees and executors make an adequate identification in the same way. However, where the stock is not in the custody of a broker, the trustee or executor must indicate on its books and records the particular stock to be sold, transferred, or distributed. Where the trustee or executor distributes stock to a beneficiary, he or she must furnish the distributee a written document identifying the particular stock [98]

[92] REG-101896-09, Notice of Proposed Rulemaking, Fed. Reg. Vol. 74, No. 241 p. 67009. 12/17/2009.

[93] "IRS Urged to Prioritize Portions Of Proposed Basis Reporting Regulations' BNA Tax Management Weekly Report, Volume 29 Number 7 (February 15, 2010), ISSN 1528-4239.

[94] Prop. Reg. § 1.6045-1(a)(5).

[95] IRC § 6045B.

[96] IRC § 6045(g)(2)(B)(i)(I); Reg. § 1.1012-1(c)(1).

[97] Reg. § 1.1012-1(c)(3).

[98] Reg. § 1.1012-1(c)(4).

The basis of mutual funds and DRP shares is generally determined on an averaging method unless the customer notifies the broker that he elects another acceptable method.[99] Wash sales must be reported as such if the purchase and the sale of identical securities occurs in the same account.[100] Section 1091 disallows losses on sales made within 30 days of a purchase of identical securities.

Brokers must include the name, address, and taxpayer identification number of the customer, the property sold, the CUSIP (Committee on Uniform Security Identification Procedures) number of the security sold (if applicable), or other security identifier number that IRS designates, the adjusted basis of the security sold, whether any gain or loss with respect to the security sold is long-term or short-term, the gross proceeds of the sale and the sale date. The information will be reported on Form 1099-B, "Proceeds from Broker and Barter Exchange Transactions."[101] A draft of the 2011 Form 1099-B is available at http://www.irs.gov/pub/irs-dft/f1099b.

B. Basis Reporting for Gifts

In the case of a transfer of covered securities by gift, the transfer statement must indicate that the security is a gift and must report the date of the gift (if known when furnishing the statement) and the fair market value of the gift on that date (if known or readily ascertainable at the time the transfer statement is prepared).[102] The transferring broker must also report the basis and original acquisition date of the donor. If the request to transfer ownership between different people is silent as to the reason for the transfer, the transfer should generally be treated as a gift.[103] In the case of noncovered securities, the transferring broker is not required to include the basis and holding period, but may choose to do so if that information is provided. The rules for reporting gifts appear to apply to all gifts, including those to charity, but not for distributions from trusts to beneficiaries, which are not gifts.

The selling broker must take these basis adjustments into account in reporting adjusted basis upon the subsequent sale or other disposition of these securities. If the transfer statement indicates that the security is acquired as a gift, the broker must apply the relevant basis and holding period rules for property acquired by gift, except that the broker is not required to account for gift taxes paid. [104] If the application of those basis rules prevents both gain and loss from being recognized, or if the initial basis of the security depends upon its fair market value as of the date of the gift but the transfer statement does not report its fair market value as of the date of the gift and this amount is not readily ascertainable by the broker, the broker must treat the initial basis as equal to the gross proceeds from the sale. This takes into account the rules under Section 1015(a) that limit losses on sales of gifted shares when the basis exceeds the fair market value of the shares on the date of the gift.

EXAMPLE

[99] IRC § 6045(g)(2)(B).
[100] IRC § 6045(g)(2)(B)(iii).
[101] Preamble to Prop. Reg. § 1.6045-1 (12/16/2009); Prop Reg. § 1.6045-1(d)(2)(i).
[102] Prop. Reg. § 1.6045A-1(b)(4)(i).
[103] Preamble to Prop. Reg. § 1.6045-1 (12/16/2009), Reporting Required in Connection with Transfers of Gifted and Inherited Securities.
[104] Prop. Reg. § 1.6045-1(d)(6)(ii)(B)(2).

X instructs Broker S to give to Y shares of stock in a publicly traded company that X holds in an account with S. On X's instruction, Broker S transfers custody of the stock to T, Y's broker. The transfer settles on August 15, 2013. Broker S must indicate on the transfer statement that the transfer is a transfer of gifted securities and report X's basis and original acquisition date. Broker S must also indicate that the date of the gift was August 15, 2013, if the settlement date was known when S furnished the statement, and the fair market value of the shares on that date.[105]

EXAMPLE

M makes a gift to N of shares of stock which M holds in an account with Broker F. The shares are stock of a publicly traded company with a readily ascertainable fair market value. In connection with the transfer, F provides a transfer statement to Broker G, N's broker, reporting that the transfer was a gift of covered securities originally acquired on April 2, 2012. G receives custody of the shares on June 4, 2015 and sells them on March 24, 2016.[106]

Because the transfer statement reported the transfer as a gift, Broker G must apply the basis rules for property acquired by gift in determining the basis when reporting the sale. Depending on the gross proceeds of the sale, Broker G may determine the reported basis from the basis reported on Broker F's transfer statement, the fair market value of the gifted shares on June 4 that Broker G determines from readily ascertainable records, or the gross proceeds determined from the sale.

EXAMPLE

Assume the same facts as in the above example except that the stock is a privately held company with no readily ascertainable fair market value and the transfer statement did not report a fair market value as of the date of the gift to N. If Broker G must determine the reported adjusted basis from the fair market value of the shares, G must treat the gross proceeds from the sale as the adjusted basis. Broker G may instead rely on a fair market value provided by N in determining basis under the relevant basis rules for property acquired by gift and is deemed to have relied upon the fair market value provided by N in good faith on any subsequent reporting for purposes of penalties under sections 6721 and 6722 if G neither knows nor has reason to know that the fair market value provided by N is incorrect.[107]

EXAMPLE

M makes a gift to N of shares of stock that M holds in an account with Broker F. The shares are stock of a publicly traded company with a readily ascertainable fair market value. In connection with the transfer, Broker F provides a transfer statement to Broker G, N's broker, reporting that the transfer was a gift of covered securities

[105] Prop. Reg. § 1.6045A-1(b)(4)(iii), Ex. 1.
[106] Prop. Reg. § 1.6045-1(d)(6)(vi), Ex. 1.
[107] Prop. Reg. § 1.6045-1(d)(6)(vi), Example 2.

originally acquired on April 2, 2012. Broker G receives custody of the shares on June 4, 2015 and sells them on March 24, 2016.[108]

Because the transfer statement reported the transfer as a gift, Broker G must apply the rules for property acquired by gift in determining whether any gain or loss on the sale is long-term or short-term within the meaning of Section 1222 when reporting the sale of the shares. Depending on the gross proceeds of the sale, Broker G may determine the holding period based on the date M acquired the shares or the June 4, 2015 date of the gift.

C. Basis Reporting for Inheritances

Under the proposed regulations, when covered securities are transferred from a decedent, the transfer statement must indicate that the securities are inherited.[109] The transfer statement must also report the date of death as the acquisition date and must report adjusted basis in accordance with the instructions and valuations provided by an authorized representative of the estate. The proposed regulations require that the selling broker take these basis adjustments into account in reporting adjusted basis upon the subsequent sale or other disposition of these securities. If the securities are noncovered the transferring broker may report the basis information, but is not required to.

If the authorized estate representative does not provide complete instructions or valuations to the broker effecting the transfer at the time the representative requests the transfer of the security, the broker must ask the representative for instructions or valuations regarding the basis before preparing the transfer statement. If the broker does not receive complete instructions, the transfer statement must indicate that the transfer consists of an inherited security, but may otherwise report the security as if it were a noncovered security.

EXAMPLE

V owns shares of stock in C, a publicly traded company, in an account with Broker Q. V dies on May 15, 2013. In her will, V directs that W receive all of her shares of stock in C. Following the terms of V's will and upon the instruction of an authorized representative of the estate that the basis of the transferred securities should be adjusted to the fair market value as of the date of V's death, Q transfers custody of the stock to R, W's broker. The transfer statement must report that the shares are inherited or bequeathed securities with an original acquisition date of May 15, 2013, and an adjusted basis that reflects the instructions of the authorized representative of the estate.[110]

EXAMPLE

Assume the same facts as the example above except that the instruction from the authorized representative of the estate to transfer the securities to W does not include an instruction regarding the basis of the shares of stock in C. Q must contact the

[108] Prop. Reg. § 1.6045-1(d)(7)(iv), Example 1.
[109] Prop. Reg. § 1.6045A-1(b)(3)(i).
[110] Prop. Reg. § 1.6045A-1(b)(3)(iv), Example 1.

authorized representative and ask for an instruction or valuation regarding the basis of the shares of stock in C before preparing the transfer statement. If Q still does not receive an instruction regarding the basis of the shares of stock in C, Q may treat the shares of stock in C as noncovered securities when transferring the stock. If Q receives complete instructions or valuations from the authorized representative after furnishing the transfer statement, Q must furnish a corrected statement within fifteen days of receiving the instruction or valuation from the authorized representative that no longer reports the shares of stock in C as a noncovered security and reflects the instruction or valuation from the authorized representative.[111]

If the security is transferred from a decedent or a decedent's estate in order to satisfy a cash legacy, then the basis is the amount of the cash legacy.[112]

EXAMPLE

Assume that V directs in her will that W receive $3,000. To satisfy this legacy, Broker Q transfers custody of the shares of stock in C to R on a date when the stock has a fair market value of $3,000. Because the shares are transferred from V's estate to satisfy a cash legacy, the transfer statement must report that the adjusted basis is $3,000 and that the original acquisition date is the date of settlement for the transfer. Additionally, the transfer statement must not indicate that the securities are inherited or bequeathed securities.[113]

EXAMPLE

O's aunt dies on May 15, 2013. In her will, she directs that O receive all of her shares of stock in C, a corporation. H, O's broker, receives a transfer statement reporting that the transfer is an inheritance or bequest of covered securities with an original acquisition date of May 15, 2013. O then sells the shares on July 15, 2013. H must apply the rules for property acquired from a decedent when reporting whether any gain or loss on the sale is long-term or short-term.[114]

IX. PASSIVE ACTIVITIES OF ESTATES AND TRUSTS

Estates and trusts often find themselves owning an interest in a family business, ranch, rental property, or similar trade or business. They may own these interests either directly or indirectly through a passthrough entity such as an S corporation or partnership. Special rules apply to limit deductions for losses incurred by trade or business activities if the owner does not materially participate in the business.[115] Individuals must meet one of the seven tests for material

111 Prop. Reg. § 1.6045A-1(b)(3)(iv), Example 2.
112 Prop. Reg. § 1.6045A-1(b)(3)(iii).
113 Prop. Reg. § 1.6045A-1(b)(3)(iv), Example 3.
114 Prop. Reg. § 1.6045-1(d)(7)(iv), Example 2.
115 IRC § 469(h)(1).

participation described in Reg. § 1.469-5T in order to deduct passive losses.[116] However, Reg. § 1.469-8, which describes how these rules apply to estates and trusts, has not yet been written.[117]

Therefore, a host of questions arises when the business is producing losses. For example, should material participation be determined by the actions of the trustee, the beneficiaries, the agents or employees of the trust, or all three? Can the estate or trust "dispose" of the activity" and free up the suspended losses if it passes it to a related party? Do unused suspended passive losses of the estate carry out to the beneficiaries? If so, do they pass out on termination of the estate or when the activity is transferred to a beneficiary?

A. Material Participation

In 2003, the District Court for the Northern District of Texas addressed material participation by a trust for the first time in *Carter v. United States*. [118] The Carter Trust was a testamentary trust that owned a 15,000 acre working cattle ranch with minerals. The trustee had extensive business, managerial and financial experience and maintained regular office hours related to trust business. However, he delegated certain aspects of the ranch operations to a full-time ranch manager and several employees who performed all of the ranch activities. The trust claimed losses in connection with the ranch operations, which the IRS disallowed as passive losses under § 469. The IRS maintained that "material participation" of a trust is determined by evaluating only the trustee's activities. Because the trustee delegated much of his responsibility, the IRS argued that he did not personally participate materially. The Carter Trust, however, argued that because the trust (not the trustee) is the taxpayer, "material participation" should be determined by assessing the collective activities of its fiduciaries, employees, and agents.

Agreeing with the Carter Trust, the district court held that the material participation in the ranch operations should be determined by reference to all the persons who conducted the business of the ranch on Carter Trust's behalf, including the trustee. The evidence was clear that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation.

Notwithstanding the decision in *Carter v. United States*, the IRS issued TAM 200733023, which held that the sole means for a trust to establish material participation in a trade or business activity is for the fiduciary to be involved in the operations of the activity on a regular, continuous, and substantial basis.[119] It maintains that focusing on the trustee's activities for purposes of material participation accords with the general rationale for individuals that an individual business owner may not look to the activities of the his employees to satisfy the material participation requirement.[120] Because a trade or business generally involves employees or agents, if an owner can satisfy the material participation test by looking to the activities of his employees, it would gut the material participation test altogether.

However, TAM 200733023 may provide a roadmap for trustees wishing to establish material participation. In the TAM, the trust appointed "Special Trustees" to run the business. However their powers were so limited as to preclude their classification as fiduciaries for

[116] Temp. Reg. § 1.469-5T, T.D. 8175 (Feb. 19, 1988).
[117] Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).
[118] Carter v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).
[119] TAM 2007 33023 (Aug. 17, 2007).
[120] Tax Reform Act of 1986, Sen. Rep. No. 99-313, at 735 ("the activities of [employees]… are not attributed to the taxpayer.")

purposes of the material participation test. They could not legally bind or commit the trust to any course of action and had no discretionary powers. In addition, their duties of negotiating tax matters, handling the entry of new partners, and reviewing operating budgets had a questionable nexus to the conduct of the business. The legislative history suggests that active participation in the operations of the business is required. Therefore trusts should require special trustees to participate on a regular, continuous, and substantial basis in the operations of the business activity and vest in those trustees the discretionary power to bind the trust.

B. Disposition of the Asset

All current and suspended passive losses may be fully deducted, however, in the year that a person completely disposes of his or her interest in the passive activity. To qualify as a complete disposition, a person (or trust) must dispose of their entire interest in the passive activity to an unrelated party in a "fully taxable transaction."[121] A fully taxable liquidation, sale, or exchange qualifies as a complete disposition.

A disposition for purposes of the passive activity rules may not involve a related party until the related party sells to a person unrelated to the owner.[122] A related party is defined under IRC § 267(b) and includes a fiduciary and its beneficiaries.[123] It also includes family members of the trustee and the beneficiaries under constructive ownership rules, which attribute stock owned by the trust to the beneficiaries. Thus a sale of the activity to a family member of the trustee or any of the beneficiaries is not a disposition that frees up passive losses.[124] Family member includes a person's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.[125] Nor is a distribution of a passive activity to a beneficiary a disposition under the passive loss rules.[126] In this case, the unused passive loss adds to the basis of the activity in the hands of the beneficiary and the unused losses are not deductible for any taxable year.[127]

Therefore, selling or transferring a passive activity to a beneficiary is not a disposition that frees up the estate or trust's passive losses. It appears that the only type of disposition that would free up suspended passive losses of an estate or trust is a sale or exchange to a party who is unrelated to the trustee or any of the beneficiaries.

However, in *Bilthouse v. United States* the Seventh Circuit recently held that the owners of an S corporation disposed of their entire interest in an activity for passive loss purposes in the year the company became insolvent and the stock became worthless.[128] The Court relied on IRC § 165(g), which provides that if any security that is a capital asset becomes worthless during the taxable year, the loss resulting therefrom is treated as a loss from the *sale or exchange* of a capital asset. The parties agreed on this point, but could not agree on which year the stock became worthless. Thus, an estate or trust wishing to deduct losses of a passive entity should show that the stock is worthless. Keep in mind that the taxpayer has the burden to prove its worthlessness and the year in which it became worthless.

121 IRC § 469(g)(1).
122 IRC § 469(g)(1)(B).
123 IRC § 267(b)(6)
124 IRC § 267(c)(1).
125 IRC § 267(c)(1).
126 IRC § 469(j)(12).
127 Ibid.
128 Bilthouse v. United States, 103 AFTR 2d 2009-429 (7th Cir 2009).

X. ANNUAL EXCLUSION GIFTS OF FAMILY PARTNERSHIPS

Two recent cases show us that we cannot take the annual exclusion for granted on gifts of family partnership interests. In *Fisher v. United States* and *Price v. Commissioner* the courts upheld the IRS's determination that gifts of interests in an LLC and a family limited partnership respectively were gifts of a future interest that did not qualify for the annual gift tax exclusion.[129]

Fisher v. United States

In *Fisher v. United States*, the LLC's principal asset was beach front property on Lake Michigan. The Fishers claimed the annual exclusion for gifts of an interest in the LLC to their children. However, upon audit, the Government asserted a gift tax deficiency of $625,986.00. The Fishers paid the deficiency and sued for a refund, alleging, in part, that the gifts of membership interests in the LLC were gifts of present interests.

The District Court found that the children did not have a right to distributions because any potential distribution was subject to a number of contingencies, all within the exclusive discretion of the General Manager. Relying on *Hackl,* a right to distributions, when such distributions occur, is not a right to a "substantial present economic benefit" because distributions that occur only after some uncertain, future event constitute a future interest. The Court also found that the children did not have an unrestricted right to unilaterally transfer their interests in the LLC because the LLC had a "right of first refusal" that made it virtually impossible for them to realize a substantial economic benefit. If the LLC decided to purchase the interest, it could pay the member with a non-negotiable promissory note payable over a period up to 15 years in equal annual installments of principal and interest. The Court found that this arrangement effectively prevented the Fisher children from transferring their interests in exchange for immediate value and therefore they did not have a substantial present economic benefit.

The Fishers also argued that the children possessed a substantial present interest because they had an unrestricted right to possess, use, and enjoy the LLC's primary asset, the beach front property. However, there was no indication in the operating agreement that this right was transferred to them when they became members. Regardless, their right to possess, use, and enjoy the property was not a right to a "substantial present economic benefit" based on *Hackl*. Rather, it was a right to a non-pecuniary benefit.

Price v. Commissioner

In *Price*, the taxpayers had claimed annual exclusion gifts of $30,000 in each of 2000 and 2001 and $33,000 in 2002 on their annual gift tax returns. Upon disallowance, they were assessed deficiencies on these amounts because they had previously used their lifetime gift tax exclusion. The Tax Court found that the limited partnership agreement effectively prevented the donees from realizing any substantial financial or economic benefit from the units. The partnership agreement expressly prohibited partners from selling, assigning, or transferring their partnership interests to third parties or from otherwise encumbering or disposing of their partnership interests without the written consent of all partners. It also stated that the partnership's primary purpose was to achieve a reasonable rate of return on a long-term basis with respect to its investments and that neither the partnership nor the general partner had "any

[129] Fisher v. United States (No. 1:08-cv-00908), S.D. Ind., (Mar. 11, 2010); Price v. Comm'r, T.C. Memo 2010-2 (Jan. 4, 2010).

obligation" to distribute profits. Moreover, the partnership agreement generally prevented any partner from withdrawing capital contributions. Despite this restrictive language, the partnership actually made distributions in four of the six years under review by the IRS.

In reaching its decision, the Tax Court relied on its previous decision in *Hackl v. Commissioner*. [130] In *Hackl*, the court held that to establish entitlement to an annual exclusion under Section 2503(b) a taxpayer must show that the transfer conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of the property or (2) of income from the property. In either case, the immediate use, possession, or enjoyment must be of a nature that substantial economic benefit is derived from it. The Court concluded that the Prices failed to show that their gifts of interests in the partnership conferred upon the donees the immediate use, possession, or enjoyment of either (1) the transferred property or (2) the income therefrom.

A. Use of the Partnership Property

In both Fisher and Price the courts found that contingencies stood in the way between the donees and their receipt of economic value from the partnership interests. In both cases transfers were subject to a first right of purchase by the partnership. The terms of the buy out in Price involved a complicated valuation process and did not provide any time limit for exercising the purchase option. In *Fisher*, the LLC could issue a 15 year non-negotiable promissory note in payment for the interest. Thus the ability to sell the units back to the partnership was not enough to constitute use of the property. Nor was the ability to use the beach front property in *Fisher* or the enhanced borrowing power obtained by owning the asset in *Price* sufficient to constitute a present interest. Given that transfer restrictions are common in family partnership situations, it may be that donees will not be able to establish that they have an immediate substantial economic benefit from the right to use, possess, or enjoy the property. As such, they may be forced to rely on a right to the income as discussed below.

B. Use of the Partnership Income

In order to show enjoyment of income from the property, *Hackl* requires that: (1) The partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees could be readily ascertained. Because the *Price* partnership owned real properties generating rents under long-term leases, it was expected to generate income at or near the time of the gifts. But the Price's failed to establish that any ascertainable portion of the partnership income would flow steadily to the donees, despite that distributions were actually made in all but two years since its inception. The restrictive language in the partnership agreement controlled over the actual practice of making distributions. In *Fisher*, there was no certainty that the partners would ever receive distributions because they were at the sole discretion of the managing member.

Based on *Hackl, Price*, and *Fisher* it is recommended that partnership agreements be amended to remove any language that unduly restricts or prevents the partnership from making partnership distributions, or even makes them secondarily important. Perhaps language such as the following would be adequate:

[130] Hackl v. Comm'r, 118 T.C. 279 (2002), 92 AFTR 2d 2003-5254 (2003).

Distribution of Cash Available for Distribution. Cash Available for Distribution *shall* be distributed at least annually within 90 days following the end of such taxable year and *shall* be paid to all Partners in accordance with their respective Sharing Ratios.

Cash Available for Distribution. The amount of cash balances of the Partnership at the end of any taxable year after provision has been made, in the sole discretion of the General Partners, for the current obligations and operating expenses of the Partnership and reserves have been established, in the sole discretion of the General Partners, for partnership expenses, obligations, liabilities, and capital investments.

The partnership should make distributions every year of at least amounts sufficient to cover the partners' income taxes. And finally, donees should have a limited right to demand income or capital, similar to a Crummey power, which commonly is used to qualify gifts in trust for the annual exclusion. Because this may lessen the valuation discount by as much as 15 percent, the donors will need to evaluate whether the benefit of the annual exclusion outweighs the benefit of the valuation discount.

XI. ISSUES TO WATCH FOR IN 2010-2011

A. Income Tax Rates for Individuals, Estates, and Trusts

Even if Congress does nothing, tax rates for individual, estates, and trusts are scheduled to rise in 2011 due to the sunsetting of many of the Bush tax cuts in EGTRRA.

	2009		2010		2011
Maximum Individual, Estate, & Trust Tax Rate	35%		35%		39.60%
AMT Exemption					
Married Filing Jointly	70,950		45,000		45,000
Single	46,700		33,750		33,750
Estates & Trusts	22,500		22,500		22,500
3% Itemized Deduction Haircut - § 68 (does not apply to estates & trusts)	1%		N/A		3%
Personal Exemption Phase-Out (does not apply to estates & trusts)	applies		N/A		Applies

President Obama proposes to raise only the top two tax brackets, which would raise 33% to 36% and 35% to 39.6%. The other income tax rates would stay the same.[131]

In addition, the President proposes to allow the 3 percent itemized deduction haircut and the personal exemption phase-out to reinstate in 2011 on schedule, but only for married taxpayers making over $250,000 and single taxpayers making over $200,000.[132] The 3 percent

[131] General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 127-128.
[132] *Id.* at p. 129-130.

haircut would reduce overall itemized deductions by 3 percent of AGI in excess of the $250,000/$200,000 thresholds, but not by more than 80 percent of the otherwise allowable deductions. The personal exemption phase-out would reduce the personal exemption by 2 percent for each $2,500 that AGI exceeds the $250,000/$200,000 thresholds.

While Republicans in Congress will fiercely oppose the increase, the large Democratic majorities in both chambers make this a likely outcome.

B. Capital Gains and Dividend Rates

The administration has proposed increasing the tax rate for capital gains and dividend income from 15 to 20 percent, for taxpayers in the top two tax brackets only.[133] Other taxpayers would continue to pay the 15 percent rate, and taxpayers in the lowest tax bracket would continue to have zero taxes on capital gains and dividends, as they do today.

	2009		**2010**		**2011**
Capital Gain Rate					
For brackets 15% and under	0%		0%		10%
All other brackets	15%		15%		20%
Qualified Dividends	15%		15%		39.60%

Some in Congress are likely to push for an across-the-board tax increase on capital gains and dividends, but at this point, the more likely outcome is the Administration's Proposal.

C. Estate Tax Reform

The failure of Congress to act on the estate tax in 2009 has made this issue one of the most complex and contentious on the legislative agenda. In 2010 the estate tax is zero, the result of a quirk in the 2001 tax law that has the estate tax disappear in 2010 and then return with a $1 million unindexed exemption in 2011 and beyond. In addition, for 2010 only, the basis of inherited property for decedents is a modified carryover basis.[134]

This means that inherited property will have the same basis as it had in the hands of the decedent, plus a few add-ons. These include $1.3 million plus any unused capital loss or NOL carryovers from the decedent's last taxable year, plus any losses the decedent would have been able to deduct under § 165 if property had been sold immediately before his death.[135] Some commentators believe that the additional basis for built-in losses at death will give many estates enough basis to step up all assets to fair market value at death. Property left to a surviving spouse is entitled to an additional $3 million increase.[136]

The table below summarizes the variety of rates and rules that apply under current law to gifts and inheritances in 2009, 2010, and 2011.

[133] *Id.* at p. 131.
[134] IRC § 1022.
[135] IRC § 1022(b)(2).
[136] IRC § 1022(c)(2).

Estate and Gift Tax Rates Under Current Law

	2009	2010	2011 and after
Annual Gift Exclusion (indexed)	13,000	13,000	13,000
Gift Tax Rate	41-45%	35%	41-55%[137]
Lifetime Gift Limit	$1m	$1m	$1m
Maximum Estate Tax Rate	45%	0%	55%[138]
Estate Tax Exclusion	$3.5m	Unlimited	$1m
GST Exclusion	$3.5m	Unlimited	$1.34m (indexed)
State Death Tax	Deduction	None	Credit
Basis of Inherited Property	FMV	modified carryover	FMV

Many factors are causing the delay in estate tax reform, including a packed congressional schedule, a focus on deficit reduction, the upcoming mid-term elections, and PAYGO. As of this writing, the House and Administration support a $3.5 million exemption and a 45 percent top rate. However, there is uncertainty in the Senate, where neither those favoring a permanent $3.5 million exemption and a 45 percent rate, nor those favoring a $5 million exemption and 35 percent rate have the needed votes for passage.

One possible course of action is a two year patch with a $3.5 million exemption and 45 percent rate, which would be exempt from the provisions of PAYGO. The Statutory Pay-As-You-Go Act of 2010 (PAYGO, or "the Act") requires that all new legislation affecting taxes, fees, or mandatory expenditures, taken together, not increase projected deficits.[139] However, PAYGO exempts the cost of extending the estate tax at the 2009 level to 2010 and 2011 (indexed). In other words an extension of the $3.5 million exemption and a 45 percent rate for two years would be scored at zero. Any reform extending beyond 2011 must be revenue neutral in keeping with PAYGO requirements. Thus a 2-year patch would be an easy quick fix.

D. Discounts on Family Limited Partnerships and LLCs

Unless the IRS prevails under § 2035 or 2036 for transfers at death or under the step transaction or indirect gift theory for gifts, taxpayers can usually expect discounts of 20 to 45 percent on the transfer of a family partnership interest. In *Astleford v. Commissioner*, the Tax Court approved a discount of 30 percent for gifts of family limited partnership interests where the partnership held a significant amount of farmland and an interest in another partnership.[140] In *Holman v. Commissioner*, the Tax Court found discounts of 16 and 25 percent for lack of control and of lack of marketability of a marketable securities limited partnership.[141] And in *Keller v.*

[137] 60% for estates between $10,000,000 and $17,184,000.

[138] *Id.*

[139] Statutory Pay-As-You-Go Act of 2010 (PAYGO, or "the Act"), Public Law 111-139, enacted February 12, 2010.

[140] Astleford v. Comm'r, T.C. Memo 2008-128.

[141] Holman v. Comm'r., 130 T.C. 170 (2008).

United States, the court approved discounts for lack of control and lack of marketability of a combined 47.5 percent for a limited partnership consisting of bonds and cash.[142]

However, the window of opportunity for partnership discounts may close soon. Either Congress will act to amend § 2704 to reduce the availability of discounts on transfers of closely held entities or the IRS will issue regulations to do the same thing under the broad authority granted them in § 2704(b)(4).

Section 2704(b)(1) currently provides that "applicable restrictions" are to be ignored in valuing intra-family transfers of interests in family controlled corporations and partnerships.[143] An "applicable restriction" is any restriction (A) which effectively limits the ability of the corporation or partnership to liquidate, and (B) with respect to which either…(i) the restriction lapses in whole or in part after the transfer [or] (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction. [144]

However, the statute excepts from this definition "any restriction imposed, or required to be imposed, by any Federal or State law."[145] IRS regulations dilute this exception even further by providing that any liquidation restriction "that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction" is not an applicable restriction.[146] As a result, most partnerships have been able to avoid an applicable restriction under § 2704(b) simply by including liquidation provisions that are no more restrictive than state law.

The President's Fiscal Year 2011 Revenue Proposal (Greenbook) attempts to put some teeth back into § 2704.[147] It would add a new category of "disregarded restrictions" that would be ignored in valuing an interest in a family controlled entity transferred to a member of the transferor's family if, after the transfer, the restriction will lapse or may be removed by the transferor or his family. Restrictions that would be disregarded would include limitations on a holder's right to liquidate that are more restrictive than *a standard to be identified in the regulations* and any limitation on a transferee's ability to become a full partner or equity holder (i.e. assignee). Oddly, the Greenbook also proposes to authorize the IRS "to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

The Joint Committee on Taxation criticized the President's Greenbook Proposal because the IRS already has broad authority to do the same thing in regulations and because the Greenbook only targets liquidation discounts and not minority discounts.[148] In fact, the Joint Committee on Taxation declined to score the revenue effect of this proposal because of its lack

142 Keller v. United States, 104 AFTR 2d 2009-6015 (S.D. Tex. 8/20/09).

143 IRC § 2704(b)(1).

144 IRC § 2704(b)(2).

145 IRC § 2704(b)(3)(B).

146 Reg. § 25.2704-2(b).

147 General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 124.

148 "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal," Staff of the Joint Committee on Taxation (September 8, 2009).

of specificity. The Greenbook, however, estimated that its proposal would raise about 19 billion over 10 years.[149] This is significant compared to other Greenbook provisions.

In the meantime, the IRS has included "Guidance under § 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership" on its Priority Business Plan for six years. The IRS has very broad authority under the statute to draft regulations identifying other restrictions that will be ignored. Section 2704(b)(4) provides:

> **Other restrictions.** The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

The authority granted in this statute makes these regulations "legislative regulations" having the full force and effect of the law.[150]

IRS representatives have stated verbally that these regulations are already drafted and only waiting to see whether Congress will act on the Greenbook Proposal before releasing them. If Congress acts on the Greenbook Proposal, a large part of the new statute will need regulations to flesh out its contours. But if Congress delays the Greenbook Proposal inordinately, the IRS may issue the regulations and any window of opportunity will close because the regulations will be nearly impossible to challenge.

Therefore, it makes sense to implement a gifting program now before the effective date of any new statute or regulation.

E. Grantor Retained Annuity Trusts (GRATs)

A GRAT is a popular estate planning strategy under § 2702 that allows the transferor to gift appreciating assets (like partnerships and corporations) to an irrevocable trust with little or no transfer tax consequences. [151] The grantor transfers assets to a GRAT, which pays the grantor an annuity for a certain term of years. The assets remaining in the GRAT at the end of the term are transferred to the remainder beneficiaries. Grantors can zero out the GRAT by setting the assumed value of the annuity under actuarial tables to equal the entire value of the property transferred to the trust. This produces a zero value on the remainder interest and thus a zero value for gift tax purposes. If the assets in the trust achieves a rate of return substantially in excess of the § 7520 rate assumed in valuing the annuity, substantial value can pass to the remainder beneficiaries with no further tax consequences.

If the grantor dies before the end of the GRAT term, the assets in the trust needed to produce the retained annuity for the rest of the term are included in the grantor's estate for estate tax purposes. Therefore, the goal is to create a GRAT term that will not outlive the grantor. A popular term for a short-term GRAT is two years. Such GRATs are oftentimes referred to as *Walton* GRATs for the case that seemed to allow two years for a GRAT. Using a two-year

[149] General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 151.
[150] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).
[151] IRC § 2702

GRAT limits the risk of estate tax inclusion while availing the grantor an opportunity to make tax-free gifts to the grantor's children.

For example, under current law, a grantor could transfer $1 million to a 2-year GRAT that would pay him an annuity of $524,136 for two years. If the grantor survives the GRAT term, none of the GRAT property is included in the grantor's estate regardless of its value.

The President's 2010 and 2011 Budget Proposals would increase the downside risk of a GRAT by imposing a minimum term of ten years, prohibit any decrease in the annuity during the GRAT term, and provide that the remainder value must be greater than zero.[152] How much greater than zero is needed is not certain. But the Budget Proposal indicates that the remainder could be nearly zero. Under the proposal, the GRAT in the example above would pay the grantor $118,430 over 10 years. The grantor could still nearly zero out the gift tax value, but would have to wait ten years before the asset is completely out of his or her estate.

This GRAT provision now appears in the "Small Business and Infrastructure Jobs Tax Act of 2010" (H.R. 4849), which passed the House by a vote of 246-178 on March 25, 2010. The provision would likely be effective on the date of enactment and is estimated to raise about $3 billion over 10 years, which is relatively minor compared to other tax provisions.[153] Therefore, taxpayers have a limited window of opportunity to create a two-year GRAT.

But all is not lost with a 10-year GRAT. It tends to shift more wealth to the beneficiary because the grantor continues to pay the income tax on the property that much longer, without it being treated as an additional gift to the remainder beneficiary.[154] It can also shift more wealth to the remainder by locking in today's low interest rates longer. For example, a $1 million GRAT with a 2-year term will pay an annuity of $525,652 per year compared to a 10-year term GRAT that will pay an annuity of $119,636 per year. If the grantor invested these sums at 6 percent for 10 years, he would accumulate $1,829,441 with payments from the 2-year GRAT versus only $1,671,511 with payments from the 10-year GRAT.

Year	2-Year GRAT Annuity	Grantor's Fund Balance	10-Year GRAT Annuity	Grantor's Fund Balance
1	525,652	557,191	119,636	126,814
2	525,652	1,147,814	119,636	261,237
3		1,216,683	119,636	403,725
4		1,289,684	119,636	554,762
5		1,367,065	119,636	714,862
6		1,449,088	119,636	884,569
7		1,536,034	119,636	1,064,457
8		1,628,196	119,636	1,255,139
9		1,725,887	119,636	1,457,261
10		1,829,441	119,636	1,671,511

[152] General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, p. 126.
[153] *Id.* at p. 151.
[154] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

A long term GRAT also saves the same amount of estate taxes as a short term GRAT if the grantor survives the term. If the grantor dies before the GRAT term ends, the amount included in the grantor's estate is the lesser of the amount in the GRAT or the principal necessary to pay the annuity for the rest of the GRAT period without reducing or invading principal.[155]

> **Example.** D transferred $100,000 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 before the end of the GRAT term 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][156]

Thus, if interest rates rise and the GRAT property appreciates, the value includible in the grantor's estate with a 10-year GRAT could be less than what would have been included if no GRAT had been created.

There should be no income tax consequences to the grantor or his estate when the grantor dies during the term of the GRAT, even if the annuity payments continue to be paid to the estate. The IRS and the courts have consistently held that the moment a trust ceases to be a grantor trust, it becomes a separate nongrantor trust.[157] In the conversion, the grantor is deemed to have transferred his property to the trust. If there is any consideration in the exchange (cash, debt relief, an annuity, etc.) paid to the grantor, the transfer is taxable to the grantor to the extent that the consideration exceeds the grantor's basis in the property.[158] However, because GRAT property is included in the grantor's estate when he dies during the term of the GRAT, the property receives a stepped up basis. Thus it is unlikely that the value of the remaining annuity payments paid to the grantor's estate (if any) will exceed the basis of the property.

F. Consistency Between Income Tax Basis and Form 706 Reported Value

Current law provides that property be included in a decedent's gross estate under § 2031 at fair market value and that the basis of property acquired from a decedent be its fair market value under § 1014. However, no statute explicitly requires that the value under § 2031 be the same as the value under § 1014. As a result, recipients of property from a decedent may have reported a different basis for income tax purposes than was used on the Form 706. By the time they sell the property, the statute of limitations may long since be closed for the IRS to audit the Form 706.

Inconsistency can also work to the taxpayer's detriment. The estate may have claimed a large discount on the Form 706 and the beneficiary/partners may have used that low basis to compute their gain or loss on sale of the asset. If the IRS subsequently determines, after an extended audit of the Form 706, that the estate tax discount was too high and the basis of the

[155] Reg. § 20.2036-1(c)(2)(i); Prop. Reg. § 20.2036-1(c)(3).
[156] Example based on Reg. § 20.2036-1(c)(2)(iii), Ex. 2.
[157] Treas. Regs. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; Technical Advice Memoranda 200011005; General Counsel Memoranda 37228.
[158] *Id.*

assets should be increased, it may be too late for the beneficiaries to amend their individual income tax returns.

To attack such inconsistencies, the IRS and courts have successfully applied a common law duty of consistency.[159] This requires taxpayers to use the same basis for federal income tax purposes as the estate tax values finally determined. The duty of consistency is a judicial doctrine that applies when (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations.

The IRS Appeals Settlement Guidelines for Family Limited Partnerships illustrates the duty of consistency with partners using the undiscounted basis for federal income tax purposes, while benefiting from discounted values for estate tax purposes.[160] It references *Janis v. Commissioner* in which the trustee used an undiscounted basis for determining the cost of art sold in a retail business, even though the executor had used a blockage discount when valuing the art inventory for estate tax purposes.[161] The Tax Court held that the trustee had a duty of consistency to use the same basis for estate and income tax reporting purposes.

To prevent such inconsistencies, the Administration's 2011 Greenbook proposes to impose a statutory reporting and consistency requirement on the estate and the recipient of inherited property.[162] A similar requirement would also extend to donors and donees in gift transactions. The proposal would require the basis of property received from a decedent under § 1014 to equal the value of that property for estate tax purposes. It would also require the basis of property received by gift during the life of the donor to equal the donor's basis determined under § 1015. The proposal would also require that the basis of property in the hands of a recipient be no greater than the value of that property as determined for estate and gift tax purposes (subject to subsequent adjustments).

This proposal would require the executor and the donor to provide the necessary information to the recipient and the IRS. The IRS would have authority to write regulations for situations where no estate or gift tax return is filed or where the recipient has better information about the value and basis than the executor or donor.

159 Janis v. Comm'r, TC Memo 2004-117, *aff'd* 469 F.3d 256 (2nd Cir. 2006).

160 APPEALS SETTLEMENT GUIDELINES, FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS, Uniform Issue List (UIL) 2031.01-00 (Jan. 29, 2007).

161 Janis v. Comm'r, TC Memo 2004-117, *aff'd* 461 F.3d 1080 (9th Cir. 2006), *aff'd on different grounds* 469 F.3d 256 (2nd Cir. 2006).

162 *Id.* at p. 122.