INCOME TAXATION OF TRUSTS AND ESTATES

Texas CPA Tax Institute Conference
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by John R. Hunter

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Excerpts from Jeffrey N. Pennell’s outline for State Bar of Texas Advanced Estate Planning and Probate Course from June 2015 used to prepare outline.
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BIOGRAPHICAL INFORMATION

John R. Hunter, partner with The Blum Firm, P.C. with law offices in Fort Worth, Dallas, Houston, and Austin, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Mr. Hunter is an attorney and certified public accountant and is Board Certified by the Texas Board of Legal Specialization in Tax Law. He received his undergraduate degree in Economics cum laude and his Master’s Degree in Accounting from Rice University. Mr. Hunter received his law degree cum laude from The University of Houston Law Center.

Mr. Hunter has practiced in both the private sector and with the government, where he represented the Commissioner of Internal Revenue before the United States Tax Court. He is a frequent speaker on estate planning and tax topics.

Mr. Hunter is consistently voted a “Texas Super Lawyer” (2004-2014) by Thomson Reuters – an honor given to only five percent of all attorneys in the state, and Fort Worth, Texas magazine has recognized him as one of Tarrant County’s “Top Attorneys” in both Tax Law (2009-2013) and Probate, Estates, and Trusts (2010-2013). Mr. Hunter was also honored as Professional of the Year for 2009 by the Community Foundation of North Texas.

Mr. Hunter and his wife, Carmen, live in Fort Worth with their three children.
INCOME TAXATION OF TRUSTS AND ESTATES

TABLE OF CONTENTS

I. Introduction

II. Taxable Income
   A. No Standard Deduction for Trusts or Estates
   B. The 2% Floor Only Applies to Some Fees for Trusts and Estates
   C. Charitable Deductions for Trusts and Estates
   D. Expenses of Administration

III. Distributable Net Income
   A. Three Functions of DNI
   B. Determining DNI
   C. Separate Share Rule
   D. Tax Years

IV. Simple Trusts
   A. Tax Treatment of Simple Trusts

V. Estates and Complex Trusts
   A. In-Kind Distributions and Specific Bequests
   B. Accumulated Income
   C. Multiple Trust Rule
   D. Sixty-Five Day Rule
   E. The Tier Rules
   F. Separate Share Rule

VI. Distributions In-Kind

VII. Realization Events

VIII. Income and Deductions in Respect of a Decedent
   A. Tax Consequences of IRD
   B. Deductions in Respect of a Decedent
   C. Deductions for Taxes Attributable to IRD

IX. Grantor Trusts
   A. How to Trigger Grantor Trust Treatment
      678 Trusts
   B. Perceived Advantages of Grantor Trusts
   C. Portion Rules
      Entire Trust Portion
      Ordinary Income Portion
Corpus Portion
Fractional Amount of Ordinary Income or Corpus Portion
Specific Asset Portion
Chronological Portion

D. Toggle Switch Planning Issues—Termination of Grantor Trust Status May Be a Realization Event
   - Rev. Rul. 85-13 on Changing Grantor Trust Status
   - TAMS on Changing Grantor Trust Status
   - More Examples of How the Government Has Approached Changes in Grantor Trust Status
   - Grantor Trust “Toggle Off” Example
   - Death of the Grantor

E. Common Planning Choices
F. How to File a Tax Return for a Grantor Trust
   - General Rule – Form 1041
   - First Alternative – 1099 in lieu of 1041
   - Second Alternative – Changing Ownership Listing of the Trust’s Assets

Other Reporting Issues

X. Application of the 3.8% Surtax
A. Grantor Trusts
B. Nongrantor Charitable Lead Trusts and Charitable Remainder Trusts
C. NII Comes Out Consistent with Tier Rules
D. Passive Versus Active Participation Rules Under Section 469
   - Aragona Trust

XI. State Income Taxation of Trusts and Estates
A. 678 Trusts
B. Reciprocal Trusts
C. Estates
D. Estate Distributions
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I. INTRODUCTION

Special thanks to Jeffrey N. Pennell, the Richard H. Clark Professor of Law at Emory University School of Law, for letting us use excerpts from his speech on Income Taxation of Trusts and Estates given at the State Bar of Texas Advanced Estate Planning & Probate Course in June 2015. A majority of this outline comes from his speech and we are grateful for his permission to use his work. His material is extracted from a student text on estate planning in general and appropriately is simplified. It will support our conversation during the time we have together but it is not adequate for serious study. For added guidance and self-study, see 1 Casner & Pennell, Estate Planning Chapter 5 and Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts and Beneficiaries.

The income tax provisions that apply to estates and trusts, and their beneficiaries, are found in Subparts A-D of Part I of Subchapter J of the Internal Revenue Code (commonly referred to as just Subchapter J). In addition, a separate set of rules in Subpart E can trump all of the rest of Subchapter J. These are the grantor trust rules, which can cause a trust (but not an estate) to be regarded as a pass through entity with virtually all its tax consequences flowing to the grantor (or a third party treated as the grantor) for income tax purposes.

Although for some purposes fiduciary entities are subject to pass through taxation similar to S corporations and partnerships, estates and trusts are treated as separate tax paying entities for income tax purposes and therefore must be considered separately. Estates and trusts file annual federal income tax returns (Form 1041) and may incur income tax on net earnings, capital gains, and other income that is not distributed currently to their beneficiaries. On the other hand, they are treated as conduits to the extent they pass “distributable net income” (“DNI”) to their beneficiaries on a current basis. In most respects income that is distributed to beneficiaries currently has the same character (tax exempt, capital versus ordinary, preference items for alternative minimum tax purposes, and such) in the beneficiaries’ hands as it would on the fiduciary’s return if it was not distributed.

As we will see, estates and trusts are subject to their own unique set of income tax rules, and any comparison to pass through entities or “conduit” taxation is a gross generalization. As the following material demonstrates, the operation of Subchapter J in its entirety is complex and technical.
II. TAXABLE INCOME

The taxable income of an estate or trust is generally the same as it is for an individual taxpayer. The principal differences between the tax treatment of the income of an estate or trust and that of an individual are the income tax deductions allowed to the entity under Sections 651(a) and 661(a) for distributions made (or required to be made) to beneficiaries. With few exceptions, any distribution made from an estate or trust to a beneficiary (whether made from current or accumulated income, or from principal) is treated as a distribution of current income to the extent of the entity’s DNI. In addition, an unlimited deduction is allowable under Section 642(c) for amounts paid (or, in some circumstances, permanently set aside) for a charitable purpose.

Under Section 643(c) the term “beneficiary” is as you would expect: an heir, a legatee, or a devisee. But under Section 643(a), DNI is a term of art, created by the tax law to serve a limited but pivotal role in the income taxation of estates and trusts. The primary function of DNI is to serve as a yardstick or measure, placing a limit on the amount of the entity’s distributions deduction and on both the amount and the character of current income that is attributable to the income beneficiaries for taxation in the current year. DNI also serves as an element in a number of other rules that seldom are relevant these days, so we can defer an examination of the meaning and function of DNI because first we need to consider some special aspects of estate and trust taxable income, which is at the core of DNI.

With few exceptions, an estate or trust is permitted the same deductions that are allowed to individuals. For example, estates and trusts are denied the Section 151 personal exemption afforded to individuals but are entitled instead to a Section 642(b) deduction in lieu of the personal exemption, granted in various amounts, all of which are much lower than the amount granted to individuals. For example, the deduction in lieu of an estate’s personal exemption is $600, and the amount allowed to a trust is even less: $300 if the trustee is required to distribute all of the trust’s income currently, and only $100 otherwise. Notably, estates and trusts cannot elect the Section 179 deduction.

For these deductions and most other purposes, the statutory reference to trust “income” means state law fiduciary accounting income and is to be contrasted with “taxable income,” which is determined under the income tax rules. In most states fiduciary accounting income is determined under the Uniform Principal and Income Act or the Revised Uniform Principal and Income Act, under which capital gains and losses are excluded for most purposes from the determination of income for fiduciary accounting purposes.

A. No Standard Deduction for Trusts or Estates

Because Section 63(c) does not apply to an estate or trust, there also is no standard deduction. Thus, every dollar of an estate or trust’s net taxable income is subject to tax at rates

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1 See IRC § 641(b).
2 IRC § 642(b).
that by far are the most onerous rates applicable to any taxpayer under the Code.\(^3\) To illustrate, look at Section 1(e) to see that fiduciary entities enter the highest marginal tax bracket (39.6% at the time of this writing) at a remarkably low level ($12,300 is the inflation indexed amount at the time of this writing). Also notice that, unlike other taxpayers, there is no 35% bracket.

In addition, the 3.8% Medicare surtax may apply to the undistributed net investment income ("UNII") of a trust or an estate, as it would to an individual.\(^4\) See Section X below for an elaboration of UNII (which is not to be confused with UNI, as discussed in Section V below). Considering this surtax, most trust income will be subject to a combined income tax rate of 43.4%. As such, accumulating income for taxation inside the entity normally is not favorable, unless it would be subject to the same tax in the beneficiary’s hands or there are important reasons not to make that income available to the beneficiary (such as because it would disqualify the beneficiary for need-based governmental entitlements or because the beneficiary is a spendthrift).

B. The 2% Floor Only Applies to Some Fees for Trusts and Estates

One favorable discrimination in the taxation of fiduciary entities is Section 67(e), which specifies that the 2% (of adjusted gross income) loss of deductible miscellaneous itemized deductions for individuals will not apply with respect to “costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate.” Some uncertainty exists with respect to the meaning of this provision in the context of deductible items that are attributable to expenses that would be incurred even if the property were not held in an estate or trust. For example, a fiduciary’s costs to prepare the Form 1041 Fiduciary Income Tax Return are fully deductible, notwithstanding the 2% rule, because this return is necessary only because the property is held in a fiduciary capacity. But what about the fiduciary’s own fees for administration of the entity?

Suppose, for example, that the grantor of a trust paid for investment advice prior to creation of the trust, but that the trustee of the trust provides investment counsel with respect to trust assets as part of the services it renders. A trustee that does not account or charge separately for this investment function must allocate (unbundle) its fees to identify items of expense that would have been incurred if the property was not held in the trust. *Knight v. Commissioner* makes it clear that investment advisor fees paid to a third party are subject to the 2% loss of deduction.\(^5\) Section 1.67-4 of the Treasury Regulations\(^6\) requires unbundling of a fiduciary’s integrated fee, subject to an important exception. Treasury Regulations Section 1.67-4(c)(2) states the following): “If a bundled fee is not computed on an hourly basis, only the portion of

\(^3\) All references to “IRC” or the “Code” are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

\(^4\) Treas. Reg. § 1411(a)(2) imposes the 3.8% tax on “the lesser of (A) the undistributed net investment income” (“UNII”) of the trust or estate or (B) adjusted gross income of the entity minus $12,300. Because the subtraction amount is so much lower for a trust or an estate than for any individual beneficiary, in many cases distribution of the UNII will avoid the 3.8% tax entirely because the beneficiary’s AGI will not exceed the beneficiary’s threshold amount.


\(^6\) All references to the “Regulations” or to “Treas. Reg.” are to the regulations promulgated under the Code unless otherwise specified.
that fee that is attributable to investment advice is subject to the 2-percent floor; the remaining portion is not subject to that floor.” The typical fiduciary fee is not computed on an hourly basis—meaning that the only determination a fiduciary must make is that portion of its bundled fee that is attributable to the investment function performed by the fiduciary. Other elements of an integrated fee need not be identified as allocable to items that are subject to the 2% floor and those that are not.

A proposed regulation in 2007 listed items that would be fully deductible as fees for services related to

- fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters.

And falling outside the safe harbor list were fees for services related to

- custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

Similar items are included in the final regulation, and the 2007 proposed regulation presumably also gives taxpayers clues regarding the reasonable allocation standard, which did not change. Items that the final regulation mentions as subject to the 2% floor include (1) costs incurred in defense of a claim against the estate, the decedent, or a non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust, (2) “ownership” or carrying costs incurred by any owner of property, such as condominium fees, insurance premiums, and maintenance expenses, (3) costs of preparing gift tax returns (but not estate, generation-skipping, fiduciary income tax, or the decedent’s final income tax returns), and (4) investment fees. Items that are excluded from the 2% loss of deduction include (a) appraisal fees incurred for estate or generation-skipping transfer tax purposes or “to determine value for purposes of making distributions” and (b) other fiduciary expenses that are uncommon to individuals, such as probate court and certified death certificate fees and costs, fiduciary bond premiums, legal publication costs for notice to creditors or heirs, and costs related to fiduciary accounts.

C. Charitable Deductions for Trusts and Estates

In calculating a trust or estate’s taxable income another important difference involves the charitable deduction. The Section 170 deduction is allowed to individuals for charitable contributions, subject to certain limitations based on the type of property transferred and character of the recipient. In its stead Section 642(c) allows an unlimited deduction to an estate or trust for any amount of its gross income that is paid for a charitable purpose or use. The
deduction is allowed for amounts paid pursuant to a direction in the will or other governing instrument and for amounts paid pursuant to the exercise of fiduciary discretion granted in the instrument, including any current gross income of an estate that is permanently set aside for future charitable distribution. This Section 642(c)(2) set-aside deduction is not available to most trusts. As a result, a trust that serves as a will-substitute is well advised to make an election under Section 645 for the period of estate administration, so as to garner the Section 642(c)(2) entitlement.

D. Expenses of Administration

Finally, expenses of administration that are allowable as estate tax deductions under Section 2053 also may qualify as income tax deductions under Sections 162, 163, 165, or 212, as a reduction of the sales price in determining gain on the disposition of assets, or as Section 213 medical expenses deductible on the decedent’s final income tax return. The decedent’s personal representative must elect under Section 642(g) whether to take an income tax or an estate tax deduction (or some of each) with respect to these items, the law precluding utilization of the same expenditures to work double duty under each of the estate and income taxes.

III. DISTRIBUTABLE NET INCOME

Unique to the income taxation of trusts and estates is the concept of distributable net income. We begin our study of DNI by looking at why we need it and the primary purpose it serves. Recall that gifts are income tax-free under Section 102. Thus, if X gave or bequeathed property to Y, Section 102(a) provides that Y does not recognize gross income from the transfer. But Section 102(b) specifies that any income subsequently produced by the gifted property is taxable to Y.

Similarly, if X gratuitously gave or bequeathed income producing property to a trust for the benefit of Y, neither the transfer into the trust nor any subsequent distribution of the trust corpus to Y would constitute gross income to either Y or to the trustee. This is because Section 102(a) excludes gifts and inheritances from gross income, and it does not matter whether the property is transferred directly to the donee or beneficiary immediately or is held and distributed in the future through the medium of a trust.

On the other hand, income from gifted corpus is taxable. So too, income produced by the trust property subsequent to X’s transfer should be subject to income taxation, either to beneficiary Y or to the trust (as a separate entity). Moreover, the beneficiaries of a fiduciary entity should be taxed only on their distributive share of any taxable income of the entity, which requires that the tax exempt character of the estate or trust’s income must be preserved. So the statutory challenge is to determine the extent to which distributions to beneficiaries are tax-free distributions of corpus or of tax exempt income, as compared to taxable income (produced by corpus that is not yet distributable). This identification of estate or trust distributions is geometrically more complex if distributions are made to multiple beneficiaries, especially if the nature of their beneficial interests varies (e.g., income and remainder beneficiaries). Since 1954,
Subchapter J has used the concept of distributable net income as the device that determines the extent to which distributions to beneficiaries are taxable.

A. Three Functions of Distributable Net Income

DNI is a tax term of art that has no meaning or use outside Subchapter J. Even within Subchapter J, the role of DNI is both limiting and limited, so it is best to keep it in proper perspective. First and foremost, DNI limits the amount of estate or trust distributions that may be treated as taxable income to the beneficiaries. DNI also provides the basis for allocating various classes of income among the beneficiaries.

Known as the character rules, this DNI function is important because a distribution that is treated as income to a beneficiary is not necessarily taxable to the beneficiary, depending on the tax character of the item distributed (for example, interest from a state or municipal bond that is exempt from tax under Section 103, as opposed to taxable corporate bond interest). The character rule has the effect of treating the entity as a conduit through which income flows from its original source to the beneficiaries.

This treatment requires a pro rata allocation of various classes of income among beneficiaries according to the amount of DNI deemed received by each. In lieu of ratable sharing, the governing instrument specifically may allocate different classes of income to different beneficiaries, provided that the allocation has an economic effect independent of the income tax consequences of the allocation.

DNI has a third function, limiting the maximum amount of income tax deduction allowed to an estate or trust under Sections 651(a) and 661(a) for distributions made to beneficiaries. We will see that this just precludes a fiduciary entity from being in a loss position for income tax purposes in any given year.

B. Determining Distributable Net Income

DNI is defined in Section 643(a) as the taxable income of the estate or trust for the tax year with a number of adjustments. The first adjustment is the Section 643(a)(2) “add back” of the amount of the deduction in lieu of the personal exemption which is allowed under Section 642(b) in computing taxable income. When considering this increase, distributable net income is larger than taxable income, meaning that a larger distributions deduction is available to the entity for current income distribution. Similarly, a larger amount is subject to inclusion in the taxable income of the beneficiaries of the estate or trust who received distributions, in each case because distributable net income is a cap on each. The net effect is to deny the benefit of the deduction in lieu of the personal exemption to the trust or estate beneficiaries. As a result, that deduction serves only to reduce tax consequences to the entity. It does not flow through and benefit the beneficiaries (who have their own personal exemptions).

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7 IRC §§ 652(a), 662(a).
8 IRC §§ 652(b), 661(b), and 662(b); Treas. Reg. §§ 1.652(b)-2 and 1.662(b)-2.
9 See Treas. Reg. § 1.652(b)-2(b).
The second adjustment is an additional “add back,” with a similar effect on DNI, dictated under Section 643(a)(5) for Section 103 tax exempt income. This add back serves to permit this form of tax favored income to pass through to the beneficiaries by increasing DNI, and thus increasing both the distributions deduction and the amount subject to inclusion at the beneficiary level. If distributed currently, the character pass through rules of the conduit system of taxation under Sections 652(b) and 662(b) (discussed in Section IV.A below) permit the beneficiaries to enjoy the special status of income items that trigger this adjustment.

Because Sections 652(b) and 662(b) dictate a pro rata allocation of the character of all items included in DNI, distributions that generate deductions for the entity are also prorated to various items of taxable and tax favored or exempt income, under Treasury Regulations Sections 1.643(a)-5(b), 1.652(c)-4, 1.661(b)-2, and 1.661(c)-2(d). Thus, care must be exercised to assure proper allocation of these items to the proper beneficiaries. Otherwise the government may attempt to allocate deductions to tax exempt income, which essentially wastes the deduction (the income and deductions balancing out) while the taxpayer attempts to allocate deductibles to receipt of taxable income to maximize their utility.

In addition to adding back the deduction in lieu of the personal exemption and tax exempt income in computing DNI, three items normally considered in the determination of taxable income are ignored for purposes of computing DNI. Thus, a third adjustment, dictated by Section 643(a)(1), is to ignore the distributions deduction allowed by Sections 651(a) and 661(a). Because that deduction is limited to the taxable portion of DNI, an unavoidable circularity otherwise would develop if DNI was equal to taxable income after allowance of the distributions deduction. The deduction would be limited by DNI and DNI would be dependent for computation on the amount of the deduction. Therefore, this modification is really just structural.

The fourth and fifth adjustments relate to items of taxable income that are allocated to fiduciary accounting principal and not currently distributed. Thus, for example, under Section 643(a)(3) and Treasury Regulations Section 1.643(a)-3, capital gains are ignored for purposes of computing DNI if they are allocated to corpus (either under the terms of the document, or under a local law such as Section 3(b)(8) of the former Uniform Principal and Income Act or Section 404(2) of the 1997 Revised Uniform Principal and Income Act) and not distributed or set aside for charity, along with capital losses used in computing taxable income. The effect is to reduce DNI and, correspondingly, to reduce the maximum distributions deduction, thereby causing these gains to be taxed to the entity in years when they are not distributed to the beneficiaries.

Similarly, but applicable only to simple trusts (defined in Section IV below) under Section 643(a)(4), taxable extraordinary or stock-on-stock dividends that are allocated to principal under the instrument or local law and that are not currently distributed are excluded from DNI, again reducing the maximum distributions deduction and causing the tax thereon to fall on the entity.10 (This is more complexity than you need to know, so let’s ignore it for now.)

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10 See Uniform Act §§ 3(b)(4) and (6); Revised Uniform Act § 401(c)(1).
The following example illustrates the foregoing adjustments in computing DNI. Assume a simple trust in which receipts and disbursements for the year include:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable Dividends, allocable to income</td>
<td>$25,000</td>
</tr>
<tr>
<td>2. Taxable Dividends, allocable to principal</td>
<td>12,000</td>
</tr>
<tr>
<td>3. Taxable Interest</td>
<td>15,000</td>
</tr>
<tr>
<td>4. Tax Exempt Interest</td>
<td>10,000</td>
</tr>
<tr>
<td>5. Long Term Capital Gain</td>
<td>7,000</td>
</tr>
<tr>
<td>6. Long Term Capital Loss</td>
<td>(2,000)</td>
</tr>
<tr>
<td>7. Fiduciary Fees, charged to income</td>
<td>(5,000)</td>
</tr>
<tr>
<td>8. Fiduciary Fees, charged to principal</td>
<td>(5,000)</td>
</tr>
</tbody>
</table>

Fiduciary Accounting Income reflects the following items:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable Dividends</td>
<td>$25,000</td>
</tr>
<tr>
<td>3. Taxable Interest</td>
<td>15,000</td>
</tr>
<tr>
<td>4. Tax Exempt Interest</td>
<td>10,000</td>
</tr>
<tr>
<td>7. Fiduciary Fees</td>
<td>(5,000)</td>
</tr>
<tr>
<td><strong>FAI</strong></td>
<td><strong>$45,000</strong></td>
</tr>
</tbody>
</table>

Taxable Income reflects the following items:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable Dividends, allocable to income</td>
<td>$25,000</td>
</tr>
<tr>
<td>2. Taxable Dividends, allocable to principal</td>
<td>12,000</td>
</tr>
<tr>
<td>3. Taxable Interest</td>
<td>15,000</td>
</tr>
<tr>
<td>5. Long Term Capital Gain</td>
<td>7,000</td>
</tr>
<tr>
<td>6. Long Term Capital Loss</td>
<td>(2,000)</td>
</tr>
<tr>
<td>7. 80% of Fiduciary Fees, charged to income</td>
<td>(4,000)</td>
</tr>
<tr>
<td>8. 80% of Fiduciary Fees, charged to principal</td>
<td>(4,000)</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td><strong>$49,000</strong></td>
</tr>
</tbody>
</table>

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11 Fees are allocable in part to the tax exempt income and become nondeductible under IRC § 265. The portion deemed allocable to that income was based here on income allocable to the income account and is consistent with the illustration in Treas. Reg. § 1.643(d)-2(a). It might be more appropriate to allocate based on all income, dividends, gains, and losses considered in computing taxable income, in which case the proper portion to exclude would be only 10 ÷ 67. A larger portion of the deduction is lost as illustrated in the regulation, which may explain the simplistic approach taken by the government.

12 For ease, this figure has been computed before the IRC § 651(a) distributions deduction, with its IRC § 643(a)(1) adjustment, and before the IRC § 642(b) deduction, with its IRC § 643(a)(2) adjustment.
Distributable Net Income is computed as:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>$49,000</td>
</tr>
<tr>
<td>Less net long term capital gain(^{13})</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Less dividends allocable to principal(^{14})</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Plus tax exempt income, reduced by allocable fees(^{15})</td>
<td>8,000</td>
</tr>
<tr>
<td><strong>DNI</strong></td>
<td><strong>$40,000</strong></td>
</tr>
</tbody>
</table>

As illustrated, fiduciary accounting income, taxable income, and distributable net income each may differ during any given year.

1. Fiduciary accounting income could exceed taxable income if deductible expenses were paid from principal or due to tax exempt interest or the deduction in lieu of the personal exemption.
2. Fiduciary accounting income could be less than taxable income if taxable items, such as capital gains or certain dividends, were allocable to principal.
3. Taxable income could exceed DNI because the distributions deduction is ignored or because capital gains or taxable dividends are allocated to principal and thus excluded in computing DNI.
4. Taxable income could be less than DNI due to tax exempt income or the deduction in lieu of the personal exemption (all considered in computing taxable income but not in determining DNI).
5. And there need be no correlation between fiduciary accounting income and DNI.

Consequently, it could be hazardous to use short-cuts to determine the tax treatment of an estate or trust, by assuming a correlation between any of these three concepts.

### C. Separate Share Rule

In determining the amount of DNI of an estate or trust that is allocable to its beneficiaries, Section 663(c) provides that substantially independent and separately administered shares of a single trust or estate will be treated as separate trusts for their respective beneficiaries. Consequently, activity such as accumulations or distributions in one separate share will not affect application of the tax rules or the tax consequences of activity in other shares. The separate share rule applies regardless of how many beneficiaries there are of any separate share or whether separate books of account are maintained for the separate shares.\(^{16}\) (Note that anecdotal evidence strongly suggests that taxpayers and the government alike ignore the separate share rule—probably due to a combination of ignorance and the added complexity that it creates.)

\(^{13}\) Under IRC § 643(a)(3), reflecting items 5 and 6.
\(^{14}\) Under IRC § 643(a)(4), reflecting item 2.
\(^{15}\) Under IRC § 643(a)(5), reflecting items 4, 7, and 8.
\(^{16}\) Treas. Reg. § 1.663(c)-3.
D. Tax Years

A final function of DNI is not very important for trust administration purposes, but it is relevant for estates, which are the only fiduciary entities with individuals as beneficiaries that routinely may have a tax year that is not a calendar year. A decedent’s estate may elect a non-calendar fiscal year as long as the first year does not exceed 12 months and the year ends on the last day of the calendar month. Under Sections 652(c) and 662(c), if an estate or trust has a tax year that is different from that of its beneficiary, the amount of income potentially attributable to the beneficiary and the time of its inclusion in the beneficiary’s gross income is based on the entity’s income for the entity’s tax year that ends during the beneficiary’s tax year.

To illustrate, assume the beneficiary is on a calendar year (most individuals are) and an estate is on a fiscal year that ends on January 31. Income distributed by the estate to the beneficiary on February 1 of year 1 is treated as the beneficiary’s income in year 2. This means that the distribution will not be returned or tax paid on it until April 15 of year 3 at the earliest (unless estimated tax is being reported by the beneficiary on a quarterly basis).

This deferral opportunity has its downside at the end of administration, in which case a “bunching” of two years’ worth of income may occur in a single year of the beneficiary. For example, in this illustration the prior year’s income would be reported in the year of estate termination, plus the income of the year beginning February 1 and ending when the administration terminates in that same year. It also may occur at a beneficiary’s death, because there is no tax year of the beneficiary with which or within which the distributing entity’s tax year ends (the entity’s tax year will end after the beneficiary’s death unless the beneficiary happens to die on the last day of the distributing entity’s tax year). Income paid to a beneficiary’s estate or successors in interest after the beneficiary’s death is taxable to those recipients as income in respect of a decedent under Section 691(a), which we study beginning in Section VIII below.

Because fiscal years are still allowed for estates, careful attention is required to coordinate the tax year of the estate with the years of its beneficiaries. Selection of tax year is one item of postmortem tax planning customarily considered by the personal representative, and administration of even a simple, no frills estate can entail time consuming and often difficult details of this type that many planners, some fiduciaries, and most beneficiaries do not recognize or appreciate.

Similarly, for both estates and trusts, some discretion exists in selecting when the last year of the entity will end for tax purposes. In this respect, both estates and trusts are deemed to continue to exist for a reasonable period necessary to perform the ordinary duties of administration, and thereafter to distribute all but a reasonable reserve for contingent claims. Any attempt to unduly prolong administration (for example, to force termination into a later tax year of the beneficiaries) will be disallowed and the entity will be deemed terminated when that reasonable time for administration has expired. Don’t ask what “reasonable” means.

17 IRC § 441(c); Treas. Reg. § 1.441-1T(b).
18 Treas. Reg. §§ 1.641(b)-3(a), 1.641(b)-3(b).
Planning Point: Accountants often use December 31 as the end of the fiscal year because it is what they are used to, but that is not always the best choice. It may make sense to consider using November 30 for clients with businesses who make a lot of year-end income in order to postpone tax payments on that income to the following calendar year. However, this choice must be weighed against practical considerations, such as the difficulty in obtaining a 1099 November 30.

IV. SIMPLE TRUSTS

For income tax purposes, trusts are commonly divided into two categories: simple trusts and complex trusts. The terms “simple trust” and “complex trust” are not used in the Code, but they are common in tax parlance because they are used in the Regulations. See, for example, Treasury Regulations Sections 1.651(a)-1, -2, -3; 1.651(b)-1; 1.652(a)-1; 1.661(a)-1. Although most tax lawyers who are familiar with this area of tax law routinely speak in terms of simple and complex trusts, the reality is that the distinction between them is of little significance today.

In essence, then, the simple trust rules are the Reader’s Digest version of the complex trust rules, stripped down to the bare essentials needed to deal with the form of trust that meets the requirements of Section 651(a) that the trust (a) must distribute all current income annually, (b) must make no distributions for the year in excess of the amount of current income, and (c) may make no charitable contributions or set asides. Notice that the trust must require distribution of all income currently, but not all income actually must be distributed to qualify. That is, even if income is not currently distributed, the fact that distribution is required will suffice to satisfy the all-income requirement.19

A trust might require distribution of income but not actually distribute it in a variety of circumstances. For example, often a trust’s tax year ends with income on hand that is not distributable until the next periodic income distribution date (monthly, quarterly, semi-annually, or whatever). This is proper administration of a trust and the Code recognizes it. Moreover, occasionally the beneficiary requests or authorizes a delay in the current distribution of the income. And sometimes the trustee is unsure of the identity of the proper beneficiary and seeks instructions while withholding trust income pending a judicial determination.

To avoid disqualification as a simple trust in any of these events, the tax rule intentionally does not require actual distribution of all income annually. It also does not require that the income entitlement of any given beneficiary be specified. For example, a trust that requires distribution of all income annually among a group of beneficiaries (a “sprinkle” trust), in whatever proportions the trustee selects, would be a simple trust even though no single beneficiary has a guaranteed entitlement.

19 Treas. Reg. § 1.651(a)-1(b).
As to the second requirement for qualification as a simple trust— that there be no distributions in excess of current income— the trustee need not be prohibited from distributing amounts in excess of current income. Rather, the trustee simply must ensure that only income is distributed in a given year, thus allowing the trust to be taxed as a simple trust for that year. This imposes a burden on the trustee to carefully monitor distributions, because expected tax consequences may be lost due to inadvertent excess distributions.

“Inadvertent” might seem to be an inappropriate term, because you might think that even the most inexperienced trustee ought to be able to tell whether a distribution exceeds income. Here, however, the difference between trust accounting income and income in a tax sense becomes important. For tax purposes, distributions made by a trust are income under Section 643(b) to the extent they do not exceed the amount of the current year’s fiduciary accounting income. Whether they exceed DNI or match taxable income is irrelevant. That is, “income” means fiduciary accounting income, as determined by the fiduciary in good faith under the governing instrument and applicable local law. Thus, Treasury Regulations Section 1.651(a)-2(a) recognizes the validity of reserves to which income may be allocated without constituting a failure to distribute all current income annually.

So it is the amount of current income, rather than the actual identity of items received as income, that is determinative for simple trust qualification purposes, regardless of the source of that distribution for trust accounting purposes.\(^{20}\) Distributions not in excess of the current year’s fiduciary accounting income are “income” for purposes of applying the simple trust rules, and it is the amount of fiduciary accounting income, not the actual source of the distribution, that the trustee must monitor to ensure qualification as a simple trust.

To illustrate, assume a trust has income of $1,000 for the current year and is required to distribute all income currently. A distribution of stock held in the trust with a fair market value of $1,000 would be regarded as a distribution of income, even though the stock was held as a part of trust corpus on the trust accounting ledger. Moreover, fiduciary accounting income may exceed either taxable income or DNI, so it is possible to distribute amounts of fiduciary accounting income in excess of what otherwise would be taxable to the trust, without losing the status of a simple trust.

A. Tax Treatment of Simple Trusts

The tax treatment of a trust that qualifies as a simple trust is “conduit” taxation, effected under Sections 651(a) and 651(b) through the “distributions deduction,” resulting in a tax wash to the trust. Distributions of fiduciary accounting income from the trust “carry out” DNI to the recipients thereof under Section 652(a) and Treasury Regulations Section 1.652(a)-1, and those recipients acquire the liability to pay tax on it.

In computing its income tax liability for the year, a qualifying simple trust may deduct the amount of income it was required to distribute. However, under Section 651(b) the distributions deduction may not exceed distributable net income, computed without inclusion of

\(^{20}\) See IRC § 651(a) (last sentence, referring to “amounts of income” described in § 651(a)(1)).
the net amount of tax exempt income. This is to prevent a deduction larger than the trust’s taxable income, which would put the trust in a loss position for tax purposes.

To accomplish this result Treasury Regulations Section 1.651(b)-1 requires reduction of DNI by the amount of tax exempt interest income specified in Section 643(a)(5) (as adjusted by any deductions allocable to it). The effect of this adjustment is to limit the distributions deduction to the taxable portion of DNI so as not to put the trust in a loss position in computing its taxes for the year. The tax exempt quality of the income is not lost, however, because it carries over to the recipients by virtue of the character rule in Section 652(b).

The tax consequence of qualification as a simple trust to beneficiaries entitled to receive required distributions of income is Section 652(a) inclusion in income of the amount allowed as a deduction to the trust, whether the income actually was distributed or only required to be distributed. Distributions can exceed the allowable deduction, because fiduciary accounting income is greater than the taxable portion of DNI. When that occurs each recipient simply includes in income a pro rata portion of the amount of the deduction, based on the total distributions made by the trust.

So complete is the pass through of tax liability to the beneficiaries that, under Section 652(b) and Treasury Regulations Section 1.652(b)-1, amounts originally received by the trust retain their tax character (tax exempt income, capital gains, tax preference items, and so forth) when distributed to the beneficiaries. Moreover, the character of all amounts included in DNI, both income (including tax exempt income) and deductions, effectively is allocated pro rata to the recipients by Section 652(b) and Treasury Regulations Section 1.652(b)-2. This can be altered only by a provision of the governing instrument specifically mandating non pro rata distribution of various classes of income. Discretionary non pro rata distributions by the trustee of various classes of income do not alter this allocation.21

In short, the overall effect of both the distributions deduction and the inclusion rules is conduit taxation that taxes the beneficiaries generally as if the trust did not exist as an intermediary. The exception to this conclusion is the treatment of capital gains that are not treated under the instrument or local law as fiduciary accounting income. They are retained by and taxed to the simple trust.

V. ESTATES AND COMPLEX TRUSTS

The complex trust rules of Subpart C (Sections 661-664) govern all estates, any trust that is not a simple trust for the year (because it may accumulate income, provides for charity, or actually made distributions exceeding current income), and all trusts in the year of termination (because principal necessarily is distributed). But the tax consequences to the entity and beneficiary essentially are the same as the conduit tax treatment of a simple trust to the extent income of an estate or complex trust is currently distributed or is required to be distributed. The entity is entitled to a distributions deduction under Section 661(a), the beneficiaries include the deducted amounts under Section 662(a), and the character of each item in DNI carries through to

21 Treas. Reg. § 1.652(b)-2(b)(1).
the beneficiaries pro rata under Sections 661(b) and 662(b) (unless the governing instrument specifically dictates otherwise).

There is one notable difference between the distributions deduction for a complex trust and that for a simple trust. Both deductions cannot exceed the amount of DNI (see Section 651(b) and the last sentence of Section 661(a)) as reduced by tax exempt income (see the last sentence of Sections 651(b) and 661(c)). But the amount of DNI will differ by virtue of application only to simple trusts of Section 643(a)(4) (exclusion from DNI of taxable dividends allocable to principal). This special rule does not apply to complex trusts and it is not commonly encountered. Ignoring it (at your very slight peril), you can see why learning the one set of rules in Subpart C will suffice for all trusts and estates. Excepting this one slight variation, Subpart B really doesn’t add anything.

One distinction is worthy of note (but not worthy of any change to the suggestion that you don’t need to learn two separate sets of rules). It is that a complex trust or an estate (unlike a simple trust) may make distributions of amounts in excess of the dollar amount of fiduciary accounting income (whether the distributed asset comes from fiduciary accounting income or principal). These distributions also are deemed to carry out income, to the extent of current DNI or prior years’ accumulations of income (known as undistributed net income (“UNI”) and defined in Section V.B below). These might generate additional distributions deductions for the estate or trust, and may require inclusion by the recipients under Section 662(a)(2).

To illustrate this difference between simple and complex trusts, assume a trust has $33,000 of fiduciary accounting income for the year, consisting of $24,000 of ordinary income and $9,000 of tax exempt income. The trustee is required to distribute all the income annually to B. If the trustee actually distributes more than $33,000 for the year, the trust would be a complex trust for that year. The distribution would carry out the $33,000 of DNI, of which $9,000 would be tax exempt to B and the trust would be entitled to a $24,000 distributions deduction (the taxable portion of DNI). In addition, the trust would have made either an accumulation distribution of UNI or a tax-free distribution of corpus (or some of each) of the amount in excess of $33,000 that was distributed to B, making the trust complex.

No additional distributions deduction would be available to the trust for this excess distribution, and the tax consequence to B would depend on the extent to which the distribution carried out UNI (which largely is irrelevant today). By way of comparison, if the trustee properly had distributed only $22,000 for the year, in this example the amounts distributed would be 24/33 × $22,000 of taxable income items and 9/33 × $22,000 of tax exempt income, and the trust would be complex by virtue of accumulating the income that was not currently distributed. B would include taxable income of 24/33 × $22,000 ($16,000) and report tax exempt income of 9/33 × $22,000 ($6,000), and the trust would deduct the full 24/33 × $22,000 ($16,000) of taxable income that was distributed.

A. In-Kind Distributions and Specific Bequests

Under Section 643(e) distributions in-kind from a complex trust carry out income (DNI, UNI, or a combination of both) only to the extent of the lesser of the distributed assets’ adjusted
basis or their fair market value. For example, distribution of stock worth $100 but with a basis of $80 can carry out (at most) the lesser $80 and only that amount could be includible in the beneficiary’s income or be deducted by the entity.

In addition, by Section 663(a)(1), excepted entirely from the income carryout rules applicable to complex trusts are transfers in satisfaction of a specific bequest, devise, or legacy payable in less than four installments, if not required to be satisfied only out of income. To constitute a “specific” disposition, the identity of the property conveyed, or the dollar amount of a pecuniary gift, must be ascertainable as of inception of the estate or trust. “Formula” bequests (for example, a marital deduction distribution that is tied to a concept such as a decedent’s gross estate for Federal estate tax purposes) do not qualify as specific bequests the satisfaction of which will not carry out DNI. This is because they are dependent on variables (such as valuation and tax elections) that make them unascertainable until sometime after the date of death. Further, in determining whether payment is to be made in less than four installments, the terms of the governing instrument, not actual administration, are determinative.

B. Accumulated Income

The principal difference between the taxation of simple trusts under Subpart B and the taxation of estates or complex trusts under Subpart C is attributable to accumulations of income in the latter. Only capital gains or other income properly allocable to corpus are taxed to a simple trust. All other income is offset completely by the distributions deduction and is thereby taxed through to the beneficiaries. In a complex trust or an estate, income that is accumulated rather than distributed will be taxed to the estate or trust because the distributions deduction is less than the total taxable income and, thus, does not wash out the full amount of income for the year. By virtue of this essential difference, the complex trust or estate as a separate taxpayer permits fragmentation of income between the beneficiaries and the entity.

At one time this fragmentation made it possible to reduce the tax paid by all. Now, however, the current rate schedule taxes trusts and estates with even modest amounts of taxable income at the maximum income tax rate, so only a very modest potential reduction in tax is available by taxing some income to the entity and some to the beneficiary. Nevertheless, when the tax rates were more favorable it was recognized that this income fragmentation opportunity necessitated several concepts that are not applicable to simple trusts, and that remain in the law.

Although the beneficiaries of complex trusts and estates still are taxed on income actually distributed, and the fiduciary receives a corresponding deduction for it (both identical to a simple trust), accumulated income (taxed to the entity) presents the potential for tax minimization. To deal with this factor, Subchapter J creates the concept of UNI and imposes seemingly complex rules known as the accumulation distribution and throwback rules.

We will not demonstrate this but hope you will take our word for the fact that the rules are hard to decipher (this is one of those cases in which you really need to know what the Code is telling you before you can read it and figure out what it says). Their application also requires a

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22 Treas. Reg. § 1.663(a)-1(b).
23 Treas. Reg. § 1.663(a)-1(c)(1).
good bit of tax related information about both the entity and the beneficiary for prior years. Still, the actual operation of a throwback computation itself is not as convoluted as many would have you believe.

Furthermore, and much more importantly, in 1997 Congress effectively repealed the accumulation distribution and throwback rules for 99% of all trusts. Although the provisions remain in the Code, they apply only to certain pre-1984 abusive multiple trusts, and to foreign trusts, so for our purposes the story of throwback is a dead letter and we won’t bother you with any further details. Suffice it to say that simple and complex trusts are taxed virtually identically to the extent this complexity is gone.

C. Multiple Trust Rule

A second rule applies to complex trusts to minimize their use to fragment income into multiple separate taxpaying entities, each with its own separate rates and deduction in lieu of the personal exemption. By the “multiple trust” rule of Section 643(f), separate trusts are regarded as a single tax paying entity if they were created by substantially the same grantor or grantors, with substantially the same beneficiary or beneficiaries, and with a principal purpose to avoid taxes. Because of compression in tax brackets the old game to which Section 643(f) was directed also is a thing of the past, so we doubt that you will encounter this either.

D. Sixty-Five Day Rule

A third special rule originally limited to complex trusts (but now also applicable to estates) is a reflection of the fact that it may not be possible to know, as of year-end, how much income must be distributed to avoid a trust accumulation. Thus, the “sixty-five day” rule of Section 663(b) permits complex trusts and estates to elect to treat distributions made within 65 days after year-end as distributions of DNI during the year just ended.

The rule originally was applicable only to complex trusts because the object was to avoid accumulations that subsequently could be subject to the accumulation distribution and throwback rules, which applied only to complex trusts and not to estates or simple trusts. With the repeal of throwback for most trusts, and the equivalent treatment of estates and trusts, this rule now applies to both complex trusts and to estates. But with effective repeal of throwback the need for this rule also has waned (although it can be useful if the beneficiaries are in lower tax brackets than the entity and washing more income out to them proves to be desirable, based on information discovered in that 65 day period).

E. The Tier Rules

A fourth concept, the “tier” rules, is made necessary in complex trusts by the ability to accumulate income for later distribution. The term “tier,” which is not utilized in the Code or Regulations, refers to the distinction drawn in Sections 661(a)(1) and 661(a)(2) between amounts of income required to be distributed currently (“Tier 1” distributions) and other amounts properly paid, credited, or required to be distributed (“Tier 2” distributions).
To illustrate the importance of this concept, assume that a complex trust has $50,000 of fiduciary accounting income for the year but DNI of only $40,000 (due to an income tax deduction for expenses that were charged to principal for fiduciary accounting purposes). Also assume that the trustee must currently distribute all income in equal shares to beneficiaries A and B, and that the trustee also makes a discretionary distribution of $50,000 to B.

A has received $25,000 while B has received $75,000. Without the tier rules, it would appear that the $40,000 of DNI ought to be prorated between A and B in proportions of $10,000 and $30,000, respectively. However, by virtue of the terms of the trust, it is apparent that A received half the current income, not just one-fourth, and should be taxed on half the DNI. The tier rules provide the mechanism for distinguishing between the various distributions to A and B to effect this treatment.

The technical definitions under the tier rules relate to distributions made by the trust. Under Section 661(a)(1), Tier 1 distributions are required current distributions of income (not in excess of DNI). So pervasive is the “required” distribution notion that, under Section 662(a)(1), a Tier 1 distribution is treated as having been made as required, resulting in DNI inclusion to the beneficiary, even if the distribution is not made in fact. Recall the comparable simple trust rule. Under Section 661(a)(2) and Treasury Regulations Section 1.661(a)-2(c), Tier 2 distributions are all other distributions, whether required or discretionary and whether made from current income, from accumulated income, or from corpus.

So, in the preceding example, A and B are equal Tier 1 beneficiaries because the trustee must make current distribution of all income to them. Consequently, the $40,000 of DNI is prorated equally between them under Section 662(a)(1) and Treasury Regulations Section 1.662(a)-2(b), rather than apportioned $10,000 to A and $30,000 to B. Any DNI remaining after satisfaction of all Tier 1 required current distributions of income similarly would be prorated under Section 662(a)(2)(B) and Treasury Regulations Section 1.662(a)-3(c) among the Tier 2 beneficiaries on the basis of their Tier 2 distributions.

Only the amount of the Tier 2 distributions in excess of any DNI remaining after Tier 1 distributions would qualify as either a Section 665(b) accumulation distribution of prior years’ UNI or a Section 102 tax-free distribution of principal. In the prior example, the $50,000 distributed to B is a Tier 2 distribution and may be taxable as UNI— if the trust has any (and if throwback applies) — or as a tax-free distribution of corpus.

F. Separate Share Rule

A final relevant concept under Subpart C is the separate share rule, mentioned in Section III.C above, applicable under Section 663(c) to trusts and (only since 1997) to estates alike. By providing that substantially independent and separately administered shares of a single trust or estate will be treated as separate trusts for DNI allocation purposes, activity such as accumulations or distributions in one separate share do not affect application of the tier rules or the tax consequences of activity in other shares.
To summarize, DNI in both simple and complex trusts is carried out to trust beneficiaries by required current income distributions. Any remaining DNI is carried out by any other distributions made. DNI is shared pro rata by the recipients within any class or tier of distribution, and each item of income in DNI is shared pro rata within each class or tier (unless the governing instrument specifically provides otherwise).

VI. DISTRIBUTIONS IN-KIND

Distributions from an estate or trust carry out income (first DNI, then UNI, to the extent either is available in the year of distribution), regardless of whether the distribution constitutes fiduciary accounting income or corpus and regardless of whether the fiduciary distributes cash or property in-kind. Section 643(e) limits the amount of income deemed distributed by a complex trust or an estate on a Tier 2 in-kind transfer of property and establishes the basis of distributed property.

Notice, however, that Section 643(e) establishes these special rules for distributions and basis only for purposes of Sections 661(a)(2) and 662(a)(2) (Tier 2 distributions) and has no application to simple trusts that are governed by Sections 651 and 652, nor to Tier 1 distributions that are governed by Sections 661(a)(1) and 662(a)(1). The reason for this is articulated more fully below, but the gist of it is that income equal to the fair market value of a distributed asset is carried out by distribution of an asset in-kind (to the extent there is sufficient DNI) if Section 643(e) does not apply—meaning if distribution is a mandatory income entitlement (simple trust or Tier 1 from a complex trust). The only exception to this would be if the distribution qualifies as a specific bequest under Section 663(a)(1).

To the extent it does apply, Section 643(e)(2) limits the income carryout on an in-kind distribution to the lesser of (1) the asset’s fair market value or (2) the adjusted basis of the asset (plus or minus any gain or loss realized on the distribution), with an election granted to the fiduciary under Section 643(e)(3) to intentionally incur gain or loss on the distribution. Further, adjusted basis to the distributee is a carryover of the distributing entity’s basis (again, as adjusted for gain or loss realized on the distribution).

To illustrate, consider an asset with a fair market value of $100 and an adjusted basis of $40. Distribution as a Tier 2 in-kind transfer would carry out income of $40, and basis to the distributee would be $40, being a carryover of the distributing entity’s basis (with no adjustment for gain or loss because none was incurred on the distribution). The effect of Section 643(e) is that less income is carried out by a Tier 2 distribution of an appreciated asset in-kind.

To appreciate this rule, let’s assume that a trustee wants to distribute $70 to a beneficiary. It could do so by distributing (1) an asset with a fair market value of $70 and a basis of any amount, (2) cash of $70, or (3) any combination of the two. Under Section 643(e) a Tier 2 distribution of cash will carry out up to $70 of DNI, but a Tier 2 distribution in-kind will carry out no more DNI than the basis of the distributed asset.
The justification for this limited DNI carry out is a feeling that it is inequitable to saddle a distributee with income equal to fair market value plus any unrealized appreciation represented by a basis that is lower than fair market value. That being the case, Section 643(e) need not apply to Tier 1 distributions governed by Sections 661(a)(1) and 662(a)(1) and to distributions from simple trusts governed by Sections 651 and 652 because those in-kind distributions are gain or loss realization events, as discussed next below. As a result fair market value and adjusted basis will be equal in the beneficiary’s hands and DNI carryout will be that same amount (at least to the extent of DNI available for distribution).

VII. REALIZATION EVENTS

The carryover of basis and DNI carry out limitation of Section 643(e) is affected by distributions that otherwise generate a new basis. Gain or loss may be realized under Treasury Regulations Section 1.661(a)-2(f)(1) by distribution of an asset in-kind, with a concomitant adjustment to basis (to fair market value) if the distribution is in satisfaction of the distributee’s right to receive some other asset (for example, if Blackacre was distributed instead of a specific bequest of stock), or the distribution is in satisfaction of the distributee’s right to receive cash (for example, if Blackacre was distributed to satisfy a debt owed to a creditor or to satisfy a beneficiary’s right to receive a specific legacy, or in satisfaction of a trustee’s mandate to distribute an amount equal to all income annually). In either case, the income tax treatment is as if the proper asset or cash was distributed and then used to purchase the actual asset distributed, with gain or loss generated on that sale if the asset had unrealized appreciation or depreciation (and nonrecognition under the Code did not otherwise apply).

VIII. INCOME AND DEDUCTIONS IN RESPECT OF A DECEDEDENT

Neither income in respect of a decedent (“IRD”) nor deductions in respect of a decedent (“DRD”) is a concept unique to the income taxation or administration of estates and trusts or the taxation of beneficiaries. Nevertheless, each applies to any taxpayer receiving income to which a decedent was entitled, or paying specified deductible expenses on the decedent’s behalf. And IRD and DRD are common to fiduciary administration and the income taxation of trusts, estates, and beneficiaries.

With respect to all taxpayers, the fundamental tax objective of both the IRD and DRD concepts is to maintain the same character of the income and deductions as if received or incurred by the decedent while alive. For fiduciary income tax purposes, any IRD received or DRD incurred by an entity enters into the computation of its taxable income, and thus into the amount of DNI.

Broadly speaking, IRD is income earned by a decedent prior to death but not recognized for income tax purposes until after the decedent’s death. Similarly, DRD consists of expenses or obligations incurred by the decedent prior to death and that would have been deductible by the decedent if they had been paid or properly accrued prior to death but they were paid by the estate or entitled beneficiary postmortem.
Although there is no statutory definition of IRD, we know from Treasury Regulations Section 1.691(a)-2 that the government regards the following items as IRD:

1. Compensation for the decedent’s services, including a bonus voted after the decedent’s death that the employer had no obligation to pay.
2. Renewal commissions of a deceased life insurance agent.
3. Accrued but unreported interest on Series EE United States Treasury Bonds.
4. Dividends on stock owned by the decedent that were payable to shareholders of record on a date prior to the decedent’s death.
5. Alimony arrearages.
6. Deferred compensation death payments made to beneficiaries under a qualified retirement plan.
7. Capital gain on a sale made during the decedent’s life and reported on an installment basis (the recipient of the right to receive those payments will continue to report them on the same basis as did the decedent).
8. Distributive share of partnership income paid to a deceased partner for the partnership’s taxable year in which death occurs, attributable to the period ending with the partner’s death, is IRD even if the deceased partner made cash withdrawals from the partnership as an advance against that income. In addition, a share of profits for periods after the partner’s death also can be IRD.

Helpful guidelines for identifying IRD refer to income that would have been taxable to the decedent if death had not occurred prior to receipt.24

Some cases refer to there being a legally significant arrangement that elevates the income above a mere expectancy and there being no outstanding economically material contingencies at the decedent’s death. It is necessary to establish that the decedent, not the ultimate recipient, performed the substantive acts that spawned the entitlement to establish that the decedent would have received and included the income had death not intervened. Thus, the recipient’s acquisition must be “passive,” not due to efforts made to generate the right (as opposed to enforcing it) after the decedent’s death.

A. Tax Consequences of Income in Respect of a Decedent

There are three primary tax consequences of an item being regarded as IRD, not all of which are disadvantageous, depending on the circumstances. First, income represented by the right to receive IRD is taxable in the year it is received. Second, under Section 691(a)(3), the character of the income is the same as if it was received by the decedent. And third, rather than a new basis at death, the item has a Section 1014(c) basis equal to what the decedent’s basis would have been if living. This treatment is necessary because otherwise, to the extent of a new basis, the IRD would not be taxable as income as received.

To illustrate, assume that D negotiated a sale of property prior to death that failed to close because of housing code violations. The sale was completed after D’s death because the buyer

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24 See Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries Section 3.3 at 3:10 (2d ed. 1993).
agreed to take the property subject to the violations, in exchange for a $2,000 reduction in the purchase price. According to Estate of Napolitano v. Commissioner, the sale proceeds were not IRD because the sale was not complete prior to death. In this case avoiding an IRD label was a great result because D’s basis in the property was $50,000 and the sale price was $240,000, so avoiding IRD treatment meant that a Section 1014(b) basis adjustment at death was available and the sale generated no gain.

Further, although there is yet no guidance on this subject, it should be that the character of the income in the decedent’s hands will determine whether the income is net investment income, subject to the 3.8% Medicare surtax. It may be passive income to the recipient who receives it postmortem, but that should not alter its status for purposes of Section 1411.

B. Deductions in Respect of a Decedent

As a counterpart to the rules governing income in respect of a decedent, a taxpayer who makes certain payments that would have been deductible if paid by a decedent prior to death is entitled to a Section 691(b) deduction in respect of the decedent. Those expenditures specifically are limited to Section 162 business expenses, Section 212 expenses of producing income or managing or safeguarding income producing property, Section 163 interest, and Section 164 deductible taxes (or the Section 27 credit for foreign taxes). In addition, the recipient of depletable property is entitled to any Section 611 percentage depletion attributable to income received therefrom, under Treasury Regulations Section 1.691(b)-1(b).

In each case, the deduction is available to the recipient of property to which the expenditure is attributable, and without limitation by the otherwise applicable Section 642(g) rule denying double duty for deductions that may be taken on either the estate tax or estate income tax return. These deductions in respect of a decedent specifically are excepted from the operation of Section 642(g) because, had they been incurred by the decedent during life, they would have reduced the decedent’s estate for estate tax purposes and still would have been deductible for income tax purposes.

C. Deduction for Taxes Attributable to Income in Respect of a Decedent

In addition to DRD, an income tax deduction is allowed under Section 691(c) for estate or generation-skipping transfer taxes attributable to IRD. This deduction is based on a theory that, had the income been received by the decedent during life, any income tax incurred on it would have been paid prior to imposition of the estate or generation-skipping transfer tax. The result would be a smaller estate subject to those taxes and, thus, less of those taxes being payable. Congress wanted to approximate that result without recomputing the estate or generation-skipping transfer tax after the income tax on the IRD has been computed. So Congress substituted an income tax deduction for the estate or generation-skipping transfer taxes attributable to the IRD. The general objective is to obtain a result that is administratively easier than recomputation of the wealth transfer tax and that approximates what would have happened if the IRD had been received during the decedent’s life.

25 Estate of Napolitano v. Comm’r, 63 T.C.M. (CCH) 3092 (1992),
In some cases an item will be income no matter who receives it, so treatment as IRD carries no detriment and allows the Section 691(c) deduction that otherwise would not be available. In those cases it pays to argue in favor of IRD treatment, which shows that the IRD label is not always detrimental.

IX. GRANTOR TRUSTS

Subchapter J establishes a third category into which trusts may fall. Estates always are taxed as a complex trust and, by virtue of Section 671, cannot be subject to the following rules. But any trust (whether simple or complex) may be subject in whole or in part to this third category of rules, being Subpart E (Sections 671 through 679) of Part I of Subchapter J: the grantor trust rules. Trusts may be subject to Subpart E in some years or only to a limited extent but, to the extent the grantor trust rules apply, Subpart E overrides the balance of Subchapter J.

Fundamental to application of the grantor trust rules is possession of prohibited enjoyment or control of trust income or corpus by a grantor or, under the Section 678 pseudo grantor trust rule, someone treated as if they were the grantor. When Subpart E applies, the normal principles we just studied are supplanted by the grantor trust rules, and the applicable portion of the trust is said to be “ignored” for income tax purposes.

To the extent this occurs, income, deductions, and credits allocable to that portion of the trust are attributed to the grantor (actual or pseudo), rather than to the trust or its beneficiaries. These tax attributes retain their character in the grantor’s hands, in most respects as if no trust had been created. Thus, for example, a distribution to charity would be treated as the grantor’s contribution, capital gains in the trust would be aggregated with the grantor’s capital gains and losses, and the statute of limitation for the trust may be that of the grantor.

The “street wisdom” regarding grantor trusts views the trust as nonexistent or ignored for federal income tax purposes. The assumed nuance is that a grantor therefore is treated as owning the assets of the trust. That position is strained when various authorities say that, as a result, transactions involving grantor trusts cannot be recognized as a sale or exchange, which is a stretch, in terms of what the Code and Regulations actually say is the real application of the grantor trust rules.

To elaborate, every grantor trust rule (Sections 673-677) begins by saying “The grantor shall be treated as the owner of any portion of a trust . . . .” The significance of this is found in Section 671:

Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.
Notice that this does not mention losses, which are considered along with gains only in determining the trust’s income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored. Further elaborating on this are the Regulations, which add only:

_Treasury Regulations Section 1.671-2(a) . . . [A] grantor . . . includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner._

_Treasury Regulations Section 1.671-3(a) . . . When a grantor . . . is treated . . . as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example—(1) If a grantor . . . is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner._

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor’s income tax return, as if the trust’s income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor. The actual treatment is as if the trust’s DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in Section 641(h). See Subsection C below. And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending on application of the portion rules.

As a result, the conclusion articulated by various authorities that the trust is “ignored” is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust (“IDGT”), based on the government’s ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust—that an exchange between the grantor and the trust “is not recognized as a sale” or exchange. It is not a gain or loss realization event.

That result is taxpayer favorable in virtually every context in which taxpayers raise it, but it is not quite what the law provides, making it slightly unreliable. Not, presumably, that anyone should worry—the government is consistent, and consistently generous, in this application.

A. How to Trigger Grantor Trust Treatment

The key to application of the grantor trust rules is whether the grantor enjoys any trust benefits, has retained so much control, or has left so many “strings” attached to the trust that the
grantor should be regarded as the true owner of the trust property for income tax purposes. Accordingly, the grantor trust provisions read like a laundry list of powers and interests in the trust, any one of which is sufficient to invoke grantor trust treatment. By way of easiest example, a revocable inter vivos trust is a Section 676 grantor trust, which is fitting given that the trust does not really change the settlor’s ownership or other tax posture with respect to trust assets.

The most common powers and interests that will trigger grantor trust treatment under Subpart E include:

1. Certain Section 674 powers in the grantor or the grantor’s spouse (exercisable without the consent of an adverse party) to control some other beneficiary’s enjoyment (subject to numerous exceptions).
2. Section 675 administrative powers permitting the grantor or the grantor’s spouse to deal at less than arm’s length with the trust property.
3. A Section 676 power in the grantor or the grantor’s spouse to amend or revoke the trust.
4. A Section 677 interest in income that may be used “for the benefit of the grantor,” including income that may be paid to the grantor or to the grantor’s spouse and income that is actually distributed to a person who either the grantor or the grantor’s spouse is obliged to support or maintain.

678 Trusts. In addition to the powers and interests discussed above, a pseudo grantor trust is taxed by Section 678 as if someone other than the grantor was the grantor. Technically Section 678 is not a grantor trust provision because it applies only to someone other than the grantor who has (or, under proper circumstances, who has released or modified) certain powers. It is included in Subpart E and it is appropriate to consider it as part of the grantor trust rules, however, because it has the effect of treating that person as the owner of that portion of the trust to which the power applies, just as if that person was a grantor who transferred property into the trust and retained certain powers or interests. Classic forms of exposure stem from five-or-five and Crummey withdrawal rights, along with inter vivos general powers of appointment, most often found in Section 2056(b)(5) marital deduction trusts or trusts for mature family members that permit withdrawal by the beneficiary as an alternative to mandatory termination when the beneficiary reaches a certain age.

The only escape from this treatment is to the extent the trust’s original grantor retains an interest or power that causes overriding grantor trust liability for income tax purposes. Under Section 678(b), grantor trust liability will pre-empt pseudo grantor trust liability if the grantor is regarded as the owner of the same portion of the trust, thereby avoiding taxation of the same items of taxable income to two different taxpayers. Although this trump provision is stated as applicable only with respect to grantor powers over income, Ferguson, Freeland, & Ascher26 opine that this limitation makes no sense and that the government treats that aspect as if it is a drafting error, causing Section 678(b) to apply if the grantor has overlapping income tax exposure from any source, interest and powers alike and with respect to income and corpus alike. See, for example, Private Letter Rulings (“PLR”) 201235006, 200730011, 200606006, and

26 See Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries Section 10.16[C] (3d ed. 2011).
To illustrate the government’s position on the proper computation of the income tax consequences of the lapse of a five-or-five withdrawal right, assume that the powerholder is entitled to trust income in future years. Thus, the release generates grantor trust exposure for the duration of the trust that will increase every time a withdrawal power lapses. See PLR 9034004, citing Revenue Ruling 67-241, 1967-2 C.B. 225, for the proposition that the powerholder is treated as the owner of a portion of the trust in the year the power is exercisable. The Ruling also holds that lapse of the withdrawal power is tantamount to a release for purposes of Section 678(a)(2). The government will not treat every year’s lapse as occurring with respect to the same five-or-five portion every year. Thus, there is an increase in the portion subject to grantor trust treatment attributable to every new lapse, computed according to a formula found in Treasury Regulations Section 1.671-3(a)(3).

\[
\text{trust portion not yet owned} = \frac{\text{total trust corpus} \times \text{withdrawable amount}}{\text{increase}}
\]

Subsequent distributions to the powerholder from the trust are deemed to come proportionately from the owned portion and from the balance of the trust.

Thus, for example, if the taxpayer may withdraw 5% of the trust corpus every year, in the first year of the trust the owned portion would be 100% ÷ 100% × 5% = 5%. The second year increase would be 95% ÷ 100% × 5% = 4.75% and a total of 9.75% would be deemed owned by the powerholder. The third year increase would be 90.25% ÷ 100% × 5% = 4.5125% and a total of 14.2625% would be deemed owned by the powerholder. In the fourth year the increase would be 4.28675% and the owned portion would increase to 18.549375%, and so on. Under this approach, the trust never would become totally owned, no matter how long the withdrawal power existed and lapsed, although the owned portion eventually would approach 100%.

The government’s computation is equitable but complicated (because it requires revaluation on an annual basis to adjust the fraction or to compute a new fraction). It also underscores the notion that the lapse of a five-or-five withdrawal power is not harmless for income tax purposes the way it appears to be under Section 2514(e) for most wealth transfer tax purposes. In many cases grantor trust status under Section 678 is generated with respect to entire trusts because contributions to the trust do not exceed the beneficiary’s withdrawal right. This may produce a favorable result if, for example, pseudo grantor trust status under Section 678 allows the trusts to qualify as permissible S Corporation shareholders under Section 1361(c)(2)(A)(i), or permits qualification for exclusion of gain on the sale of the beneficiary’s principal personal residences held in such a trust.

However, the government includes in its “no rule” list (the third Revenue Procedure issued every year) an item (actually, six separate provisions, all dealing with the same situation as it applies to various provisions of the Code) that deals with the so-called “beneficiary defective inheritors trust” (“BDIT”) in which an ostensible grantor creates a trust with a modest
contribution, gives the beneficiary a Section 678 power of withdrawal that will apply to the entire contribution and that, upon lapse, allegedly makes the entire trust a defective grantor trust as to that beneficiary. The powerholder then sells an asset to the trust in exchange for a note, and argues that the sale is not a gain or loss realization event because the trust was ignored with respect to the beneficiary, due to Section 678. The exact language is:

Section 678.—Person Other than Grantor Treated as Substantial Owner.— Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under Section 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of Section 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

It is clear from the no rule position that the government has the BDIT concept under a microscope, although it does not appear to be ready to announce why it thinks that it does not work.

If the beneficiary already is entitled to all income annually, the added cost of making the trust a pseudo grantor trust with respect to the corpus portion (for example, for capital gain) may be regarded as a small price to pay. Indeed, as with the grantor trust rules themselves, one result of Section 678 in general is that planners have the opportunity to cause income taxation to a person other than the recipient of certain income items, presumably with no transfer tax consequences to the pseudo grantor if the power of withdrawal properly is limited for wealth transfer tax power of appointment purposes.

B. Perceived Advantages of Grantor Trusts

There are other rules and exceptions, but for our purposes these are the ones on which planners tend to rely when they seek to make a trust subject to Subpart E. To appreciate why you might want to do so (by creating an IDGT), consider the following perceived advantages of grantor trust planning.

Remember that, to the extent provided under the portion rules, all income, deductions, and credits of the trust are attributed to the grantor—as if the grantor was beneficiary of the trust and DNI was passing out to the grantor. Sometimes deductions and credits generated by the entity are more useful in the grantor’s hands. It may be that the grantor is in a lower income tax bracket than the trust, or the grantor may need the income or gains generated by the trust to offset deductions, losses, or credits generated in the grantor’s individual capacity that otherwise would be lost.
In many cases the grantor simply wants to pay income tax on income distributed to someone else, because doing so constitutes a gift tax-free benefit from the grantor to that distributee under the authority of Revenue Ruling 2004-64, 2004-2 C.B. 7.

Various transactions involving the trust are deemed to be conducted with the grantor rather than with the trust. For example, a principal personal residence, owned by a marital deduction trust that is treated under Section 678 as a pseudo grantor trust, may be eligible for the Section 121 exclusion of gain on the trust’s sale of the residence. Because the trust is treated as nonexistent, the tax result is the same as if the surviving spouse was the owner of the property and personally made the sale. Because it was used as the spouse’s principal personal residence, it qualifies for the capital gain exclusion. A second example involves the Section 101(a)(2) transfer for value rule and life insurance on the life of the grantor, as to which a transfer into a grantor trust is deemed to be a transfer to the grantor personally. This may allow the Section 101(a)(2)(A) exception to the transfer for value rule to apply and thus salvage an otherwise unfortunate loss of the income tax exclusion for life insurance proceeds.27

C. Portion Rules

An important refinement, referenced earlier, frequently is overlooked, that grantor trust treatment may not apply to an entire trust. Under the “portion” rules found in Treasury Regulations Section 1.671-3, only a portion of a trust may be regarded as a grantor trust and, with it, only a portion of the trust’s income, gains, deductions, credits, and such would be treated as owned by the grantor.

The Code provides that the grantor (or a pseudo grantor) is treated as the owner of only that portion of a trust as to which a requisite power or interest exists. And several different portions may be involved. For example, a grantor with a reversion or a power to revoke the trust in its entirety may be treated as the owner of the entire trust, meaning that every item of income, deduction, and credit in the trust is attributed to that deemed owner. Similarly, the grantor (or any nonadverse party who is trustee) with unrestricted powers over income and corpus would generate entire trust portion treatment under Section 674.28

On the other hand, a grantor may be treated as the owner of only those items allocable to the fiduciary accounting income portion. For example, the grantor is treated as the current income beneficiary of only the ordinary income portion if the grantor possessed only a Section 677(a)(1) income interest. Thus, if taxable income allocable to the income account is $5,000, taxable income allocable to corpus is $2,000, and deductible expenses total $6,000, the current income beneficiary would be taxed on zero income and the excess deduction of $1,000 would reduce income allocable to corpus. Contrary to the assumption of many advisors who misapply the grantor trust rules, that excess deduction would not pass through to the income beneficiary.

This is a very important refinement, about which many advisors are unaware. Excess deductions do not pass through to the beneficiaries in a nongrantor trust, except in the year of

28 Treas. Reg. § 1.671-3(b)(3).
The same is true in a grantor trust, because essentially the calculation of each portion is based on a distributable net income analogue. Thus, a grantor who is deemed the owner of only the income portion would not be entitled to deductions in excess of ordinary income. This shows that grantor trust treatment is not the same as if no trust had been created, notwithstanding a frequent but sometimes inaccurate assumption about the application of the grantor trust rules.

Entire Trust Portion. If the grantor is the income beneficiary with Section 677(a)(1) exposure and the remainder passes to the grantor’s spouse, generating Section 677(a)(2) liability as well, the two together (but neither alone) would cause grantor trust exposure with respect to the entire trust. According to PLR 200840025 (with no mention of the portion rules) a Section 675(2) power to lend also was deemed to create whole trust exposure—which is a bizarre result in light of the proper portion if an actual loan is made.

In this regard a loan that triggers Section 675(3) might (but may not) implicate grantor trust treatment as to the entire trust. In Benson v. Commissioner, the grantor borrowed an amount equal to all income earned in the trust for a given year. The court stated that the proper inquiry is not what the grantor borrowed but what the borrowing represents in terms of dominion and control over the trust. The court focused on the wording of Section 675(3) that the grantor is treated as the owner of that “portion of a trust in respect of which” the grantor borrowed, concluding that this would be the entire trust because the grantor borrowed an amount equal to all income earned by the trust.

In a variation on this result, Bennett v. Commissioner held that a series of loans from income over several years should result in a fraction of the trust being regarded as the portion, of which the numerator was the aggregate of those loans still unpaid and the denominator was the aggregate of the income from the years represented by those loans (including the current year). That fraction was deemed to constitute the portion of the entire trust that the outstanding loans represented, and this result differed from that in Benson only in that the loans did not consume the entire income for each year and therefore did not make the portion 100% of the entire trust. As such, Benson and Bennett leave real doubt as to the proper portion, and raise serious issues about whether an actual loan should produce a smaller portion than the mere power to lend, which was implicated in the Section 675(2) PLR.

29 IRC § 642(h).
30 See Treas. Reg. § 1.671-3(c).
33 Estate of Holdeen v. Comm’r, 34 T.C.M. (CCH) 129 (1975), preceded both Benson and Bennett and also differed because the grantor borrowed trust corpus rather than income. The court held that the proper portion was the income attributable to that portion of the corpus. That income might be zero if the loan was interest free and a tracing of income from that actual corpus is dictated. Or it might be a wash if the interest income attributed to the grantor matches a deduction allowable for the interest payments. It would be some other result if the amount of the loan informed a fractional portion of the entire trust and its income from other sources. Patsey v. United States, 603 F. Supp. 60 (N.D. Cal. 1984), followed all these cases and is distinguishable only in that the grantor borrowed a large chunk of both income and corpus of a trust, making this the case for taxing the largest portion to the grantor. The court imposed grantor trust treatment as in Benson on the entire trust because the grantor “evidenced control and dominion over the entire trust,” which is hardly the appropriate inquiry. Taken together the loan cases “constitute a highly problematic body of law. They are badly inconsistent among themselves.
Ordinary Income Portion. Meaning fiduciary accounting income, by virtue of Treasury Regulations Section 1.671-2(b), this portion is to be distinguished from the corpus portion, which includes items of taxable income that are allocable to corpus. The ordinary income portion includes those items allocable to the fiduciary accounting income account and is the proper portion if the grantor is subject to Section 674(a) because of a fiduciary power to distribute ordinary income among beneficiaries with no applicable Section 674(b) or 674(d) exception. This is the right answer because “ordinary income” is the way the Regulations speak of fiduciary accounting income and Treasury Regulations Section 1.671-3(c) makes it clear that only the income portion would be attributable to the grantor, notwithstanding that Section 674(a) refers to that “portion of a trust in respect of which the beneficial enjoyment of the . . . income . . . is subject to a power of disposition” and the fact that this would be the entire trust (producing the income subject to the unprotected power).

The income portion also is the appropriate result if the grantor possessed a Section 677(a)(1) income interest. Notwithstanding that Section 677(a) refers to the “portion . . . whose income . . . may be distributed” to the grantor, implying that the entire trust is the proper portion, Treasury Regulations Section 1.677(a)-1(g) Example (1) makes clear that only the income portion is implicated by this interest. It may be possible to argue, however, that a standard limiting Section 677(a)(1) distributions to amounts necessary for the grantor’s support or maintenance should limit the portion to only that amount of corpus needed to generate the income that is needed for those purposes. If Section 677(b) is applicable, the portion similarly is limited to the corpus needed to generate the amount used for the beneficiaries’ support and maintenance.

In each of these cases the grantor is deemed to own that portion—along with its income, deductions, and credits—needed to produce the amount of net income needed for the grantor’s support or maintenance or distributed to the dependent beneficiaries. In this and other respects involving a determination of the ordinary income portion, the grantor is treated as the current income beneficiary of the portion.

Notice also that this message sometimes gets confused. For example, according to the government, each item of income, deduction, and credit of the particular portion should flow through to the grantor’s return separately (which is as if there was no trust), such that each item will conspicuously appear on the grantor’s return rather than a net amount (zero income, in this case), which would not reveal the various items that comprise the tax attributes of the trust.

Taken together, they create horrible distinctions based in part on whether loans come from income or corpus. They also often point in different directions.” Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries Section 10.13[B] (3d ed. 2011).

34 Treas. Reg. § 1.671-3(b)(1).
36 Treas. Reg. § 1.671-3(c).
37 See Notice 2000-44, 2000-2 C.B. 255, stating that it is improper for promoters of tax shelters to encourage their customers to invest in the shelter through a grantor trust, such that improper losses spun off by the shelter may be netted against other gains in the grantor trust and only the net amount reported on the investor’s return, so as to hide the tax shelter loss.
**Corpus Portion.** This portion is all items not reflected in the ordinary income portion, meaning income, deductions, and credits allocable or attributable to corpus (and all income earned thereon after accumulation as a part of corpus). In the prior example, the income allocable to corpus, taxable to the owner of this portion, was $1,000, being the $2,000 of gain allocable to corpus reduced by the $1,000 of excess deductions. A classic example of the applicability of this portion is a trust in which the grantor has a reversion that escapes Section 673 but not Section 677(a)(2), or a testamentary power to appoint accumulated income that fails the Section 674(b)(3) exception.

In a far less common example, the grantor would be treated as the owner of gains allocable to corpus by virtue of a Section 677(a)(1) right to all income, if the grantor also had a power to allocate receipts between income and corpus. However, a Section 674 power over corpus alone could result in the grantor being treated as owner of all income, not just income allocable to corpus, if the power over corpus could affect enjoyment of current income as well. For example, a power to distribute corpus currently (as opposed to a power to distribute corpus only after the occurrence of a Section 673 event) would affect enjoyment of current income because income would flow with corpus to any distributee.

**Fractional Amount of Ordinary Income or Corpus Portion.** Fractional portions reflect rights that would cause one of the prior grantor trust portions to apply, limited to less than all of the trust (for example, a Section 677(a)(1) right to receive half the income from a trust, or a Section 673 reversion of half the corpus). An interest or power stated in terms of a specific dollar amount of corpus must be converted into a fraction, using the dollar amount as the numerator and the value of the trust as the denominator, valued as of the later to occur of the beginning of the tax year in question or existence of the interest or power.

If the interest or power is computed in reference to a stated dollar amount of income, an added step in determining the numerator is required to identify the portion of trust corpus needed to produce that amount of income and that amount of corpus is used as the numerator. For example, if the grantor retained a Section 677(a)(1) right to receive $5,000 of income each year, the actuarial tables might specify that (at a 2% assumed interest rate) it requires $250,000 of corpus to produce that income, so the numerator would seem to be $250,000, not the $5,000 of income specified.

In fact, however, the Regulations dictate that the fraction be determined using the actual income rather than income presumed to be generated using the interest assumptions applicable at the time of the calculation. Treasury Regulations Section 1.671-3(a)(3) specifies that the beginning of the taxable year is the proper time for this calculation. Thus, if the trust produced $25,000 of fiduciary accounting income for the year, the fraction would be a simple one-fifth.

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39 Treas. Reg. § 1.671-3(b)(2).
40 Treas. Reg. § 1.671-3(b)(3).
41 Greenough v. Comm’r, 74 F.2d 25 (1st Cir. 1934).
43 Treas. Reg. § 1.671-3(c) (penultimate and antepenultimate sentences).
44 Treas. Reg. § 1.677(a)-1(g) Example (2).
This is the appropriate portion with respect to the Section 678(a)(1) exposure of the holder of a lapsing $5,000 or 5% power of withdrawal, with the larger of the two amounts informing the computation of the numerator of the fraction. Fortunately, in most cases involving such five-or-five powers it is the 5% amount that is the larger and the added step of converting the dollar amount is avoided.

**Specific Asset Portion.** In unusual circumstances a grantor has a taxable power over a particular asset, such as a Section 675(4)(A) power to vote closely held stock transferred to a trust. In those cases the grantor must report the income, deductions, and credits attributable to that asset as if the grantor was its owner, along with a pro rata share of any deductions not specifically identifiable with respect to the asset but properly spread among all trust assets (such as an otherwise unallocated trustee’s fee).45

**Example:** Assume a trust has the following items of income, gains, losses, and deductions for the current year.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Tax exempt income</td>
<td>5,000</td>
</tr>
<tr>
<td>Capital gains</td>
<td>16,000</td>
</tr>
<tr>
<td>Capital losses</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Trustee fees, paid half from income and half from corpus</td>
<td>(3,000)</td>
</tr>
</tbody>
</table>

The ordinary income and the corpus portions would be computed essentially as would be DNI in the trust.

The owner of the corpus portion, for example, would isolate those items of taxable income allocable to corpus and not includable in DNI as a result, and any items of deduction allocable thereto. In this case that would be the $16,000 of capital gains and $4,000 of capital losses, with none of the deductible fees being allocable to the corpus portion regardless of how they are charged for fiduciary accounting purposes.

The income portion would account for all the rest of the items illustrated: $20,000 of dividend income, $5,000 of tax exempt income (which would be included in DNI so that it could carry out to the beneficiary. In this case it would carry out to the grantor owner of the income portion) and the $3,000 of deductions, some of which might be disallowed at the grantor level under Section 265 because of the tax exempt income.

If the portion deemed owned was the entire trust, the grantor would simply reflect all these items and, if the portion was of a fractional portion only, that percentage of any of these portions.

**Chronological Portion.** Very limited authority is available on the question whether grantor trust exposure can be limited to the income for only a portion of a year. Revenue Ruling

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45 Treas. Reg. § 1.671-3(a)(2).
86-82, 1986-1 C.B. 253, involved a taxpayer who borrowed on June 11 and repaid on November 3 from a trust that reported its income on a calendar year. According to the government, “borrowing of trust corpus or income by a grantor at any time during a taxable year would result in the grantor being taxed on trust income for that entire year” and this result “is not avoided by making repayment before the year closes.” Mau v. United States involved a grantor who borrowed during the middle of a year and held that it triggered Section 675(3) liability for the entire year because the grantor trust trigger is the loan that was not (and, indeed, could not be) repaid before the beginning of the year.\footnote{Mau v. United States, 355 F. Supp. 909 (D. Haw. 1973).} Repayment cannot occur before the loan is made, which will not occur until after the year begins, meaning that the entire year in which the loan was outstanding necessarily is a Section 675(3) grantor trust year if the loan is outstanding at any time during the year. Both cases rejected taxpayer arguments that advocated a chronological portion rule that would tax under Section 675(3) only the income from a portion of a year that a prohibited loan was outstanding. The accepted wisdom appears to be that borrowing for even a day within the year causes all income in the trust for that year to be taxable to the grantor.

This makes Section 675(3) potentially a perfect “toggle switch” grantor trust rule. If the grantor borrows on the penultimate day of the year and repays the loan on the last day, presumably the grantor becomes entitled to all the trust’s income, deductions, and credits for the year in which the loan was outstanding and is able to consider anew in the next year whether to cause grantor trust treatment for that year’s trust income tax purposes. This result is not, however, nearly so clear with respect to other aspects of the grantor trust rules, especially including pseudo grantor trust liability under Section 678 attributable to a power of withdrawal, typically available for only a limited period during each year.

The government in pseudo grantor trust cases is fond of making a statement that, “until the power [of withdrawal] is exercised, released or allowed to lapse, [the pseudo grantor] will be treated as the owner . . . of that portion . . . that is subject to the power to withdraw.”\footnote{See, e.g., PLRs 9034004, 8545076, 8517052, and 8142061.} Usually the statement is irrelevant and potentially misleading to the extent it suggests that expiration of the power terminates the pseudo grantor trust liability for the balance of the year. This is because the portion of the trust not withdrawn normally remains in the trust and the powerholder continues to have rights to future income (or otherwise) that trigger Section 678(a)(2) liability. Thus, any suggestion that pseudo grantor trust liability is limited by the period of time the power itself is available essentially is dicta (coming from rulings that are not citable authority).

In a few cases the government further confounds the issue by making reference to “a pro rata share of each item of income, deduction, and credit of the entire trust” being made subject to grantor trust inclusion to the powerholder, without stating whether this proration is attributable to application of a chronological portion rule or only makes it clear that a tracing regime does not apply and that the fractional portion represented by a limited power of withdrawal reaches a fractional share of every item of income, deduction, and credit without tracing contributions made to the trust that were subject to the withdrawal power.\footnote{See PLRs 8517052 and 8142061, and cf. PLR 9541029 (“each beneficiary must include . . . those items of income, deduction, and credit . . . attributable to . . . the portion of the trust corpus over which he or she had a right of withdrawal,” without any identification of what that portion might be).}
PLR 8142061 makes the additional statement that “calculation of such pro rata share
should take into account the length of time during which [the powerholder] has the power to vest
in himself the additions of corpus to the trust, as well as the value of these additions relative to
the value of the entire trust, measured at the time that . . . power begins.” This statement might
support an argument in favor of a chronological portion rule based on termination of the power
after a certain window of withdrawal opportunity, but it probably only indicates that the pseudo
grantor trust liability does not begin until the power becomes available, sometime during the
trust and powerholder’s year. At best, these Section 678 authorities leave a great deal of doubt
and confusion about the existence of a chronological portion rule, much less its operation.

Finally, two Section 677 cases give conflicting answers to the chronological portion
question, both involving loans taken out by trusts to satisfy gift tax liabilities imposed on the
trusts by the grantor on the transfer of property to the trusts by inter vivos gift. In each case that
gift tax liability imposed on the trust constituted a Section 677(a)(1) indirect retention of
enjoyment of the trust, at least until the liability was discharged. In Estate of Sheaffer v.
Commissioner, the court rejected the suggestion that grantor trust liability ended in the middle of
the year in which the gift tax liability was repaid, stating that “a taxpayer . . . found to be a
substantial owner of a portion of a trust . . . is taxable on all the income of such portion during
the entire taxable year in issue.”49 Later, in Krause v. Commissioner, the same court stated that
Sheaffer “does not represent the views of this Court” and held that “where . . . the grantor is
divested of all interest in the trust during a taxable year, he is not taxable on the subsequently
received income of the trust.”50

Grantor trust liability cannot arise until there is an interest or power that triggers the
requisite provision of the Code, and termination of an interest (for example, because the grantor
dies) ordinarily causes expiration of the grantor trust liability. Krause may establish an
additional limitation on the grantor’s exposure under its somewhat unique facts, and may be
insufficient authority to support a proposition that a chronological portion rule exists for all
purposes under the grantor trust rules (or even under Section 677).

In the case of pseudo grantor trust liability under Section 678, the issue is even less clear
in most cases because of lingering Section 678(a)(2) liability with respect to lapsed amounts
subject to withdrawal rights and because the power of withdrawal itself often does not become
available until late in a calendar year. Typically contributions, made most often to irrevocable
life insurance trusts, are subject to a withdrawal power that is applicable only with respect to the
contribution and often in situations in which there is zero income of the trust. Often there are
multiple withdrawal rights and in the aggregate they constitute the entire trust corpus other than
the insurance policy, arguably encompassing all of the income producing property in the trust.

Adding further uncertainty is the fact that, in many instances, the taxpayer wants grantor
trust liability for the entire year (even if the triggering interest or power exists for only a smidgen
of the year). This might occur under Section 675(3), in which the liability intentionally is
triggered by a loan taken out and repaid during the year, all in hopes of acquiring toggle switch

grantor trust treatment that allows favorable tax consequences for just the one year to flow out to the grantor, or under any number of provisions designed to make the trust qualify for Subchapter S shareholder status under Section 1361(c)(2)(A) as a grantor trust rather than under Section 1361(d)(3) as a QSST. Potentially this means that the government and perhaps even the courts will have different incentives in addressing this issue in differing situations. The best that can be stated under an expansive reading of current authorities, such as they are, is that the law is in its infancy with respect to a chronological portion notion. In this light, some advisors express the opinion that the taxpayer may take whichever position is best for the taxpayer, making certain to be consistent during the entire period that the issue is relevant.

D. Toggle Switch Planning Issues—Termination of Grantor Trusts Status May Be a Realization Event

In *Rothstein v. United States*, the grantor of a trust purchased assets from the trust, using the grantor’s promissory note in payment. The court agreed with the government that the note constituted a Section 675(3) indirect loan from the trust to the grantor, creating grantor trust status for the trust. Incident to the sale, the grantor claimed a new basis in the acquired assets equal to their purchase price, which the *Rothstein* court allowed over the government’s argument that a grantor cannot acquire a new basis in assets purchased from a grantor trust because (1) the entity is treated for income tax purposes as if it was the grantor and (2) it is impossible to purchase assets from yourself.

*Revenue Ruling 85-13 on Changing Grantor Trust Status* Essential to the government’s vision of the transaction was that the grantor trust status arose “soon enough” to infect the purchase itself. According to Revenue Ruling 85-13, 1985-1 C.B. 184, 185:

> It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its vitality as a separate entity capable of entering into a sales transaction with the grantor.

If the government is right, however, then grantor trust status creates the opportunity to conduct transactions with a trust without worry about income tax sale or exchange treatment. For example, in the simplest application of this principle, PLR 200227022 concluded that transfers between a grantor trust and its grantor and back again of appreciated assets will not be gain or loss recognition events. More refined is PLR 9146025, which involved a 100% owned GRIT. The government ruled that no realization of gain occurred on a distribution of appreciated corpus in-kind to the grantor in satisfaction of the trust’s obligation to make the retained income payments. Because the trust was ignored for income tax purposes in all its dealings with the grantor, in each case the distributions were regarded as transfers by the grantor to the grantor, which cannot generate a gain.

As a result, the conclusion articulated by various rulings that the trust is “ignored” is not what either the Code or Regulations themselves actually specify. Yet Revenue Ruling 85-13 has

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been interpreted by taxpayers in a vast number of different situations to restate its conclusion by asserting that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an IDGT, which is the exact opposite of the situation involved in Revenue Ruling 85-13 and Rothstein, which involved a transfer by the trust back to the grantor. The articulation itself is based on the government’s Ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust—that an exchange between the grantor and the trust “is not recognized as a sale” or exchange. It is not a gain or loss realization event.

That result is taxpayer favorable in virtually every context in which taxpayers raise it, but it was disfavorable to the taxpayer in Revenue Ruling 85-13, and in each case it is not quite what the law provides, making it slightly unreliable. Not, presumably, that anyone should worry—the government is consistent, and consistently generous, in this application. But there are aspects of IDGT planning in which taxpayers get one over on the government in ways that are not as likely to be regarded by the government as benign.

**Technical Advice Memorandums on Changing Grantor Trust Status** In that regard, Technical Advice Memorandums (“TAMs”) 200011005, 200010011, and 200010010, potentially have a broad significance that exceeds the particular context in which they arose. The basic issue is the proper income tax treatment when IDGT status terminates, or when capital gain property transferred to an IDGT is distributed out of the trust. Unlike the situation in the TAMs, this probably is of greater interest to planners whose clients have experimented with sales to IDGTs, and it also may apply when either a GRAT or a QPRT terminates. The conclusion reached in these TAMs probably indicates just one of several approaches the government might pursue in those cases.

The actual facts of these identical TAMs involved a two year GRAT into which the taxpayer transferred very low basis stock in a family business, retaining a 94.06% annuity interest. To finance the annuity payments, the trust borrowed from another separate trust (and that trust borrowed funds from the taxpayer’s brother) to provide the aggregate funds needed. For income tax purposes the important fact is that the GRAT incurred debt to finance the annuity payments and apparently encumbered the stock as collateral (with no recourse to the taxpayer; that fact is irrelevant for income tax purposes). After the two year annuity was paid with this borrowed money the GRAT was divided into separate shares, which the TAMs refer to as a “termination and transfer” of the trust asset—the encumbered stock—to those separate share trusts.

That characterization is critical because, under traditional income tax principles, the transfer of an encumbered asset subject to the debt is regarded as a sale, with the amount of the debt constituting an amount realized. That transfer was deemed made by the taxpayer because the original trust was a grantor trust. With a very low basis in the stock, that transfer generated a capital gain, which the government regarded as taxable to the taxpayer, all under the authority of Revenue Ruling 85-13.

The effect of the transaction is therefore a gift on creation of the original trust (limited to the 5.94% difference between the FMV of the stock transferred and the retained annuity), no income tax on the annuity payments (because the payor was a grantor trust, and you can’t pay
income to yourself), and capital gain on the deemed sale of the stock for the amount (essentially) of the annuity (because no part of the loans that financed 100% of that annuity had been repaid). As a part-sale, part-gift transaction, current law permits use of the taxpayer’s full basis against the amount realized on that sale portion, meaning that the net result is the same as a straight sale of the nongift portion of the stock, with all the basis in all the stock allowed as an offset in determining that gain.

Some commentators who tout sales to IDGTs posit that the sale aspect and attendant gain or loss would be avoided if payment for the stock had been with borrowed funds but the loan was repaid before grantor trust status terminates. Under the TAMs this appears to be correct, although grantor trust status in the interim would expose the taxpayer to whatever income tax might attend to the trust acquiring the assets to pay down the debt. If, for example, the trust sold the stock to generate those funds, that income tax cost would be at capital gain rates that would be the same to the trust as to the taxpayer.

If the trust was still a grantor trust when that occurred, the tax paid by the grantor presumably would be a desirable result because it would leave fewer assets in the grantor’s estate and more wealth in the trust, at no greater transfer tax cost to the taxpayer (another concept with which the government has a problem, as discussed in Subsection B above). If, instead, the funds used to service the debt are ordinary income, the income tax rate could be much higher (particularly if state income tax is involved) and the result would be worse than if the taxpayer had simply liquidated the stock at capital gain rates. A third alternative would apply if the trust used funds transferred to the trust gratuitously, which presumably would entail some other party making a gift to the trust at gift tax rates. Overall, these alternatives indicate that there may be little opportunity for abuse in this particular context.

In another context, however, the result witnessed in the TAMs is not so easy to embrace. Assume, for example, that the taxpayer did not retain an annuity and merely sold appreciated assets to the trust, and the trust found a way to finance that purchase without realizing income that would flow out to the grantor. The net reality of these transactions is that, at the end of the day, the grantor has cash and the trust has the grantor’s appreciated asset. That looks like a sale (indeed, the TAMs specifically state that the government’s analysis of the transaction was not “intended to state or imply that the facts described . . . do not constitute a sale”) by the taxpayer of the appreciated assets to the trust. The more appropriate income tax treatment therefore might be to regard the original transfer to the trust as a gain or loss realization event, with recognition of the gain or loss being deferred while the trust is a grantor trust. That is not the position the government has chosen to take, and there is scant authority for that result.

Revenue Ruling 85-13 and these TAMs show that the government may regard termination of grantor trust status as a realization event. In a case such as this the gain or loss

is determined at that later date—rather than regarding the original transfer to the trust as a realization event with recognition of that realized gain or loss being deferred. If the asset transferred is appreciating, it actually might be preferable to realize the gain or loss at original creation of the trust, rather than later when the defect is cured or the trust terminates. In such a case the government’s approach may capture more of that appreciation in the amount realized upon termination of grantor trust status.

**More Examples of How the Government Has Approached Changes in Grantor Trust Status.** Every grantor trust defect eventually will be cured—at the grantor’s death, if not sooner—meaning that presumably this consequence cannot (easily?) be avoided. If the transferred assets are not includible in the grantor’s gross estate (and, therefore, no new basis is generated), the deemed transfer at the time of termination would be a gain or loss realization event—potentially to the grantor (reportable on the grantor’s final income tax return) or as income in respect of the grantor (as a transaction that was fully performed by the grantor during life but that was not completed until death, in which case the income would be reportable by the grantor’s estate on its first income tax return).

To date, however, the government has not pursued such results. Even if it did, perhaps deferral of the income tax on gain until termination of grantor trust status is preferable, although capturing any appreciated FMV as added gain must be offset against the time-value benefit of deferring any of the income tax. If done properly that appreciation will not be includible in the grantor’s gross estate for FET purposes, so only the potential income tax consequences of the transaction are at stake. The important aspect of the TAMs, then, is a reminder that planning with IDGTs should consider how, and when, grantor trust status will terminate, and with what income tax consequences at that time (as well as in the interim). As thus seen, therefore, timing issues are implicated by grantor trust planning.

Another illustration of this is found in Revenue Ruling 85-158, 1985-2 C.B. 175, in which the grantor was a clearinghouse that created a trust to satisfy financial obligations to customers of the clearinghouse, with Section 677(a) grantor trust liability flowing from the trust’s discharge of the clearinghouse’s legal obligations. The issue was the deductibility of the clearinghouse’s transfers to fund the trust. The government ruled that these transfers should be ignored because the trust was a grantor trust. Only when payments were made by the trust to clearinghouse customers would a deduction be allowed.

In *Madorin v. Commissioner*, the trustee of an intentional grantor trust cured the provision that made it so by renouncing the trustee’s power to add beneficiaries to the trust. The government successfully treated the trust as if it then for the first time had been created by the grantor, and regarded termination of grantor trust status as a deemed transfer that triggered a recapture of partnership losses previously allowed to the grantor. The trust owned tax shelter

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53 See, e.g., PLRs 200919027 and 200920032 in which the termination of grantor trust status on the grantor’s death did not constitute a gain or loss realization event. In part it distinguished Treas. Reg. § 1.1001-2(c) Example (5), *Madorin v. Comm’r*, 84 T.C. 667 (1985), and Rev. Rul. 77-402, 1977-2 C.B. 222, by saying “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 death of the owner which is generally not treated as an income tax event.”

investments and the intentional grantor trust was utilized to allow tax benefits to flow to the grantor prior to renouncing the power.

Termination of grantor trust status once the trust’s partnership investment “turned the corner” was deemed a tax abuse, which was precluded by the deemed recapture upon the deemed funding.\textsuperscript{55} Nevertheless, the government in Chief Counsel Advice 2009-23024 (June 5, 2009) refused to rely on Madorin in the converse situation to treat conversion of a nongrantor trust into a grantor trust as a gain realization event, notwithstanding that the particular transaction was recognized as “an abusive transaction,” stating that “asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.” Conversion was in the opposite direction from the more common termination of IDGT status, but nothing in the Chief Counsel Advice suggests that the government would treat conversion in either direction as a realization event.

**Grantor Trust “Toggle Off” Example.** As discussed above, it is possible to “toggle off” the grantor trust treatment. However when the grantor trust status is terminated during the grantor’s lifetime, he or she is deemed to have transferred all assets and liabilities to the trust.\textsuperscript{56} If the trust’s liabilities exceed the basis of the assets (both of which are deemed transferred to the trust), the grantor recognizes gain.\textsuperscript{57} Any amounts realized due to the acquisition of the property do not trigger gain. Additionally, because transactions between the grantor and the trust are generally disregarded for Federal income tax purposes as previously discussed, any liabilities should be disregarded.\textsuperscript{58}

Section 1.1001-2(c), Example (5) of the Regulations provides an illustration of the income tax consequences of “turning off” the grantor trust status:

In 1975, C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a “grantor trust” for [Federal income tax purposes] and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for

\textsuperscript{55} To the same effect was Rev. Rul. 77-402, 1977-2 C.B. 222 (release of grantor trust generating powers deemed a sale or exchange for an amount realized equal to a partner’s share of partnership liabilities immediately before the release).

\textsuperscript{56} Treas. Reg. § 1.1001-2(c); Madorin v. Comm’r, 84 T.C. 667 (1985).

\textsuperscript{57} Treas. Reg. § 1.1001-2(a)(1).

\textsuperscript{58} Rev. Rul. 85-13, 1985-1 C.B. 184.
Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a “grantor trust.” However, at the time C renounced the powers that gave rise to T’s classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C’s share of partnership liabilities ($11,000) is treated as money received. Accordingly, C’s amount realized is $11,000 and C’s gain realized is $9,800 ($11,000 - $1,200).

The IRS has identified “toggling” transactions as “transactions of interest” and in 2007, issued Notice 2007-73. “Transactions of interest” are those that “have the potential for tax avoidance or evasion, but for which the Service lacks sufficient information to classify as tax avoidance transactions.” Further, Treasury Regulations Section 1.6011-4 requires persons who enter into transactions of interest to disclose the transaction to the service. Specifically, Notice 2007-73 describes two situations it believes are transactions of interest, each of which is described in greater detail below.

1. When the grantor purchase for options, each of which is expected to fluctuate in value inversely with at least one of the others (i.e., two such options resulting in a gain with the other two resulting in loss to offset the gain).

2. Similar to situation 1, when the grantor contributes cash or marketable securities to the trust with a basis equal to fair market value. Before the substitution power becomes effective, grantor sells the remainder interest in the trust to the buyer for an amount equal to the fair market value. Prior to the effective date of the substitution power, the grantor then sells the remainder interest in the trust for an amount equal to the property’s fair market value (which results in little to no gain or loss). Then, after the effective date of the substitution power, the grantor substitutes appreciated property for the cash owned by the trust following the sale, at which point the grantor claims the trust is once again a grantor trust (and as a result, the grantor does not recognize gain on the transfer of appreciated property).

Both of these examples involve transactions that (i) occur within a very short period of time and (ii) produce tax consequences otherwise unattainable but for the suspension and restarting of grantor trust status.

Death of the Grantor. The effect of the grantor’s death is a question that commentators have debated for some time. Generally speaking, most agree that the termination of the trust is a transfer of the trust assets and liabilities from the grantor to the trust. Chief Counsel Advice 2009-23024 (June 5, 2009) analyzes the conversion of a grantor trust to a nongrantor trust, and

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discusses several authorities dealing with this subject (such as Revenue Ruling 77-402, Treasury Regulations Section 1.1001-2, Ex. 5., and Madorin v. Comm’r, 84 T.C. 667 (1985)). The ruling states that “we would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapse of grantor trust status, not that caused by the death of the owner, which is generally not treated as an income tax event.

Commentators have differing opinions on the tax consequences upon the death of the grantor, with views ranging as follows: (i) No recognition of gain and a possible step-up in basis; (ii) No recognition of gain, but no step up in basis; and (iii) Gain to the extent liabilities exceed basis and no step up.

If a grantor completes a sale for cash or the note is paid off before the grantor’s death, then there is no sale and no gain recognized. At the grantor’s death, the asset moves into the trust and no payment or note comes back to the grantor’s estate, so it is seen as a gift for income and gift tax purposes. The trust’s basis in the asset is the same as the grantor’s basis.

However, if there is a sale between a grantor and a grantor trust, and the grantor dies while the note is still outstanding, it is unclear whether this is recognized as a sale. Before the grantor’s death, there was no sale and no note to speak of because the grantor owned both the note and the assets in the trust. After the grantor’s death, both the note and the trust holding the assets pop into existence—the asset moves either subsequent or concurrent to the trust coming into existence, and the trust now owes money to the grantor’s estate. Some people argue this is a sale, while others argue this is not a sale. The best advice is to try to pay off these notes during life if at all possible to avoid the uncertainty created when a grantor dies with an outstanding note.

E. Common Planning Choices

Often the most challenging grantor trust planning issue is how to make a trust taxable to the grantor or a pseudo grantor without encountering unwanted wealth transfer tax consequences. In this respect by far the most popular defect is the Section 675(4)(C) power to swap assets. This provision essentially authorizes any person (not just the grantor) not acting in a fiduciary capacity and without the consent of a fiduciary to exchange trust assets for a full and adequate consideration (to purchase trust assets for fair market value) with no wealth transfer tax exposure to the powerholder.60

Other common approaches work in situations involving married grantors who feel confident that the marriage will last, because it is relatively easy to trigger grantor trust liability with an interest or power in the grantor’s spouse that is only deemed to be an interest or power in the grantor. See the spousal unity rule in Section 672(e). This form of intentional grantor trust exposure will generate no wealth transfer tax consequence to the grantor (although care must be taken to avoid exposing the spouse to unexpected wealth transfer tax). It should also be noted that divorce does not change a grantor trust as the grantor, which may leave an ex-spouse financially responsible for the income tax on their former spouse’s trust. Specific language can

be included in the trust to prevent this from happening, for example by including language that would trigger the dissolution of the trust or requiring distributions to a spouse be approved by an adverse party in the case of divorced spouses.

There is much more to this topic. For added guidance and self-study regarding the grantor trust rules in particular, see 1 Casner & Pennell, Estate Planning Section 5.11 (6th ed. 1995), and Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts and Beneficiaries ch. 10 (3d ed. 1999).

F. How to File a Tax Return for a Grantor Trust

**General Rule – Form 1041.** There are three ways to file a tax return for a grantor trust. The general rule is that all grantor trusts must file a Form 1041, which contains only the trust’s name, address, and tax identification number. The assets owned by the trust are normally titled so that the earnings are initially reported by the payor (i.e., the brokerage firm, partnership, or, in many cases, an S corporation, etc.) as being taxable to the trust. However, by filing the Form 1041, the trustee is in effect letting the IRS know that the items of income or deductions are instead reportable by the “deemed owner,” and providing the tax identification information for the deemed owner. The activity that is reportable by the deemed owner is summarized on a separate statement (a grantor tax information letter), which is attached to the otherwise blank Form 1041 when it is submitted to the IRS. However, there are two alternative reporting methods that allow some grantor trusts to avoid filing a Form 1041.

**First Alternative – 1099 in lieu of 1041.** One alternative method allows the trustee of the trust to file Forms 1099 in lieu of a Form 1041. In that case, the ownership of the assets themselves is listed in the normal way with the payor, so that income is initially reported as taxable to the trust. However, the taxability of that income is shifted to the deemed owner when the trustee prepares Forms 1099 showing the trust itself as the payor, and the deemed owner as the payee. As a practical matter, though, if there are multiple types of income (dividends, interest, rent, etc.) or multiple sale transactions, this method may not be any easier than filing a Form 1041. Furthermore, as described below, unless the deemed owner is the trustee or a co-trustee, filing Forms 1099 does not negate the trustee’s duty to prepare the grantor tax information letter and send it to the deemed owner to be reported on his or her personal return. In that situation, filing Forms 1099 involves virtually as much effort as filing Form 1041.

**Second Alternative – Changing Ownership Listing of the Trust’s Assets.** The other alternative, however, is a relatively easy way to avoid filing either a Form 1041 or Forms 1099. This involves changing the way the ownership of the trust’s assets is listed with the payor. Specifically, Treasury Regulations Section 1.671-4(b)(2)(i)(A) is available as long as the grantor trust is treated as owned by only one person. In this scenario, the trustee furnishes to all payors of income (e.g., a brokerage firm, etc.) the following information, so that Forms 1099 or Schedules K-1 (from either a partnership, S corporation, or a trust, as the case may be) are issued using: (i) the grantor’s name; (ii) the grantor’s taxpayer identification number (i.e., Social Security number (“SSN”)); and (iii) the trustee’s address. In this alternative, the income is

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61 See Treas. Regs. § 1.671-4(a).
reported to the IRS as being taxable directly to the deemed owner; however, the forms are mailed by the payor to the trustee. The goal of this alternative reporting method (from the IRS’s perspective) is to have Forms 1099 and Schedules K-1 issued in a manner that allows the IRS to computer match the income directly against the income shown on the individual’s Form 1040.

An often-mentioned concern with this technique, however, is that precise compliance with this alternative would tend to not leave a clear trail that the assets are legally owned by a trust, rather than owned individually, particularly if the trustee’s and grantor’s addresses are the same. This concern is particularly acute if the trust is irrevocable and the intent is for the assets to be outside of the grantor’s taxable estate. However, it is important to remember that this alternative method of reporting does not change the fact that the assets are legally titled in the trust’s name. It is merely changing the method for reporting the trust’s income and deductions. Nevertheless, someone who is looking solely at an S corporation Schedule K-1 upon the death of the grantor (showing the grantor’s name, SSN, and address) could mistakenly miss the fact that the actual stock certificates would clearly show ownership by the trust. In other words, this alternative method might cause the estate planning benefits of the trust to be inadvertently missed.

For the above reason, the best solution (to both comply with the regulation and still “leave a clear trail”) is to not give to the payors just the grantor’s name alone (as suggested by the Regulations), but rather to show both his or her name and the trust’s name on the payor’s records. Thus, if “John Doe” created the trust, the name section of the Form 1099 or Schedule K-1 would contain the following: “John Doe, grantor of the Doe Dynasty Trust dated 12/30/2012.”

In this way, the Forms 1099 or Schedules K-1 would be issued in the grantor’s SSN, and the grantor’s name would be the first item in the name section, followed by a reference to the trust. This technique gives the trustee the option to avoid filing either an annual income tax return or Forms 1099. Instead, the taxable income is reported directly on the grantor’s Form 1040.

**Other Reporting Issues.** These optional methods are not available for a trust that is merely a grantor trust because of a qualified subchapter S trust (“QSST”) election. For a QSST, a Form 1041 must be filed each year.

Also, regardless of the reporting method used (i.e., a Form 1041 or one of the alternative methods), the grantor tax information letter must be sent to each deemed owner. This step is unnecessary, however, if there is only one deemed owner who is also either the trustee or a co-trustee.

If the grantor is the trustee or a co-trustee, and the second alternative method of reporting is used, then no Form 1041, Form 1099, or separate grantor tax information letter is required. In that situation, it is important to include the name of the trust behind the deemed owner’s name so there is no confusion that the trust owns the asset.

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X. APPLICATION OF THE 3.8% SURTAX

The 3.8% Medicare surtax is imposed under Section 1411(a)(2) on the UNII of a trust or estate. The starting point for calculating this tax is the entity’s adjusted gross income, as determined under Section 67(e) as it otherwise would be for garden variety trust or estate income tax purposes. Income that is not carried out to the beneficiaries is subject to the 3.8% tax inside any garden variety trust or estate. As is true for an individual taxpayer, the 3.8% tax is applied to a trust or estate on the lesser of UNII, or AGI in excess of the threshold amount (the dollar amount at which the highest tax bracket in section 1(e) begins—the $12,300 in 2015—which is not prorated for a short tax year).

Investment income that is earned in the entity is carried out to beneficiaries under the standard DNI carryout rules, and is taxable to those beneficiaries under the normal character passthrough rules as if that income had been earned by them pro rata. All of the normal income carryout rules apply, including those that integrate with the Section 642(c) charitable deduction for income that is paid out or set-aside for charity. Because these rules apply the same character passthrough rules that normally apply to trusts and estates, and because capital gain normally is not included in DNI, at a minimum the capital gain investment income of a trust or an estate is likely to constitute UNII for typical trusts and estates under the 3.8% Medicare surtax, just as it is for normal income taxation.

A. Grantor Trusts

Grantor trusts are exempt from the 3.8% tax, because the normal grantor trust rules apply. Thus, investment income in the trust flows through to the grantor (including in a grantor trust variety of charitable lead trust).

B. Nongrantor Charitable Lead Trusts and Charitable Remainder Trusts

Nongrantor charitable lead trusts are not mentioned, but extensive special rules apply to charitable remainder trusts. These CRTs are exempt, but income “ordering” rules apply to determine the surtax consequences of CRT distributions to lead annuity or unitrust beneficiaries. Known as the WIFO (worst-in, first-out) rules, found in Treasury Regulations Section 1.664-1(d)(1)(ii), those lead distributions from CRTs normally carry out:
1. Current and accumulated ordinary income; then
2. Current and accumulated short term and long term capital gain; then
3. Current and accumulated tax exempt income; and finally
4. Tax free corpus.

C. Net Investment Income Comes Out Consistent with Tier Rules

As an overlay on these rules, the final Section 1411 regulation provides that net investment income from years after 2012 comes out under a regime that is consistent with the existing tiers. The only concept added by the final regulation is that, within each tier, the most highly taxed items are deemed to be distributed first, applying for this purpose the aggregate tax rates applicable to any particular item.
For example, current net ordinary investment income subject to the regular 39.6% tax rate and the 3.8% surtax rate is regarded as 43.4% ordinary income, which would come out of tier 1 before any other income. Similarly, short term capital gain income subject to the same 43.4% aggregate rate would come out of tier 2 before any other income in tier 2. But tier 1 income with a lower aggregate rate would come out before distribution of any income in tier 2. Thus, ordinary income in tier 1 that is exempt from Section 1411 (because it was accumulated in pre-2013 years), or tier 1 current noninvestment ordinary income (in either case subject to only a 39.6% aggregate rate) would come out before any of the tier 2 short term 43.4% capital gain.

See the examples in Treasury Regulations Section 1.1411-3(d)(2)(iii), which posit tier 1 ordinary income with aggregate rates from 43.4% down to 20% (constituting current net investment income, excluded pre-2013 net investment income, excluded rental income, nonqualified dividend income, net investment qualified dividend income, and excluded pre-2013 net investment qualified dividend income), all of which carries out before any tier 2 short and then long term capital gain income with aggregated rates also ranging from 43.4% down to 20%. Further, see Treasury Regulations Section 1.1411-3(e)(3), which appears to provide for a pro rata carryout of all classes of income that have the same aggregated tax rate in a particular tier (this is not exactly clear, because the regulation makes reference to Treasury Regulations Section 1.661(b)-1 but appears to intend to refer instead to Section 1.662(b)-1). As is true for garden variety trusts, multiple beneficiaries of charitable remainder trust distributions share the distribution items pro rata.

Nongrantor charitable lead trusts are not specifically mentioned or made exempt from these rules, and nothing in these regulations specifies how the income ordering rules will apply. As noted next below, the tiers applicable to charitable remainder trusts do not apply to lead trusts—norm proration rules apply instead—and the Regulations do not specify whether net investment income is distributed to the charitable lead beneficiary first, last, or pro rata. Because the WIFO principle specifically does not apply in a charitable lead trust, presumably it will not apply in a lead trust for Section 1411 purposes either. Thus, for most purposes under Subchapter J a proration is the expected result, and that likely is the smart default assumption for lead trust purposes also.

With one notable exception, taxpayers who relied on the proposed regulations for a tax year that began in 2013 may (but need not) adapt to these new rules, but must adapt to the final regulations for years that begin after 2013. The Section 1411 tax itself is applicable for tax years that began after 2012. The notable exception is found in Treasury Regulations Section 1.1411-3(f), which specifies that the ordering rules stated above must be applied by charitable remainder trusts for tax years that began any time after 2012—even if the year was nearly complete before these regulations were released on November 26, 2013 (and notwithstanding the regulation’s stated effective date of December 2, 2013). The preamble clarifies, however, that returns filed before these regulations were published need not be amended.

D. Passive Versus Active Participation Rules Under Section 469

A final issue is relevant because net investment income does not include income derived in the ordinary course of an active trade or business, but passive activity income is subject to
Section 1411. In this regard, the passive versus active participation rules that apply to a trust or an estate under Section 469 are not well established, and the Regulations do not address that question. Prior to March of 2014 the only case on point was *The Mattie K. Carter Trust v. United States.*\(^65\) It held that the trustee’s activities were adequate for active participation purposes and that activity of any employees and agents of the fiduciary, plus activity of the beneficiary, all may be considered to determine whether active participation exists in a trust or estate context. As discussed next below, a new case has been decided under Section 469 but its holding likely will not give much guidance to garden-variety trusts and specific guidance has not yet been promulgated regarding the application of these active participation rules for trusts or estates that are subject to Section 1411.\(^66\)

Senate Report No. 313, 99th Cong., 2d Sess. 735 (1986), indicates that the fiduciary’s activities are the relevant inquiry and the passive versus active determination is meant to be made at the entity level, although the issue is not nearly that easy (which may be indicated by the fact that the Regulations have not been drafted in this respect). Nevertheless, relying on the Senate Report and repeating the government’s position that *Carter* was wrong to consider employee activity, TAMs 201317010 and 200733023 both concluded that activities of a “special trustee” did not establish active participation, and PLR 201029014 articulates that “the sole means for a trust to establish material participation is if its fiduciary is involved in the operation of the entity on a regular, continuous, and substantial basis.”\(^67\)

*Frank Aragona Trust v. Commissioner.* It is in this context that the decision in *Frank Aragona Trust v. Commissioner* attracts significant attention.\(^68\) The case arose in the context of the Section 469 passive activity loss rules (implicating the per se passive activity rule in Section 469(c)(2) and the Section 469(c)(7) exception to it). In that regard the case is not directly significant to most trustees. But the passive versus active classification interests trustees who wish to avoid the Section 1411 tax on net investment income, because active business income is the antithesis of investment income. Unfortunately, hopes that the court’s conclusion would speak to the Section 1411 issue proved unrealistic, because the case is too fact-specific and the court dodged a critical issue for most garden-variety trusts.

Apparently the Aragona family business was centered around real estate. The trust (1) conducted rental-real-estate activities, (2) held real estate for investment purposes, and (3)


\(^{66}\) The preamble to the Section 1411 regulations noting that another guidance project is underway to address this question; see Temp. Treas. Reg. §§ 1.469-5T(g) and -8, both reserved for future elaboration on the application of the passive activity loss rules to trusts and estates.

\(^{67}\) See, generally, Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries § 8.01 (3d ed. 2011); Schmolka, Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King), 58 Tax L. Rev. 191 (2005); Lane, Application of Passive Activity and Alternative Minimum Tax Rules to Estates and Trusts, 41 Major Tax Plan. ch. 16 (1989) (arguing that material participation should be tested at the entity level and again at the beneficiary level if income passes through so that, if the beneficiary is active, interposition of the fiduciary as owner of the asset will not defeat the proper characterization of income the beneficiary actually receives); Abbin, To Be [Active] or Not to Be [Passive]: That is the Question Confronting Fiduciaries and Beneficiaries Trying to Apply the Passive Activity Loss (PAL) Rules, 23 U. Miami Inst. Est. Plan. §§ 305 – 306 (1989) (recounting recommendations of the American Institute of Certified Public Accountants and of the American Bar Association, along with predictions of the government’s yet to be formulated response).

\(^{68}\) *Frank Aragona Trust v. Comm'r,* 142 TC No. 9 (March 27, 2014).
engaged in real-estate-development operations. Some of the business was conducted (a) directly by the trust, some (b) through wholly-owned pass-through entities (such as an LLC), and the rest (c) through entities owned in part by the trust and the balance by two children of the settlor.

The trust had six trustees—one was an “independent trustee” (a tax/estate planning attorney) and the remaining five were the settlor’s five children (two of whom were the owners of the interests noted in (c) above). One of those two children was designated as the “executive trustee (in order to facilitate daily business operations)” but “the trustees acted as a management board for the trust and made all major decisions regarding the trust’s property.” Together they met every few months to discuss the trust’s business, and three of the five children worked full time for the LLC that was wholly owned by the trust and that managed most of the trust’s rental-real-estate properties. In short, the trust’s settlor was into real estate, several of his children were actively engaged in those real estate endeavors, and the trust was the entity that owned and controlled the various assets and entities that were involved.

As is true of many real estate ventures, the government sought to deny tax losses under the Section 469 passive activity loss rules. The specific legal ground for this denial was that the taxpayer (the trust) did not materially participate in the trades or businesses that generated the losses. Indeed, Section 469(c)(2) provides that “any rental activity is considered a passive activity, even if the taxpayer materially participates in that activity”—rental activity is per se passive unless the exception in Section 469(c)(7) applies (which requires that two tests be met—a “personal services” test and a 750-hours-of-services test).

For these purposes, “a taxpayer is treated as materially participating in real-property trades or businesses if the taxpayer is involved in the operation . . . on a basis which is regular, continuous, and substantial.” But, the government argued, “a trust cannot perform personal services” as defined by Treasury Regulations Section 1.469-9(b)(4) (which describes “work performed by an individual”) because a trust is not an individual.

On that specific basis the court rejected the government’s argument. Distinguishing “individual” from “any natural person” and citing Treasury Regulations Section 1.469-9(b)(4), the court’s most significant holding was:

If the trustees are individuals, and they work on [sic] a trade or business as part of their trustee duties, their work can be considered “work performed by an individual in connection with a trade or business.” We conclude that a trust is capable of performing personal services and therefore can satisfy the Section 469(c)(7) exception.

The disappointment here is that the court’s holding does not speak to a trust of which the trustee is not an individual and therefore employs individuals to perform trust or trustee functions. Nor does it speak to a trust in which the beneficiaries are the individuals who are active in a trade or business, and the trustee wants their activities attributed to the trustee. All of which means that the court’s conclusion doesn’t directly inform the active or material participation determination that most trusts need to address in terms of the Section 469 passive loss rule or to avoid the Section 1411 “investment income” label.
Also as stated by the court: “The IRS would have us ignore the activities of the trust’s non-trustee employees.14 Additionally, the IRS would have us ignore the activities of the three trustees who are employees of [the] LLC.” Footnote 14 simply says “The IRS disagrees with Carter Trust v. United States, 256 F. Supp. 2d 536, 541 (N.D. Tex. 2003), which held that the activities of the trust’s non-trustee employees (and of the trustee) are considered in determining whether the trust materially participated in ranching activity.” To support its argument the government relied on S. Rep. No. 99-313, which states that a trust “is treated as materially participating in an activity . . . if . . . [a] fiduciary, in his capacity as such, is so participating” and further that “the activities of . . . [employees] are not attributed to the [fiduciary].” The same Report also provides that “[t]he fact that a taxpayer utilizes employees . . . to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.”

Although it is a critical issue to most garden-variety trusts, the court did not resolve this employee/agent issue. Instead, the court side-stepped it, saying that “[e]ven if the activities of the trust’s non-trustee employees should be disregarded . . . the activities of the trustees . . . should be considered . . . .” And, via the court’s footnote 15, the opinion made clear that “[w]e need not and do not decide whether the activities of the trust’s nontrustee employees should be disregarded.” The opinion thus leaves open a critical question for many trusts that must satisfy the material participation requirement for active versus passive activity income through activities of employees or other agents.

Fortunately, perhaps, the court did conclude that the three individual trustees’ activities as employees of the wholly-owned LLC . . . should be considered in determining whether the trust materially participated in [the LLC’s] real-estate operations. Considering the activities of all six trustees in their roles as trustees and as employees of [the] LLC, the trust materially participated in its real-estate operations.

Regrettably, that holding is of no help to corporate trustees, nor to individual trustees who are not also active participants in the daily activities of the trades or businesses whose income or losses must meet the active versus passive standard.

To date Aragona Trust and Carter Trust are the only cases on point, presumably meaning that this issue will continue to bedevil taxpayers and the government alike—perhaps even after the government issues proposed regulations on this subject that are alleged to be in production.

XI. STATE INCOME TAXATION OF TRUSTS AND ESTATES

Almost every state imposes its own income tax and most states that tax income recognize trusts and estates as separate taxpayers under principles that sometimes only vaguely resemble the federal income tax regime in Subchapter J. Just as the issue can arise at the federal level whether a trust or estate is subject to income taxation in the United States or a foreign jurisdiction, the question at the state level is whether a trust or estate is subject to income
taxation under the laws of more than one state. Unfortunately, the nature of the various state income taxes is such that many trusts and estates are exposed to income taxation on at least a portion of their income in multiple jurisdictions. And not all states allow a credit for income tax paid to another state or country (unless the trust is a resident trust).69

The issue at the state law level is whether a particular state has enough of a connection to a trust or estate to impose an income tax with respect to the entity’s undistributed income. One or more of at least six different factors may constitute a sufficient nexus to permit a state’s income tax to apply to a trust or an estate: (1) locus of the trust or estate’s creation, (2) locus of the trust or estate’s administration, (3) situs of trust or estate corpus (which might differ from the locus of the entity’s administration), and domicile of (4) the settlor or decedent, (5) the fiduciary (which might differ from the situs of entity assets or the locus of its administration, although the latter is not common), and (6) the beneficiaries.70

Because there may be trust or estate assets, administration, and beneficiaries sprinkled among multiple jurisdictions, a number of states may claim the right to tax some or all of the entity’s income, although entity administration, assets, and fiduciary domicile provide the strongest anchors to justify state income taxation of the entity. In addition, the beneficiaries may be subject at the individual level to the same form of taxation of distributions as they encounter at the federal level.

Because there is such a wide diversity in potential sources of taxation, there is no substitute for careful investigation into the tax statutes of the various states that may attempt to reach the income of a particular entity, with an eye toward whether multiple answers are raised by questions such as:

1. Applying the various factors at the time of taxation, which states enjoy a sufficient nexus— in terms of current benefits and protections provided by that jurisdiction— to justify imposing that state’s tax on entity income? For example, the location of the trust’s creation is not likely to be a sufficient contact to justify taxation in a subsequent year unless some other connection to that state exists.71


70 See Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999); John S. Swift, Jr. Trusts v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987), cited in and distinguished by Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991), and 804 S.W.2d 27 (Mo. Ct. App. 1991), confirming that more than just items (1) and (4) must exist, but in Westfall item (3) was met because a portion of the trust corpus was Missouri realty. Westfall paid no income tax to any other jurisdiction, and the court rejected the contention that only income earned from the trust’s Missouri assets could be taxed in Missouri.

71 Contra, District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. Ct. App. 1997) (although the trustee, trust assets, and trust beneficiaries all were located elsewhere, the District constitutionally could tax all the net
2. What actions might the fiduciary consider to minimize the income tax in one or more jurisdiction—such as a change in situs for administration, a change in the nature or scope of administration, addition or deletion of co-fiduciaries to alter the locus of that administration, or even alteration of the entity’s investments to preclude taxation based on the source of income?

3. If more than one state imposes its income tax, are there credits provided by those overlapping jurisdictions that minimize double taxation of the same income?

4. Is there an entity level distributions deduction under the state income tax that precludes double taxation of the entity and its beneficiary to the extent income has been distributed?

5. Are other taxes applicable, such as business and profit or intangible and personal property taxes?

Because the situs of entity assets, the locus of the entity’s administration, and the domicile of the fiduciary all are the same in the vast majority of garden variety trusts and estates—particularly if the assets are not realty and only a single fiduciary is acting—the scope of exposure to income taxation in multiple jurisdictions can be minimized. Often only the domicile of the beneficiaries is likely to be beyond the fiduciary’s control. Because most state income taxes look to the beneficiaries only to impose an income tax on amounts distributed to the beneficiary and, in turn, do not tax the entity on amounts distributed, double taxation is less likely to be a source of concern based on beneficiary domicile.

One final note, relevant today only in New York State, is the potential for states to pass legislation to preclude the state income tax avoidance represented by ING trust planning. In 2014 New York amended its state income tax to treat an ING trust as a grantor trust, notwithstanding its nongrantor trust status under federal law. New York Tax Law Section 612(b)(41) adds to a New York taxpayer’s federal adjusted gross income “the income of [a] trust [that] would be taken into account in computing the taxpayer’s federal taxable income if [the] trust in its entirety were treated as a grantor trust for federal tax purposes” and applies if “the grantor’s transfer of assets to the trust is treated as an incomplete gift” under Code Section 2511. In the same legislation, New York Tax Law Section 612(b)(40) also now restores the long dormant accumulation distribution and throwback rules of Code Sections 665–667.