

Income Tax Oddballs

ACTEC New England Fellows Institute

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Standard Income Taxation of Trusts

- Grantor Trust:
 - Taxed to grantor/owner
- Nongrantor Trust:
 - Simple or Complex
 - Beneficiaries taxed on distributed income
 - Trust taxed on retained income and income allocated to trust principal (with some flexibility)

Exceptional Trusts

Type of Trust	Code Section(s)
Alimony Trust (no longer available)	682
Business Trust	7701
Charitable Remainder Trust	664
Common Trust Fund	584
Foreign Grantor Trust	679
Foreign Nongrantor Trust	672(f), 665-668
Pooled Income Fund	642(c)(5)
S Corporation Shares Held in Trust	1361(c)(2)

What Causes an Exception to Apply?

- Property in the trust is subject to special income tax rules (S Corporation shares, Alimony)
- The trust's beneficiary or grantor is subject to special income tax rules (Charitable trusts, Pooled income funds)
- The trust is taxed as a different type of arrangement, such as a business or disregarded entity (Business trust, Common trust fund)
- The trust is foreign (Foreign nongrantor trust)

Trust Property Subject to Special Income Tax Rules

- S Corporation stock
- Alimony

Trusts as S Corporation Shareholders

- **S Corporation taxation:** taxed as a pass-through entity for federal income tax purposes. In contrast C corporations are taxed annually at the corporate level, and distributions to owners are taxable dividends (double taxation). S Corporation status avoids corporate level tax and double taxation
- **Trusts holding S Corporation stock:** must meet certain requirements to allow the S Corporation to keep its status
- **Risk:** if a trust owns S Corporation shares and does not meet the requirements, the company could be reclassified and taxed as a C corporation

S Corporation Shareholder Requirements § 1361(c)(2); § 1.1361-1

- All shareholders must be U.S. individuals, estates, or certain trusts
- Eligible trusts:
 - Grantor trusts with U.S. citizen or resident grantors
 - Qualified Subchapter S Trusts (QSSTs)
 - Electing Small Business Trusts
 - Voting Trusts

Estates and Testamentary Trusts

- “Estate” refers to a domestic probate estate during a reasonable period, including a § 6166 payment period
- “Estate” includes a bankruptcy estate
- A revocable trust subject to a § 645 income tax election will be taxed as part of the decedent’s estate during the two-year 645 election period
- A testamentary trust can qualify for two years after the date of transfer of deemed distribution to the trust without making a QSST or ESBT election

Types of Trusts Eligible to Hold S Corp Shares

- Grantor trusts with U.S. citizen or resident grantors
- Electing Small Business Trusts (ESBTs)
- Qualified Subchapter S Trusts (QSSTs)
- Voting Trusts
- All trusts are subject to the maximum number of shareholders rules

Maximum Number of S Corp Shareholders: 100

- Spouses and their estates count as one shareholder
- Descendants (and their estates) of one common ancestor, up to six generations, count as one shareholder
- ESBT: all potential current beneficiaries must be eligible shareholders, provided that non-US persons may be beneficiaries.
- QSST: beneficiary must be an eligible shareholder
- Voting trusts: all owners must be eligible shareholders
- Each trust beneficiary counts as one shareholder, subject to relationship rules. Potential beneficiaries of unexercised powers of appointment may be disregarded

Grantor Trusts

- Grantor must be a U.S. person
- Any grantor trust under §§ 671-679 qualifies to hold S corporation shares, so long as the grantor is a U.S. person
- Grantor trust status terminates at the grantor's death

Electing Small Business Trust § 1361(e)

- Election available for multi-beneficiary spray trusts. If an ineligible shareholder becomes a potential current beneficiary, the trust has 12 months to cure the problem by disposing of the S corporation stock
- Interests in the trust must have been acquired by gift or bequest, not by purchase
- Not available for charitable remainder trusts or fully charitable trusts
- Charitable lead trusts may qualify as ESBTs after the death of the grantor under certain conditions; see PLR 199908002
- Trust may convert from ESBT to QSST and vice versa

Taxation of ESBTs: § 641(c)

- The ESBT's S corporation stock is taxed as a separate trust for income tax purposes
- Unique tax treatment: distributions to beneficiaries do not carry out taxable income
- All S corporation items flow through to the separate trust and are taxed to the separate trust
 - All income is taxed at the trust's income tax rates
 - No income or deductions are carried out to the beneficiaries and the trust receives no distribution deductions
 - Deductions are allowed only for administrative expenses and state and local taxes

Making the ESBT Election

§ 1.1361-1(m)(2)

- No form available; advisors must prepare the submission to the IRS by following the requirements in the regulation
- Trustee must sign the election
- Due within 2 months and 16 days after S corporation stock is transferred to the ESBT
- Late election relief is available an additional 3 years and 75 days; see Rev. Proc. 2021-1
<https://www.irs.gov/pub/irs-irbs/irb21-01.pdf>

Qualified Subchapter S Trust Requirements Part 1

- Must actually distribute, or be required to distribute, all income to one U.S. person
 - Exception: a married couple can be “one” U.S. person
 - Withdrawal powers (lifetime powers of appointment) do not qualify
 - Spray provisions are impermissible even if they apply only after the trust no longer holds S corporation stock
 - An actual distribution to a beneficiary does not qualify if it satisfies the trust’s donor’s obligation to support such beneficiary

Qualified Subchapter S Trust Requirements Part 2

- No principal distributions to anyone other than the income beneficiary
 - Cannot have lifetime power to appoint or distribute principal to another person
 - Again spray provisions are impermissible even if they apply only after the trust no longer holds S corporation stock
- Income beneficiary's interest must be for life or until the trust terminates
- Upon trust termination, must distribute all assets to income beneficiary, if living
- Income beneficiary must file a QSST election

Taxation of QSSTs

- Unique tax treatment: a QSST is taxed as a grantor trust with respect to the S corporation shares, and the beneficiary is treated as the trust's owner under § 678
- The QSST beneficiary is taxed directly on the income of the S corporation shares, as though the QSST did not exist
- If the QSST holds assets other than the S corporation shares, those assets are taxed under the normal trust income tax rules of Subchapter J

Filing a QSST Election

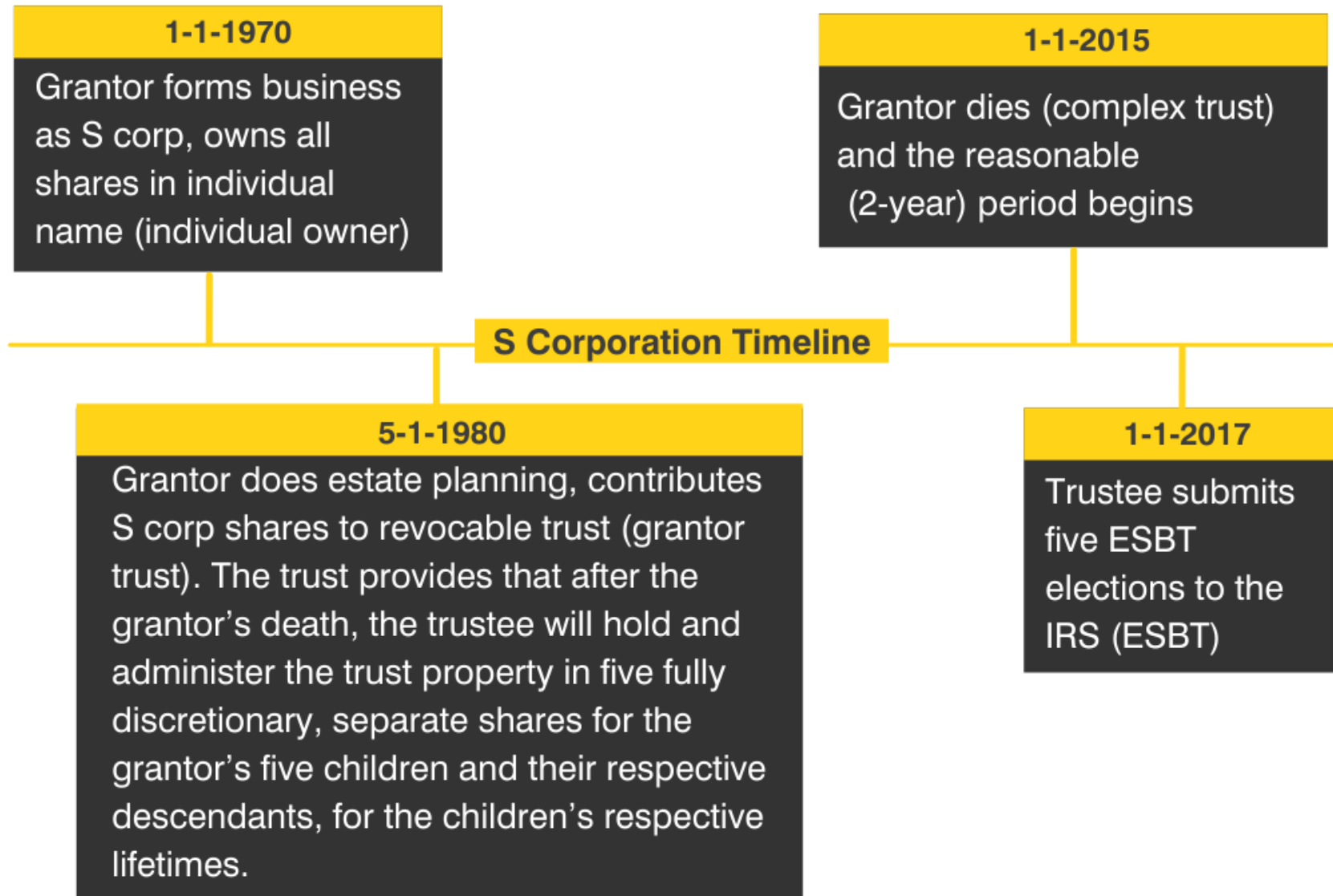
§ 1.1361-1(j)(6)

- No form available; advisors must prepare the submission to the IRS by following the requirements in the regulation
- Beneficiary must sign the election. A guardian or parent can sign for a minor beneficiary
- Due within 2 months and 16 days after S corporation stock is transferred to the QSST
- Late election relief is available an additional 3 years and 75 days; see Rev. Proc. 2021-1
<https://www.irs.gov/pub/irs-irbs/irb21-01.pdf>

Voting Trusts

- A “voting trust” is a trust created primarily to exercise the voting power of the stock transferred to it
- The voting trust is looked through for S corporation eligibility purposes
- Requirements
 - Written trust agreement
 - Beneficiaries delegate voting power to trustees
 - All corporate distributions must be paid to the beneficiaries
 - Beneficiaries must receive title and possession of the stock upon the trust’s termination
 - There must be a specified termination date for the trust
 - The beneficiaries must be taxable as grantors of the trust

Illustration of One S Corp Estate Plan



Alimony Trusts

§ 682

- Repealed for divorce or separation instruments executed or modified after December 31, 2018. Still effective for pre-existing trusts
- Unique because alimony tax rules previously superseded the trust income tax rules that otherwise would apply
- Alimony previously was taxed to the recipient spouse as income, deductible by the payor spouse
- Child support is not alimony and is taxed like any other trust distribution

Pre-TCJA Alimony Trusts

- Effective for trusts created pursuant to separation agreements executed on or before December 31, 2018 and not modified after that date
- The alimony rules apply equally to pre-existing trusts characterized as alimony in a divorce, and to trusts created specifically for alimony
- The trust does not have to be mentioned in the divorce decree, although that is good planning

Trust Beneficiary or Grantor Subject to Special Income Tax Rules

- Charitable Trusts
- Pooled Income Funds

Split-Interest Charitable Trusts

- Charitable Remainder Trusts (CRTs) § 664
 - Income interest retained by the donor or given to other individuals for life or for a term of years
 - Remainder interest passes to charity after the income interest expires
- Charitable Lead Trusts (CLTs) Various Rev. Procs.
 - Income interest goes to charity for a period of years or for an individual's lifetime
 - Remainder interest passes to individual beneficiaries

CRT General Income Taxation

- Unique because the trust's remainder interest will be taxed as a charity
- Start with the general complex nongrantor trust rules
 - Income distributed to a beneficiary is taxed to the beneficiary (but see special rules regarding accumulated income)
 - Capital gains and undistributed income will be taxed to the trust

CRT Taxation of Distributed Income

- Unique rule for CRT: beneficiary taxed on CRT's current income and accumulated income since creation, "worst out first"
 - First, income includible in gross income (ordinary, dividends)
 - Then, capital gains
 - Then, other income (tax-exempt interest)
 - Finally, tax-free return of principal
 - Any income subject to the 3.8% Net Investment Income Tax will carry out that tax – for CRTs established prior to 2013, NII received in 2013 or after is distributed out first
 - In each category, current-year income is distributed, then the oldest accumulated income (subject to NII rule). Then go to the next category

CRT Taxation of Capital Gains

- Unique rule for CRT: Remainder is tax exempt
 - Unrelated Business Income (UBI) is taxed at 100%, but since 2007, UBI doesn't disqualify the CRT from tax-exempt status
 - No capital gains tax on sale of appreciated assets
 - Private foundation excise taxes on self-dealing and taxable expenditures apply – see §§ 4941, 4945

Types of CRTs

- Annuity
 - Fixed payout to income beneficiaries at least annually
 - Payout may be a fixed dollar amount or a fixed percentage of the value of the initial contribution
 - Payout is independent of investment performance
 - May only be funded once
- Unitrust
 - Payout at least annually, equal to a fixed percentage of the then-current fair market value of the trust assets
 - Percentage is fixed, but the distribution varies based on the fair market value of the assets
 - May accept additional contributions

Types of CRUTs

- Standard (CRUT)
 - If income is less than the fixed amount to be distributed, then principal is distributed to make up the shortfall
- Net Income CRUT (NICRUT)
 - Distribution to income beneficiary is the lesser of (i) standard CRUT distribution amount and (ii) net income
- Net Income with Make-up CRUT (NIMCRUT)
 - Same as the NICRUT, except if net income is less than the fixed amount to be distributed, then a make-up account is created
 - In subsequent years, if net income is greater than the fixed amount, then the trustee distributes the fixed amount, plus all remaining income up to the balance of the make-up account

Limits on CRT Payouts

- Timing: must occur at least annually, within a reasonable time after the close of the year
- Minimum and maximum payouts:
 - CRATs: at least 5%, but no more than 50%, of the initial fair market value of the trust assets
 - CRUTs: at least 5%, but no more than 50%, of the fair market value of the trust assets determined annually
 - Both CRATs and CRUTs: value of the remainder interest must be at least 10% of the initial fair market value of the trust assets
- Splitting a CRT? See Rev. Rul. 2008-41

CLT General Income Taxation

- All income is fully taxed to the grantor (if a grantor trust) or to the trust (if a nongrantor trust)
- All amounts distributed to charity qualify for income tax deductions

CLT Drafting

- Inter Vivos Grantor and Nongrantor Charitable Lead Annuity Trust Sample Instruments Rev. Proc. 2007-45;
- Testamentary Charitable Lead Annuity Trust Sample Instrument Rev. Proc. 2007-46
- Inter Vivos Grantor and Nongrantor Charitable Lead Unitrust Sample Instruments Rev. Proc. 2008-45
- Testamentary Charitable Lead Unitrust Sample Instrument Rev. Proc. 2008-46

Pooled Income Funds (PIFs)

§ 642(c)(5)

- Charitable investment fund; not the same as a pooled trust for individuals receiving public benefits
- Maintained by a single charity; individuals can make contributions in exchange for an income interest for life. The charity receives the remainder
- Unique treatment: the trust is fully taxable but never pays income tax. All income is distributed annually to the individual income beneficiaries, and capital gains are tax-exempt
 - Note that the income is not subject to the CRT tier system
 - PIFs are prohibited from investing in tax-exempt securities, so all distributions will be fully taxable as ordinary income

POOLED INCOME FUND	POOLED TRUST
26 U.S.C. § 642(c)(5)	42 U.S.C. § 1396p(d)(4)(C)
Trust is maintained for the benefit of a charitable organization	Trust is established and managed by a non-profit organization
Transferred property is commingled	Transferred property is held in a separate account
Income must be paid to donor	No required distributions
Remainder passes to charitable organization	Remainder is used to reimburse State for medical assistance paid on beneficiary's behalf

Trust Taxed as a Different Type of Arrangement

- Business trust
- Common trust fund

Business and Investment Trusts

§ 7701

- The entity will be taxed as a business, not a trust
- Business Trusts
 - E.g. Massachusetts business trusts
 - Beneficial interests in the trust are held as shares, and beneficiaries may vote their shares
 - Check the box rules apply
- Investment Trusts
 - E.g. Real Estate Investment Trusts
 - Special tax provisions may apply

Identifying Business Trusts

§ 301.7701-4(a)

- Trusts are distinguished from business entities based on facts and circumstances
- Key factors for identifying a business trust:
 - Is the trust conducting business?
 - Are two or more beneficiaries conducting business for profit?

Investment Trust Taxation: May be Business or Trust

§ 7701; Reg. 301.7701-4(c)

- Investment Trusts may be taxed as check-the box entities, or as trusts, depending on the terms
- To be taxed as a trust, there can be no power under the trust agreement to vary the investment of the certificate holders. Additionally, if there are multiple classes of owners, the existence of multiple classes must be incidental to trust's purpose of facilitating direct investment in the trust's assets

Investment Trusts Taxed as Trusts § 7701; Reg. 301.7701-4(c), Example 2

- Example of an investment trust taxed as a trust:
 - Corporation M purchases a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to M certificates evidencing rights to payments from the pooled mortgages; M retains class D and sells class C certificates to the public
 - There are two classes of certificates, identical except that, in the event of a default on the underlying mortgages, class D payment rights are subordinated to the rights of class C certificate holders
 - The interests of certificate holders are substantially equivalent to undivided interests in the pool of mortgages, coupled with a limited recourse guarantee from M to class C certificate holders
 - The existence of multiple classes of ownership interests is incidental to the trust's purpose of facilitating direct investment in the assets of the trust

Investment Trusts Taxed as Business Entities § 7701; Reg. 301.7701-4(c), Example 1

- Example of an investment trust taxed as a business entity:
 - A corporation purchases a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to the corporation certificates evidencing rights to payments from the pooled mortgages; the corporation sells the certificates to the public.
 - There are two classes of certificates. The holders of the class B certificates will have “call protection” (freedom from premature termination of their interests on account of prepayments).
 - The trust creates investment interests with respect to the mortgages held by the trust that differ significantly from direct investment in the mortgages
 - The existence of multiple classes of trust ownership is not incidental to any purpose of the trust to facilitate direct investment

Liquidating Trusts Taxation: Business or Trust § 7701; Reg. 301.7701-4(d)

- Liquidating trusts occur in bankruptcy, insolvency, or corporate reorganization. May be taxed as check-the box entities, or as trusts, depending on the facts
 - If organized primarily to liquidate and distribute assets, it will be taxed as a trust
 - If liquidation continues for an unreasonably long period, or “if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned,” it will be taxed as a business
 - Agencies and trusts formed to protect security-holders’ interests will be taxed as trusts as long as they are organized primarily to protect interests in assets that are being liquidated or distributed
 - If those agencies are “subsequently utilized to further the control or profitable operation of a going business on a permanent continuing basis,” they will be taxed as business entities

Reporting Business Trusts

- Form 8832: Check-the-box election to be taxed as a corporation, partnership, or disregarded entity under Reg. § 301.7701-2
- Default rule if no election: partnership (if 2 or more owners) or disregarded entity (if 1 owner)

Common Trust Funds

§ 584

- Similar to mutual funds, but they are maintained by a bank or trust company and regulated by the Federal Reserve, rather than the Securities and Exchange Commission
- Pools the resources of multiple individuals, estates, trusts, and retirement vehicles for investment purposes
- Unique rule: the trust is completely flow-through and does not pay income tax. All income and expenses flow through to the underlying trusts and estates, proportionately

Foreign Trust

- Foreign Nongrantor Trust
- Foreign grantor trusts are taxed to the grantor, just like domestic grantor trusts

Foreign Trusts Overview: §§ 7701(a)(31)(B), 7701(a)(30)(E)

- Unique treatment because otherwise, taxpayers could use foreign trusts to take advantage of differing tax rules among jurisdictions
- Deters U.S. taxpayers from:
 - Transferring assets to a foreign trust and accumulating income outside the U.S.
 - Transferring low-basis assets to a foreign trust and realizing the gain tax-free outside the U.S.
 - Converting trust distributions to U.S. beneficiaries from taxable income to tax-free gifts

Foreign Trusts Overview: Court and Control Tests

- A trust will be a “foreign trust” for U.S. tax purposes unless it passes BOTH the court test and the control test.
- Court test:
 - A U.S. court must have primary jurisdiction over the trust’s administration
 - The U.S. can have simultaneous authority with another jurisdiction, but the trust must be administered exclusively in the U.S., and there can be no automatic migration provision (Reg. § 301.7701-7(c)(1))
- Control test:
 - One or more U.S. persons (citizen, resident, or corporation) must have authority to control ALL substantial decisions of the trust
 - “All substantial decisions:” A trust protector with power to remove the trustee is a “substantial decision.” Even a veto power held by a non-U.S. person will create foreign trust status. See the list in Reg. § 301.7701-7(d)(i)
 - A non-U.S. person can serve as a trustee if there are at least 2 other U.S. trustees and the trust provides that a majority rules
 - Cure period: if there is an inadvertent change in a trust’s residency, the IRS allows 12 months to fix it

Foreign Grantor Trusts with U.S. Grantor: § 679

- Every foreign trust is a grantor trust if it has a U.S. donor and a U.S. beneficiary
- U.S. donor:
 - Any transfer by a U.S. person qualifies, including a constructive transfer or transfer through an intermediary
 - Immigration: If a donor establishes a foreign trust for a U.S. beneficiary and becomes a U.S. person within 5 years, then the foreign trust becomes a grantor trust as soon as the donor becomes a U.S. person
- U.S. beneficiary: there is a presumed U.S. beneficiary unless
 - 1) No income or principal may be paid to or accumulated for the benefit of a U.S. person (other than a contingent interest that is so remote as to be negligible); and
 - 2) If the foreign trust terminates, no income or principal would be paid to or for the benefit of a U.S. person.
 - Annual test
 - If a U.S. person uses trust property without paying fair market rent, there is a U.S. beneficiary

Exceptions to Foreign Grantor Trust Status for Trusts with U.S. Grantor: § 679

- Does not apply to foreign pensions or deferred compensation trusts
- Does not apply to foreign charitable trusts
- Does not apply to foreign trusts established for a fair market transfer, but if a note is involved, see Reg. § 1.679-4(d)(1)

Foreign Grantor Trusts with Non-U.S. Grantor § 672(f)

- The grantor trust rules for non-U.S. grantors are specific and very limited
- For a non-U.S. person to establish a grantor trust under U.S. law, the trust must meet one of the following qualifications
 - Revocable by the non-U.S. donor, alone or with the approval of a related or subordinate party
 - For the benefit of the non-U.S. donor and the non-U.S. donor's spouse, exclusively, during the non-U.S. donor's lifetime
 - Compensatory trust: distributions are taxable to the non-U.S. donor as compensation for personal services
 - Grandfathered trust: qualified as a foreign grantor trust on 9/19/1995

Foreign Nongrantor Trusts

- Foreign trusts that do not qualify as grantor trusts will be foreign nongrantor trusts
- Many unique income tax rules apply:
 - If a U.S. person contributes property, the § 684 built-in gains tax will apply
 - Generally, the trust will be taxed by the U.S. like a non-resident, non-citizen
 - All distributions to U.S. persons will be subject to expanded and unique income tax rules

Contributions from U.S. Persons to Foreign Nongrantor Trusts: § 684

- Unless an exception applies, any contribution from a U.S. person to a nongrantor trust will be taxed as a deemed sale, so that all built-in gains will be realized
- Exceptions:
 - Does not apply so long as the foreign trust is a grantor trust for tax purposes
 - Does not apply to transfers into foreign trusts at death, as long as the trust property is entitled to a stepped up basis under § 1014. But watch out for foreign insurance trusts
 - Transfers to foreign charitable trusts
 - Transfers to unrelated foreign trusts for fair market value

U.S. Income Taxation of Foreign Nongrantor Trusts

- Non-resident, non-citizen rules apply, and are subject to modification by treaty:
 - No U.S. income tax on foreign-source income
 - No U.S. income tax on U.S.-source capital gains, except gains from the sale of U.S. real estate, which are subject to FIRPTA
 - 30% U.S. withholding tax on fixed, determinable, annual, or periodical income (FDAP), including interest, dividends, and rent
 - Regular U.S. income taxation rules apply to income from a U.S. trade or business

U.S. Taxation of Distributions to U.S. Persons from Foreign Nongrantor Trusts

- Unique U.S. income tax rules will apply to all distributions to U.S. beneficiaries
 - Capital gains will be treated as DNI, but if they are not distributed in the year they are realized, then they lose their character as capital gains and become ordinary income
 - Foreign-source income will be included in DNI
 - Any loan to a U.S. donor, U.S. beneficiary, or any person related to the U.S. donor or beneficiary, is treated as a distribution, unless it is commercially reasonable and the borrower agrees to certain requirements provided in Notice 97-34
 - If a beneficiary uses trust property after March 18, 2010 without paying fair market rent, this will be a “deemed distribution” and the beneficiary will be taxed on the fair market value of the use of the property. § 643(i)
- The “throwback tax” will apply

“Throwback Tax” §§ 665-668

- Designed to discourage accumulation of income and capital gains in foreign trusts
- If the trust does not distribute all of its income and realized capital gains every year, then it will have undistributed net income (UNI)
- With limited exceptions, any distribution to a U.S. beneficiary in excess of the trust’s income will carry out UNI
- The oldest UNI will be carried out first, and penalties and punitive interest will apply from the year in which the UNI accumulated to the year of distribution
- The U.S. tax, interest, and penalties cannot exceed 100% of the distribution of principal

Questions?

Thank you!

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