SELECTED SUBCHAPTER J SUBJECTS

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SELECTED SUBCHAPTER J SUBJECTS

I. Introduction to Subchapter J

A. Overview.

1. **Subchapter J in the Internal Revenue Code.** Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986, as amended (the "Code")[1] comprises of Code §§641-692 ("Subchapter J").

> Title 26 – Internal Revenue Code: Subtitle A – Income Taxes
>
> Chapter 1 – Normal Taxes and Surtaxes
>
> **Subchapter J – Estates, Trusts, Beneficiaries, and Decedents**
>
> Part I – Estates, Trusts, and Beneficiaries (Code §§641 to 685)
>
> Subpart A **-** General Rules for Taxation of Estates and Trusts (Code §§ 641 to 646)
>
> Subpart B **-** Trusts Which Distribute Current Income Only (Code §§ 651 to 652)
>
> Subpart C **-** Estates and Trusts Which May Accumulate Income or Which Distribute Corpus (Code §§ 661 to 664)
>
> Subpart D **-** Treatment of Excess Distributions by Trusts (Code §§ 665 to 669)
>
> Subpart E **-** Grantors and Others Treated as Substantial Owners (Code §§ 671 to 679)
>
> Subpart F **-** Miscellaneous (Code §§ 681 to 685)
>
> Part II – Income in Respect of Decedents (Code §§691 to 692)

2. **Allocation of tax burden among beneficiaries.**

   a. **Congressional purpose.** The legislative objective of Subchapter J is to allocate the tax burden among the persons benefiting from income from an estate or trust.

   b. **Challenges include:**

      (1) A person enjoying the benefit of income from an estate or trust may not receive current distributions.

      (2) A trust divides beneficial interests on a temporal basis, with both current and future beneficiaries. Relatedly, there may be multiple trust beneficiaries in a class of beneficiaries and the identity of a future beneficiary may be unknown or such beneficiaries may have only a contingent interest.

[1] References to "Code §" are to sections of the Internal Revenue Code. References to "Treas. Reg. §" are to sections of the United States Treasury Regulations promulgated under the Code. References to "parts", "sections", "subsections" and "paragraphs" are to portions of this outline.

3. **Separating gifts from income earned on gifts**.

a. **General definition of income.** Code §61(a) provides that **"**[e]xcept as otherwise provided in [Subtitle A – Income Taxes], gross income means all income from whatever source derived, including (but not limited to) the following items:... (14) Income from an interest in an estate or trust."

b. **Gift or bequest itself is not gross income.** Code §102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise or inheritance.

c. **Income on gift or bequest is gross income.** Code §102(b) provides that Code §102(a) is not applicable ***with respect to income*** from property acquired by gift, bequest, devise or inheritance.

4. **Origins of Subchapter J**.

a. ***Irwin v. Gavit****,* 268 U.S. 161 (1925). *Irwin v. Gavit,* a landmark decision under pre-1942 law (involving rules similar to Code §102), concerned a trust created under a Will, the terms of which provided that income should be used for the education and support of the decedent's granddaughter and one-half of the unused income was to be paid in quarterly installments to the granddaughter's father (decedent's son-in-law). The IRS taxed the granddaughter's father on the distributions of income to him under the testamentary trust. The father filed suit seeking a refund of these taxes, claiming that he should not be subject to tax because he received a "bequest" of income from the decedent. The court held that that the income from the testamentary trust was taxable income to the father and not a gift or bequest under pre-1942 law.

b. **Congressional response.** After *Irwin v. Gavit*, Congress enacted Code §102(b)(2), which provides that Code §102(a) does not exclude from gross income the amount of such income where the gift, bequest, devise, or inheritance is of income from property.

5. **Types of trusts under Subchapter J.** Subchapter J divides trusts into categories.

a. **Grantor v. non-grantor trusts.** First, a trust may be categorized in one of two ways:

(1) grantor trusts; and

(2) non-grantor trusts.

(3) Note that a trust may be deemed partially a grantor trust, with the balance treated as either a simple or complex trust.

b. **Division of non-grantor trusts.** Second, non-grantor trusts further are categorized as follows:

(1) simple trusts;

(2) complex trusts (and estates); and

(3) charitable remainder trusts.

B. **The hybrid entity/conduit system.**

1. **Purpose of the hybrid entity/conduit system.** Since dollars are fungible, a system is required to distinguish Code §102(b) income from Code §102(a) principal when a distribution is made from an estate or a non-grantor trust. This system further provides for the allocation of a single tax between the estate or non-grantor trust and the beneficiaries, with further allocation rules among beneficiaries.

2. **Subchapter J characteristics similar to entity approach.** The tax structure under Subchapter J begins as though the estate or non-grantor trust is taxed as a separate entity.

a. Code §641(a) provides "[t]he tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust...."

b. Code §641(b) provides "[t]axable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in [Part 1 of Subchapter J, Code §§641-685]."

3. **Subchapter J characteristics similar to conduit approach.** Thereafter, Subchapter J allows for a special deduction for amounts paid to beneficiaries and corresponding inclusion for beneficiaries.

a. An estate or non-grantor trust is entitled to a deduction for distributed income, known as a distribution deduction, under Code §§651 and 661.

b. The beneficiary includes any income received or required to be distributed from an estate or non-grantor trust in his or her income under Code §§652 and 662.

4. **General concepts for calculating taxable income of an estate or non-grantor trust.** First, compute the taxable income as though the estate or non-grantor trust is an individual. Second, modify the calculations based on Subchapter J. Specifically, the calculation involves the following steps:

a. **Gross income.** Compute gross income of an estate or non-grantor trust. Common items of gross income for an estate or trust include, for example, interest, dividends, rents, royalties, business profits and gains from the sale of real property.

b. **Deductions.** Reduce such gross income by allowable deductions to determine the net taxable income. The step includes determining the above-the-line deductions, which are taken into account in order to compute adjusted gross income, and below-the-line deductions, such as itemized deductions and the personal exemption. Additional deductions for estates and trusts, discussed below, include the distribution deduction (Code §§651 and 661) and the (charitable contribution deduction (Code §642(c)).

c. **Tax rate.** Apply the tax rate to net taxable income to determine the tax liability.

d. **Credits.** Reduce the tax liability by any allowable credits.

C. **Imposition of tax on the income of estates and non-grantor trusts.**

1. **Tax on trusts and estates.** Code §1(e) as modified by Code §1(j) through 2025, imposes a tax "on the taxable income of – (1) every estate, and (2) every trust, taxable under this subsection a tax determined in accordance with the following table:

If taxable income is:	**The tax is:**
Not over $2,550	10% of taxable income.
Over $2,250 but not over $9,150	$255, plus 24% of the excess over $2,550.
Over $9,150 but not over $12,500	$1,839, plus 35% of the excess over $9,150.
Over $12,500	$3,011.50, plus 37% of the excess over $12,500."

2. **Inflation adjustment**. Code §1(f) provides for an inflation adjustment for the table set forth in Code §1(e). For 2022, the threshold for the highest bracket of 37% is met if the estate or non-grantor trust has over $13,450 of taxable income.

3. **History**. The trust tax rates were compressed under The Tax Reform Act of 1986 in order to reduce the incentives for splitting income among taxpayers to achieve lower rates.

D. **Distributable net income ("DNI").**

1. **DNI**. The extent to which a distribution from an estate or non-grantor trust carries out gross income to a beneficiary is based on DNI and not the state law definition of income. Without the concept of DNI, there would be a variety of definitions of income depending on applicable state law.

2. **Quantitative element**. DNI serves the following quantitative functions, helping to determine how much of the income is taxed at the estate or non-grantor trust level and how much of the income is taxed to the beneficiaries: (A) DNI limits the amount that a trust or estate may deduct due to distributions, (B) DNI limits the amount on which beneficiaries will be taxed and (C) DNI determines the allocation of distributed income among beneficiaries. Treas. Reg. §1.643(a)-0.

3. **Qualitative element**. DNI determines the character of income items taxed to the estate or non-grantor trust and beneficiaries. DNI passes through to the beneficiaries the character of income received by the estate or non-grantor trust and the benefit of some of the deductions incurred by the estate or trust (such as trustee commissions).

4. **Practice note**. DNI is usually less than fiduciary accounting income ("FAI"), which is discussed below, because expenses allocable to principal (which do not reduce FAI) may reduce DNI. As an example, the portion of trustee commissions allocable to principal constitutes an expense which reduces DNI (but not FAI). Therefore, over time, the beneficiaries receiving distributions are receiving a tax benefit in the form of reduced DNI. Note that the DNI rules developed before the compressed trust income tax rate brackets when taxpayers were shifting assets to trusts so they would be subject to a lower income tax rate.

5. **Basic computational rules (Code §643(a))**. DNI reflects the taxable income of the estate or non-grantor trust with certain modifications. Code §643(a).

   a. **Determine taxable income.**

   b. **Apply modifications.**

      (1) **No distribution deduction.** No distribution deduction under Code §§651 or 661. Code §643(a)(1); Treas. Reg. §1.643(a)-1.

      (2) **No personal exemption.** No personal exemption deduction under Code §642(b). Code §643(a)(2); Treas. Reg. §1.643(a)-2.

      (3) **Generally exclude capital gains.** Exclude certain capital gains and losses. Code §643(a)(3). The general rule is that capital gains are excluded from DNI but there are exceptions. *Id.;* Treas. Reg. §1.643(a)-3.

         (a) **Exceptions.** The following exceptions will apply (*i.e.*, capital gains will be included in DNI) if the allocations of capital gains are made "pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. §1.643(a)-3(b).

            i. **Capital gains allocated to FAI.** Capital gains will be included in DNI if they are allocated to FAI. Treas. Reg. §1.643(a)-3(b)(1).

               (A) **Unitrust.** If income under a state statute is defined as a unitrust amount, a discretionary power to allocate gains to income also must be exercised consistently and the amount so allocated to income may not be

greater than the excess of the unitrust amount over the amount of DNI determined without regard to Treas. Reg. §1.643(a)-3(b). *See Id.*

ii. **Certain capital gains allocated to principal.** Capital gains will be included in DNI if they are allocated to principal and "paid, credited or required to be distributed to any beneficiary during the taxable year." Code §643(a)(3). The Regulations further divide this category.

(A) Capital gains allocated to principal but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary will be included in DNI. Treas. Reg. §1.643(a)-3(b)(2). Once an approach is selected, it must be followed. In other words, if the fiduciary determines to consistently treat capital gains on its books, records, and tax return as part of a distribution to a beneficiary, then all capital gains thereafter (whether or not distributed) will be included in DNI. *See* Acker, 852-4th T.M., *Income Taxation of Trusts and Estates* (hereinafter "Acker BNA") at A-84.

(B) Capital gains allocated to principal but (i) actually distributed to the beneficiary or (ii) utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary will be included in DNI. Treas. Reg. §1.643(a)-3(b)(3).

iii. **Capital gains allocated to principal and for charitable purposes under Code §642(c).** Capital gains will be included in DNI if they are allocated to principal and "paid, permanently set aside, or to be used for [charitable] purposes specified in §642(c)."

(b) **Capital losses.** In general, capital losses do not reduce DNI unless capital gains are included in DNI. If capital gains are included in DNI, then in certain cases capital loses will reduce those capital gains. For instance, the amount of capital gains allocated to FAI may be netted against the amount of capital losses so that the net gain is available for distribution to the beneficiary and in order to calculate DNI. *See* Acker BNA at A-81; Treas. Reg. §1.643(a)-3(d).

(4) **Exclude certain extraordinary dividends and taxable stock dividends**. With respect to simple trusts, exclude certain extraordinary dividends and taxable stock dividends. Code §643(a)(4); Treas. Reg. §1.643(a)-4.

(a) Specifically, the Code provides that DNI of a simple trust does not include "extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument <u>and</u> applicable local law." *Id.*

(b) Note that extraordinary dividends and taxable stock dividends always will be included in DNI for estates and complex trusts. *See* Acker BNA at A-86.

(5) **Add net tax-exempt income.** Add net tax-exempt income under Code §103. Code §643(a)(5); Treas. Reg. §1.643(a)-5.

c. **Purpose of DNI modifications.** The foregoing adjustments transform taxable income into a figure that is similar to FAI.

d. **Consequence of DNI modifications**. The items that are excluded from DNI (such as capital gains) are taxable to the estate or trust.

E. **Fiduciary accounting income.**

1. **State law concept.** FAI is a state law concept of income. FAI is similar to, but distinct from, DNI. State law (widely modeled after the Uniform Principal and Income Act ("UPIA") and, increasingly the Uniform Fiduciary Income and Principal Act, finalized in 2018 ("UFIPA") helps fiduciaries determine whether specific receipts are income or principal. In addition, such state law helps the fiduciary determine whether specific expenses should be charged against income or principal.

2. **Governing instrument.** Governing instruments often provide how to allocate receipts and expenditures between income and principal. Where the governing instrument is silent, a state statute (likely a modified version of UPIA or the UFIPA) will apply. If the terms of a governing instrument are fundamentally different than traditional principles of income and principal, such terms will not be respected for federal income tax purposes. Treas. Reg. §1.643(b)-1.

3. **Prudent investor rule shaped UPIA**. The Uniform Prudent Investor Act of 1994 ("UPI Act") (which has been enacted in more than forty states) changed trust investment law to accommodate modern portfolio theory and to set forth requirements for prudent investing which allowed trustees to invest for total return, as opposed to investing for a specific income level.

a. **Response to UPI Act.**

(1) **UPIA.** Since the total return approach under the UPI Act may not provide equitably for both income and principal beneficiaries, UPIA gives fiduciaries methods to reallocate resources for fair administration of trusts, largely through the power to adjust and through the definition of income as a unitrust amount.

(2) **DNI rules.** In turn, the DNI Regulations were amended in 2004 to respond to these changes. For instance, as described above (and below), capital gains may be included in DNI under certain circumstances. *See* Treas. Reg. §1.643(b)-1.

4. **Definition in the Code.** The Code defines FAI as follows: "[T]he amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income." Code §643(b).

5. **Significance.** Except with respect to Subpart E (dealing with grantor trusts), the term "income," unless preceded by the words "taxable," "distributable net," "undistributed net" or "gross," means FAI in the Code. Code §643(b).

a. **Practice note.** The definition of income is critical in applying the Subchapter J rules. For example, with respect to distributions to a U.S. beneficiary from a foreign trust, a U.S. beneficiary must pay an income tax on undistributed net income ("UNI"), which is known as the "throwback rules." *See* Code §§665-668. The tax on UNI, however, is payable only to the extent a distribution to a U.S. beneficiary exceeds income – meaning FAI under Code §643(b). Code §665(b) (final sentence). Therefore, even if a distribution to a U.S. beneficiary exceeds DNI (but not FAI), there is no accumulation distribution with respect to such distribution.

6. **Guidance in the Regulations.** The Regulations provide that "items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal." Treas. Reg. §1.643(b)-1. The Regulations also provide additional guidance with respect to certain allocations that will be respected for federal income tax purposes as a reasonable apportionment, which are listed below.

   a. **Unitrusts.** Allocations of receipts between income and principal under local law will be respected if local law provides for reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. Treas. Reg. §1.643(b)-1. A state statute providing that income is a unitrust amount no less than 3% and no more than 5% of the fair market value of the trust is a reasonable apportionment of the total return of the trust. *Id.* For an example of a state unitrust statute, *see* New York Estates, Powers and Trusts Law §11-2.4.

   b. **Power to adjust.** Under UPIA, a trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, and the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income. UPIA §104(a). In addition, "The court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by [UPIA] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power." UPIA §105(a). The Regulations allow a trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries. Treas. Reg. §1.643(b)-1 ("A state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust").

   c. **An allocation of gains to income from the sale of trust assets under certain circumstances.** "[A]n allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either <u>pursuant to the terms of the governing instrument *and* applicable local law</u>, or <u>pursuant to a reasonable and impartial exercise of a discretionary power granted</u> to the fiduciary by applicable <u>local law</u> <u>*or*</u> by the <u>governing instrument</u>, if not prohibited by applicable local law." Treas. Reg. §1.643(b)-1.

F. **Simple trusts.**

1. **Three requirements to qualify as a simple trust**. A non-grantor trust is a simple trust if it meets three requirements:

   a. **Must be required to distribute all FAI to beneficiaries currently in the trust agreement.** The trust is required, by local law or the terms of the trust instrument, to distribute all of its income (FAI) to the beneficiaries currently.

   b. **No charitable contributions.** The trust cannot make, in the current year, any charitable contributions, which are deductible under Code §642(c).

   c. **No distributions in excess of current income.** The trust cannot make, in the current year, any distribution in excess of its current income.

2. **Status of trust can change year-to-year**. Notably, a trust can be a simple trust in one year and a complex trust in another year.

G. **Complex trusts.**

1. **Qualifying as a complex trust**. All non-grantor trusts that are not simple trusts or charitable remainder trusts are complex trusts.

2. **Examples of complex trusts**. Complex trusts include:

   a. A trust in which less than all income (FAI) must be distributed currently (that is, a trust in which accumulation of income is permitted).

   b. A trust in which an amount other than income (FAI) is in fact distributed.

   c. A trust in which a distribution is made to charity.

H. **Charitable remainder trusts.**

1. **Code §664 governs charitable remainder trusts ("CRT").** Code §664(a) provides "[n]otwithstanding any other provision of [Subchapter J, Code §§641-692], the provisions of this section shall, in accordance with regulations prescribed by the Secretary, apply in the case of a charitable annuity trust and a charitable remainder trust."

   a. Code §664(d)(1) governs charitable remainder annuity trusts ("CRATs").

   b. Code §664(d)(2) governs charitable remainder unitrusts ("CRUTs").

2. **Character of distributions.** Distributions from a CRAT or CRUT are deemed to have the following characteristics in the hands of the recipient beneficiary:

   a. First, as amounts of income (other than capital gains) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;

   b. Second, as capital gain to the extent of the capital gain of the trust for the year and undistributed capital gain of the trust for the prior years;

   c. Third, as other income (that is, tax exempt income) to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and

   d. Fourth, as a distribution of corpus.

3. **Taxation of CRT**.

   a. **Generally tax-exempt.** In general, a CRT is tax-exempt. Code §664 provides that it shall "not be subject to any tax imposed by [Subtitle A- Income Taxes]."

   b. **Exception for unrelated business taxable income ("UBTI")**. Under Code §512, UBTI is subject to a 100% excise tax. UBTI generally refers to the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business (subject to certain modifications). Common sources of UBTI in CRTs include passthrough entities such as partnerships (hedge funds and PE funds) and debt-financed property (which generally is defined as property held to produce income and with respect to which there is an acquisition indebtedness at any time during the tax year under Code §514(b)(1)).

I. **Grantor trusts.**

1. **Subpart E in the Code**. Code §§671-679 comprise subpart E of part I of subchapter J of chapter 1 of the Code ("Subpart E" or "grantor trust rules").

2. **Overview of Subpart E.** The Subpart E rules provide that the grantor, or in some instances a third party, is treated as the owner of a portion (or all) of the income and principal for federal income tax purposes.

a. Code §672 contains certain key definitions.

b. Code §§673-677 (and Code §679 with respect to certain foreign trusts) set forth rules to determine whether the grantor is to be treated as the owner of a trust.

c. Code § 678 provides rules for treating a person other than the grantor as the owner of a trust.

d. Code §671 provides that, if the grantor or another person is treated as the owner of any portion of a trust, the grantor or such other person treated as the owner is to include those items of income, deductions and credits in determining his or her income.

e. The Subpart E rules may apply to a portion of a trust. Such portion may relate to FAI, principal, a fractional share of the trust or a specific asset held by the trust.

3. **History of Subpart E**.

a. **Original purpose of Subpart E**. The Subpart E rules originally were designed to prevent shifting of the grantor's income tax liability to one or more trusts taxed at a lower marginal rate in those cases in which the grantor retained substantial control over the transferred assets.

b. **History of Subpart E**. Most of the grantor trust provisions were made part of the Code in 1954. At that time, the income tax rates reached historically high levels (up to 91%). The legislation was broad and designed to sweep taxable income into the grantor's income, even if there were modest elements of control, in order to capture income at the highest marginal tax bracket.

c. **Tax Reform Act of 1986**. The Tax Reform Act of 1986 significantly reduced the income tax rates for individuals and trusts and compressed the income tax rates applicable to trusts.

(1) Thereafter, attribution of trust income to the grantor no longer was punitive, at least at the federal level, since trusts were usually taxed at the highest rates regardless (if a trust had taxable income over $7,500).

(2) As income tax shifting became less of an issue, tax advisors began to focus on the grantor trust rules as a wealth transfer device.

4. **Wealth transfer planning under Subpart E**.

a. **Grantor trust rules and transfer tax rules not aligned.** The grantor trust rules for income tax and the transfer tax rules are not aligned.

b. **Intentionally defective grantor trust.** It is possible to structure a trust whose grantor is treated as the owner of the underlying trust property for income tax purposes; yet, the grantor's transfers to the very same trust may be complete for gift tax purposes, and the trust property may be excluded from the grantor's gross estate. This type of trust commonly is referred to as an "intentionally defective grantor trust." The common reference to "intentionally defective" is a holdover from a time when income tax grantor trust status was considered adverse.

c. **Considerations in planning:**

(1) Select the type of provision that triggers grantor trust status for income tax purposes.

(2) Do not run afoul of estate tax planning.

J. **Income in Respect of Decedents ("IRD") (Code §§691 to 692).**

1. **IRD in general**. IRD generally refers to amounts owed to a decedent at the time of his or her death and that would have been included in the decedent's gross income had the decedent lived to collect such amounts. A common example of IRD includes retirement plan distributions (other than a Roth IRA). The purpose of the IRD system is to eliminate the impact of death on the application of the income tax where there is no policy reason for income tax forgiveness. Notably, Code §691(c) allows an income tax deduction for the estate tax attributable to IRD to minimize the disparity arising because of first the estate tax and then the income tax being imposed against the item (rather than the imposition of the income tax first and then the estate tax).

II. **Basic Fiduciary Income Tax Rules**

A. **Determining the taxable income for trusts and estates.**

1. **First, determine the taxable income of an individual.** "The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part." Code §641(b).

a. **Taxable income in general.** In general, taxable income means gross income minus deductions. Code §63(a).

b. **Taxable income for non-itemizer.** For taxable years from the present through 2025, the taxable income for an individual who does not itemize deductions means adjusted gross income minus the (1) the standard deduction, (2) the so-called "pass through deduction" under Code §199A for certain qualified business income; and (3) the charitable deduction of Code §170(p) (charitable contributions of up to $300 or $600 in the case of a joint return). Code §63(b). Under Code 63(c)(7), the standard deduction for an unmarried individual, as adjusted for inflation under Rev Proc 2021-45, 2021-48 IRB, Sec. 3.15(1), is $12,950 ($25,900 for joint filers).

2. **Second, consider the standard deduction and personal exemption for trusts and estates**.

a. **Standard deduction.** "In the case of…an estate or trust….the standard deduction shall be zero." Code §63(c)(6).

b. **Personal exemption.** Instead, trusts and estates receive the following personal exemption deductions (which are not subject to an inflation adjustment). Code §642(b)(3).

(1) **Estates.** Estates are allowed a $600 personal exemption deduction. Code §642(b)(1).

(2) **Trusts required to distribute all income currently (e.g., simple trusts).** Trusts that are required to distribute all income currently are allowed a $300 personal exemption deduction. Code §642(b)(2); Treas. Reg. §1.642(b)-1(a $300 personal exemption applies where a trust is required to distribute all income currently and where it distributes amounts other than income in the taxable year).

(3) **Other trusts.** Other trusts (e.g., complex trusts) are allowed a $100 personal exemption deduction, subject to special rules for "qualified disability trusts." *Id.*

B. **Simple trust (Subpart B) – tax calculations.**

1. **Three requirements to qualify as a simple trust**. A non-grantor trust is a simple trust if it meets three requirements:

   a. **Must be required to distribute all FAI to beneficiaries currently in the trust agreement.** The trust is required, by local law or the terms of the trust instrument, to distribute all of its income (FAI) to the beneficiaries currently. Code §651(a)(1).

      (1) **Income used to discharge or satisfy a person's legal obligation**. The term "income required to be distributed currently" includes income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation as that term is used in Treas. Reg. §1.662(a)-4.

      (2) **Power to sprinkle mandatory income distributions.** It is immaterial, for purposes of determining whether all income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument (*i.e.*, where the trustee has discretion to sprinkle income among a class of beneficiaries or among named beneficiaries) provided that all income is required to be distributed currently. Treas. Reg. §1.651(a)-2(b).

   b. **No charitable contributions.** The trust cannot make, in the current year, any charitable contributions, which are deductible under Code §642(c). Code §651(a)(2).

   c. **No distributions in excess of current income.** The trust cannot make, in the current year, any distribution in excess of its current income. Code §651(a) ("This section shall not apply in any taxable year in which the trust <u>distributes amounts other than</u> amounts of <u>income</u> described in paragraph (1)"). A trustee is permitted to have the power to distribute principal under a trust instrument but the trustee cannot exercise such power in the current year for the trust to qualify as a simple trust.

2. **Status of trust can change year-to-year**. As noted above, a trust can be a simple trust in one year and a complex trust in another year.

3. **Distribution deduction for the trust (Code §651).** If a trust qualifies as a simple trust, a distribution deduction is allowed under Code §651(a). The deduction generally is equal to the lesser of FAI and DNI under Code §651(b). *See also* Treas. Reg. §1.651(b)-1. For this purpose, DNI does not include "items of income which are not included in the gross income of the trust and the deductions allocable thereto," meaning that DNI does not include net tax-exempt interest. Code §651(b).

4. **Income inclusion for the beneficiaries (Code §652(a)).** Income required to be distributed to the beneficiaries of a simple trust is included in gross income of beneficiaries under Code §652(a). Such income inclusion is limited to the lesser of FAI and DNI (reduced by net tax-exempt income), which is equal to the distribution deduction under Code §651. Code §652(a). If the amount of FAI required to be distributed exceeds the DNI of the trust, then each beneficiary includes in his gross income an amount equivalent to his proportionate share of such DNI. *Id.* ("If [FAI] such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries."); Treas. Reg. §1.652(a)-2.

5. **Timing of deduction and inclusion**. If income is required to be distributed to a beneficiary in the current tax year but no such distribution is made until the following year, the trust is entitled to a deduction in the current year. Code §651. Likewise, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not the income is distributed. Code §652(a); Treas. Reg. §1.652(a)-1.

6. **Character of income inclusion for the beneficiaries (Code §652(b)).** The character of the distributed income is the same in the hands of the beneficiary as it was in the hands of the trust. Code §652(b); Treas. Reg. §1.652(b)-1. The amounts which are required to be included in the beneficiary's gross income are treated as consisting of the same proportion of each class of items entering into DNI of the trust as the total of each class bears to such DNI of the trust unless (A) the terms of the trust specifically allocate different classes of income to different beneficiaries or (B) local law requires such an allocation. Treas. Reg. §1.652(b)-2.

7. **Specific allocations to determine character of income inclusion**. The character of a beneficiary's distribution is determined in accordance with the DNI rules *unless* "the terms of the trust specifically allocate different classes of income to different beneficiaries." Code §652(b). The Regulations provide that "[t]he terms of the trust are considered specifically to allocate different classes of income to different beneficiaries <u>only to the extent that the allocation is required in the trust instrument</u>, and only to the extent that it has an <u>economic effect independent of the income tax consequences of the allocation</u>." Treas. Reg. §1.652(b)-2(b).

    a. **Not a specific allocation.** A trustee's power to exercise discretion to allocate different classes of income to different beneficiaries is not a specific allocation under the terms of the trust instrument. *Id.* A trust provision directing the trustee to pay $x to A from income and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's amount is not a specific allocation under the terms of the trust instrument. *Id.*

    b. **Example of a specific allocation**. A trust provision directing the trustee to pay half of the class of income (such as dividends) to A, and the balance of the income to B, is a specific allocation under the terms of the trust instrument. *Id.*

    c. **Practice note**. In practice, specific allocations of certain trust investments to specified beneficiaries are unusual. In general, trusts attempt to provide for beneficiaries out of the trust assets more generally.

8. **Allocation of deductions**. Deductions, which are considered in determining DNI, must be allocated to the classes of income included in DNI. *See* Acker BNA at A-96. In general, for allocation purposes, there are two types of deductions – direct expenses and indirect expenses.

    a. **Direct expenses.** Deductible items directly attributable to one class of income will be allocated to such class of income. Treas. Reg. §1.652(b)-3(a). For instance, if a trust owns rental property, the expenses for repairs to that property would be allocated to the rental income as direct expenses. *Id.* If a direct expense exceeds the class of income to which it is attributable, then the excess is treated as an indirect expense (except, if the class of income was tax-exempt interest, then the excess does not reduce other income). Treas. Reg. §1.652(b)-3(d).

    b. **Indirect expenses**. A trustee may allocate indirect expenses to any class or classes of income (including capital gains); however, a portion must be allocated to tax-exempt income (which effectively disallows such portion of those expenses). Treas. Reg. §1.652(b)-3(b). As an example, if a trust has income of $30 (after direct expenses), consisting of $10 of dividends, $10 of tax-exempt interest and $10 of rents, and trustee commissions of $3, then $1 (1/3) of the trustee commission must be allocated to tax-exempt interest and the $2 balance can be allocated to rents and dividends as the trustees elect. *Id.* Indirect expenses include trustee commissions, a safe deposit box rental fee and state income and personal property taxes. Treas. Reg. §1.652(b)-3(c).

9. **Trust level taxation.** In sum, a simple trust only has taxable income when there is a variation between FAI and DNI or when a simple trust has capital gains. A simple trust is taxed on (A) ordinary income in excess of its FAI, (B) capital gains that are not included in DNI, (C) phantom income and (D) receipts from other trusts and estates that are principal for accounting purposes but income for tax purposes. If FAI is less than DNI, a simple trust will have taxable income because

the deduction permitted under Code 651 is limited to the lesser of FAI and DNI. Therefore, the distribution of FAI to a beneficiary will not carry out all of the DNI, leaving some DNI to be taxed by the trust. FAI will be less than DNI when charges against FAI are greater than deductions allowed for income tax purposes. On the other hand, FAI may exceed DNI when expenses are deductible for tax purposes but do not reduce FAI (such as trustee's commissions that are fully deductible for income tax purposes but only a portion of which is charged against FAI under state law).

C. **Complex trusts (Subpart C) – tax calculations.**

1. **Qualifying as a complex trust**. All non-grantor trusts that are not simple trusts or charitable remainder trusts are complex trusts.

2. **Examples of complex trusts**. Complex trusts include:

   a. A trust in which less than all income (FAI) must be distributed currently (that is, a trust in which accumulation of income is permitted).

   b. A trust in which an amount other than income (FAI) is in fact distributed.

   c. A trust in which a distribution is made to charity.

3. **Tier system for distribution deduction and income inclusion (Code §§661-662)**. Under the tier system, distributions are divided into two categories.

   a. **Tier one.** Income required to be distributed currently. This includes any amount required to be distributed that may be paid out of income or principal to the extent such amount is paid out of income for the year. Code §661(a)(1).

   b. **Tier two.** Any other amounts properly paid or credited or required to be distributed.

      (1) This includes discretionary distributions of income or principal and mandatory distributions of principal. Code §661(a)(2); Treas. Reg. §1.662(a)-3(b).

      (2) A beneficiary can be both a tier one and tier two beneficiary.

   c. **Distribution deduction.** In general, a complex trust is entitled to a distribution deduction for all amounts paid, credited or required to be distributed under both tiers to the extent of DNI (exclusive of net tax-exempt income). Specifically, the distribution deduction is subject to the following limitations: (i) the distribution deduction cannot exceed DNI, (ii) no deduction is allowed for net tax-exempt income, (iii) no deduction is allowed for specific gifts and bequests that fall under Code §663(a)(1) (see Section (II)(E)(1) below, discussing the rule that a distribution of a specific amount or specific property, payable in three or less installments, does not carry out DNI to the beneficiary), (iv) no deduction is allowed for amounts if Code §661 applied in a preceding taxable year under Code §663(a)(3) (denial of double deduction) and (v) no deduction is allowed for the right to receive future IRD. *See* Acker BNA at A-103.

   d. **Special rules for annuity payments.** There are special rules for annuity payments. In general, an annuity will be treated as income to the extent that there is an amount that is required to be distributed out of income or principal of a trust and the trust has FAI that is not paid, credited or required to be distributed to other beneficiaries, which is therefore available to pay the required annuity. *See* Code §§661(a)(1), 662(a)(1) and Treas. Reg. § 1.662(a)-2(c) ("an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to <u>other</u> beneficiaries for the taxable year").

e. **Effect of charitable deduction under the tier system**. First tier beneficiaries do not receive a benefit from the charitable deduction under Code §642(c). *See* Code §§662(a)(1), 662(b) (last sentence). The Regulations provide that "for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently [*i.e.*, first tier beneficiaries], the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently." Treas. Reg. §1.662(b)-2. As reflected in Example 1 of Treas. Reg. §1.662(b)-2, income required to be distributed is considered as distributed first to the individual beneficiaries and then to charities. *See* Treas. Reg. §1.662(b)-2 (Ex. 1); *see also* Acker BNA at A-115.

f. **Allocation of DNI to beneficiaries**.

(1) **Total distributions do not exceed DNI.** If the total distributions to beneficiaries do not exceed DNI, then the tiers are irrelevant. In such case, all distributions carry out DNI, each reflecting its proportionate share of the items of income and deductions in DNI (except to the extent of special allocations). Remaining DNI is taxed to the trust. *See* Acker BNA at A-113.

(2) **Total distributions exceed DNI**. If the total distributions exceed DNI, then the tiers are relevant.

(a) **First tier distributions do not exceed DNI.** If the first tier distributions do not exceed DNI, then:

i. **First tier.** Income required to be distributed currently to a beneficiary (whether or not distributed) will be included in the tier-one beneficiary's gross income based on the amount and character of DNI. *See* Treas. Reg. 1.662(a)-2(a).

ii. **Second tier.** Any remaining DNI is allocated to tier-two beneficiaries to whom deductible distributions are made on a pro rata basis. Any tier two distributions in excess of DNI are not taxed to the beneficiary. *See* Treas. Reg. 1.662(a)-3. As a consequence, two beneficiaries may receive exactly the same amount from a trust, but different tax consequences may result for each beneficiary. If there are no first tier distributions, second tier distributions are included in a beneficiary's gross income equal to the lesser of his or her proportionate share of DNI based on the percentage of second tier distributions that each beneficiary received or the value of his or her distribution. *See* Acker BNA at A-116.

(b) **First tier distributions exceed DNI.** If the first tier distributions exceed DNI, then:

i. **First tier.** If the amount of income that must be distributed currently exceeds DNI for the year, then each beneficiary will include only his or her pro rata share of DNI in gross income with respect to the distribution. A beneficiary's pro rata share of DNI is based on the percentage of income required to be distributed to such beneficiary. Code 662(a)(1). As such, the result would be similar to a simple trust except that the calculation of DNI differs. For instance, extraordinary dividends and taxable stock dividends are included in the DNI of a complex trust, even if allocated to principal. *See* Acker BNA at A-105.

ii. **Second tier.** Second tier distributions are not included in the beneficiary's gross income. *Id.*

g. **Character of inclusion.** DNI allocated to each beneficiary has the same character in the hands of the beneficiary as in the hands of the estate or trust. Items of income as well as items of deduction need to be allocated to each beneficiary in proportion to their respective make-up in DNI (except to the extent of special allocations). Provisions similar to Code §652(b) and the Regulations applicable to such section govern the character of inclusion for the beneficiary and specific allocations. *See* Code §662(b); Treas. Reg. §1.662(b)-1.

4. **Importance of classification of a trust as a simple trust versus a complex trust**.

a. **Purpose**. The distinct category of simple trusts was created in order to facilitate an easy calculation of income taxes for such trusts. It avoids working through the complicated tier system in relatively straight forward circumstances.

b. **In general.** The classification as a simple trust versus a complex trust can have economic consequences but this result is rare in reality.

c. **Personal exemption.** The amount of the personal exemption may change from $100 to $300 depending on whether income is required to be distributed currently.

d. **Timing of inclusion.** The classification may affect the timing of required inclusion by a beneficiary. For instance, if a trust is a simple trust, a distribution of principal is required to be made in the current year and the trustee distributes such principal late, then the beneficiary can include the amount of the principal distribution in the year of actual distribution (not year 1). Treas. Reg. §1.651(a)-3(b). However, if a trust is not classified as a simple trust, then it must include the late distribution of principal in year 1 when it was required to be distributed. Code §662(a)(2).

e. **65 day rule election**. A simple trust cannot make a 65 day election because any income distributed late will be included in year 1 regardless.

f. **Extraordinary dividends and taxable stock distributions.** Extraordinary dividends and taxable stock distributions only are excluded from DNI in a year that the trust is classified as a simple trust.

D. **Other deductions specific to trusts and estates.**

1. **Charitable deduction (Code §642(c))**.

a. **In general.** In general, Code §642(c) allows an estate or non-grantor trust, other than a simple trust, a charitable contribution deduction in lieu of the Code §170 charitable deduction for individuals. The charitable contribution deduction generally is allowed for any amount of gross income (not principal) which is paid pursuant to the terms of the governing instrument for a purpose specified in Code §170(c).

b. **Requirements of Code §642(c).** Under Code §642(c), in order for the charitable deduction to apply, an estate or non-grantor trust (other than a simple trust) must meet the following requirements:

(1) **Requirement 1 - Gross income.** Contribute an amount of gross income from the estate or non-grantor trust (other than a simple trust).

(a) **Tracing requirement.** The source of a charitable contribution must be from gross income that is taken into account in computing the taxable income of the estate or trust. As an example, a bequest to a charity will be deductible for estate tax purposes, but will not be deductible for income tax purposes because satisfaction of a bequest is a distribution of principal. *See* Rev. Rul. 2003-123 (no charitable income tax deduction was available for a trust contributing a conservation easement to charity because it was not paid from the trust's gross income). Tracing is required because the statute specifically requires the source of the contribution to be from gross income. *See e.g., Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972); Acker BNA at A-43 ("Tracing of charitable distributions is still required under Code §642(c)"); Section 12.04, Requirement That Source of Contribution Be From Gross Income, Fox: Charitable Giving: Taxation, Planning and Strategies (WG&L).

(b) **Definition of gross income.** Gross income, which means taxable income (and not FAI), includes the following items:

i. **IRD.** For purposes of Code §642(c), IRD is includible in gross income. Treas. Reg. §1.642(c)-3(a). In PLR 200221011, the IRS ruled that IRD items specifically allocated to a charity under a Will were entitled to a charitable set aside deduction where the estate was the beneficiary of an IRA.

(A) **Practice note**. For philanthropic clients, they should consider to use retirement accounts to make charitable bequests. In such case, the IRA beneficiary designation form should designate the charity directly (it is easier to bypass the estate entirely). In the event that the IRA beneficiary designation form does not designate charity but the individual provides for charity under his estate plan, the governing instrument should state that any items of IRD will be allocated to the charitable share.

ii. **Capital gains.** Capital gain recognized by an estate or trust is eligible for a charitable income tax deduction under Code §642(c). Rev. Rul. 78-24.

(c) **Payments from accumulated gross income.** A contribution made out of income accumulated in earlier years is deductible, but only if no deduction was allowed to the trust for any previous year for the amount currently contributed to charity. *Old Colony Trust Co. v. Comm'r*, 87 F.2d 131 (1st Cir. 1936); Treas. Reg. §1.642(c)-1(a)(1) (the charitable deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year but only if no deduction was allowed for any previous taxable year to the estate or trust).

i. **Practice note.** In order to avoid difficulty tracing accumulated income, if payments to charity are likely, separate accounts for accumulated income and principal should be maintained (rather than adding accumulated income each year to principal).

(2) **Requirement 2 - Code §170(c) purpose.** For a purpose specified in Code §170(c) (without regard for Code §170(c)(2)(A)).

(a) Under Code §170(c), the term "charitable contribution" means a contribution or gift to or for the use of (1) government entities exclusively for public purposes; (2) a corporation, trust or community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. Such entity need not have been created or organized in the U.S. or under U.S. law (*see* Code §170(c)(2)(A)); (3) certain war veterans' organizations; (4) fraternal societies; and (5) cemetery companies.

(3) **Requirement 3 - "Pursuant to" requirement.** "Pursuant to" the governing instrument of the estate or non-grantor trust.

(a) **In general.** Where a Will or trust specifically requires a payment of gross income to be made to charity, such payment is made pursuant to the terms of the governing instrument.

(b) **Discretionary payments to charity.** The U.S. Supreme Court held that a payment to a charity by a trust or estate will qualify for the charitable income tax deduction under Code §642(c) if the governing instrument specifically vests the trustee with the discretion to make a payment to charity. *See Old Colony Trust Co.*, 301 U.S. 379 (1937) (charitable use of trust assets must be authorized in the instrument but the trust instrument need not direct a charitable distribution).

i. **"Pursuant to" requirement satisfied.** A distribution of trust income to charity was made pursuant to the governing instrument (and was entitled to a charitable deduction under Code §642(c)) where the trust agreement gave the beneficiary an *inter vivos* limited power of appointment that could be exercised only in favor of charities and where the beneficiary exercised such power. PLR 200906008; *see also* PLR 201225004.

ii. **"Pursuant to" requirement not satisfied.** The "pursuant to" requirement is not satisfied if the governing instrument merely provides discretion to distribute to any beneficiary, including a charity, where the instrument does not specifically refer to a discretionary power to distribute to charity. *See Weir Foundation v. U.S.*, 362 F.2d 928 (SDNY), aff'd, 508 F.2d 894 (2d Cir. 1974) (An unrestricted general testamentary power of appointment for the surviving spouse in a testamentary trust did not evidence intent of the testator to benefit charity and the subsequent appointment by the spouse to charity was not entitled to a Code §642(c) deduction); *Brownstone v. U.S.*, 465 F.3d 525 (2d Cir. 2006) (following *Weir Foundation* and holding that the wife's exercise of the power of appointment in favor of charity under the husband's Will was not pursuant to the governing instrument – the husband's Will – because he did not express a sufficient charitable intent with respect to the trust principal).

(c) **Payments to charity by operation of law deemed to be made pursuant to terms of governing instrument**. In Rev. Rul. 78-24, the IRS ruled that, if a Will is silent, a payment of an item of gross income to charity will be considered to be made pursuant to the terms of the Will where, under local law, the charity is entitled to receive such item of gross income. In that case, the payment of income to the charitable remainder beneficiary of the estate was made pursuant to the terms of Will, which was silent regarding the distribution of gross income, where local law gave the residuary charitable beneficiary the right to income earned by the estate during the administration period. *Id; But see* PLR 8031024 (where a charity was entitled to a pecuniary bequest in a Will and local law permitted a bequest shortfall to be satisfied out of gross income earned by the estate during administration, the IRS ruled that the Code §642(c) deduction was not available because the payment was not made pursuant to the terms of the Will).

(d) **Pass-through charitable contributions.** If an estate or trust has no provision allowing distributions to charity but such estate or trust owns an interest in a partnership or an S corporation, which makes a charitable contribution out of its gross income, then a charitable deduction is permitted by the estate or trust under Code §642(c). *See* Rev. Rul. 2004-5.

(e) **Electing small business trust ("ESBT")**. An ESBT has an S portion, which consists of S corporation stock, and a non-S portion, which consists of all other trust assets besides S corporation stock. The ESBT's share of an S corporation's charitable contribution will be deemed to be paid pursuant to the terms of the ESBT's governing instrument. *See* Treas. Reg. §1.641(c)-1(d)(2)(ii).

(f) **Charitable payment arising from settlement of Will or trust contest.** A payment to charity from the gross income of an estate or trust under a settlement agreement resulting from a Will or trust contest is made pursuant to the terms of the governing instrument and entitled to a Code §642(c) deduction. *See* Rev. Rule 59-15. Note that the settlement agreement and payment to charity must result from a genuine dispute. *Id.*

c. **No percentage limitations on Code §642(c) deduction.** An individual's charitable deduction generally is limited to a percentage of the individual's contribution base (adjusted gross income). The charitable deduction allowed under Code §642(c) for estates and trusts does not contain any percentage limitations. However, a Code §642(c) charitable deduction may not be carried over to later years. Treas. Reg. 1.642(d)-1(b).

d. **Reduction of Code §642(c) deduction allocable to tax-exempt income.** The Code §642(c) deduction is not permitted for a distribution of an amount excluded from gross income, including tax-exempt income earned by the trust. *See* Treas. Reg. §1.642(c)-3(b)(1). In determining whether a distribution includes tax-exempt income, if the governing instrument specifically provides as to the source to which amounts are to be distributed to charity, such provision should control. Treas. Reg. §1.642(c)-3(b)(2). However, such provision controls for federal tax purposes only if the provision has economic effect independent of income tax consequences. Treas. Reg. §1.652(b)-2(b) (an allocation of tax-exempt income has economic effect where it affects the actual dollar amounts passing to beneficiaries). As an example, an allocation has economic effect where it provides that all tax-exempt income shall pass to non-charitable beneficiaries and all taxable income shall pass to charitable beneficiaries. Treas. Reg. §1.642(c)-3(b)(2)(Ex. 2). Absent a specific provision regarding the source of the charitable contribution, an amount to which Code §642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total each class bears to the total of all classes. Treas. Reg. §1.642(c)-3(b)(2); Treas. Reg. §1.643(a)-5.

e. **Reduction of Code §642(c) deduction to a trust (but not an estate) having income allocable to UBTI.** The Code §642(c) deduction is reduced by the amount of income of a trust which would constitute UBTI under Code §512 if the trust were a tax-exempt entity under Code §501(c)(3). *See* Code §681. Likewise, a trust instrument may specify the source of the charitable contribution if the specific allocations have independent economic effect; however, in the absence of such provision, the trust's charitable contribution is allocated to UBTI in the proportion which the trust's UBTI bears to the total income of the trust (determined without the deduction for personal exemption under Code §642(b), the charitable contribution deduction under Code §642(c) and the distribution deduction under Code §661(a)). *See* Treas. Reg. §1.681(a)-2(b),(c) (Ex. 3).

(1) **Exception - partial deduction allowed for UBTI for charitable trusts**. A partial deduction for UBTI is allowed by Code §512(b)(11), which provides that, "In the case of any trust described in section 511(b) [charitable trusts], the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business) and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution." This deduction, however, is subject to "the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income … (in lieu of with reference to adjusted gross income)." In addition, with respect to computing the deduction allowable for UBTI, "there shall be allowed a specific deduction of $1,000." Code §512(b)(12). *See* Treas. Reg. § 1.681(a)-2 (for an example calculation of the partial deduction).

f. **The Code §642(c) deduction for contributions of appreciated property is limited to cost basis.** The IRS has ruled that where an estate or trust makes a charitable contribution of appreciated property that was purchased with gross income, the estate or trust only may deduct its cost basis in the property. *See* CCA 201042023. By way of an example, if a trust purchases stock for $500 with gross income of the trust, the stock appreciates to $700 and the trustee later donates the stock, the charitable deduction is limited to $500, the trust's basis in the stock.

g. **Election to treat contributions as paid in preceding taxable year.** The executor or trustee may elect to deduct in one tax year charitable contributions that were actually made in the following tax year if the election is made not later than the time prescribed for filing the income tax return for the subsequent tax year (including extensions). Code §642(c)(1); Treas. Reg. §1.642(c)-1(b).

h. **Charitable contributions to foreign charities.** A charitable contribution by an estate or trust to a foreign charity qualifies for a deduction under Code §642(c). Treas. Reg. §1.642(c)-1(a)(2).

i. **The distribution deduction under Code §661 does not apply to a charitable contribution by an estate or trust.** Code §663(a)(2) provides that, if the estate or trust is entitled to a charitable contribution deduction for the amount paid, used or permanently set aside, a distribution deduction under Code §661 is not permitted. *See also* Treas. Reg. §1.633(a)-2.

j. **Set aside charitable deduction for estates and pre 1969 trusts (Code §642(c)(2)).**

(1) **Set aside deduction rule.** The charitable deduction for amounts permanently set aside only applies for estates and certain inter vivos trusts created one or before Oct. 9, 1969 or testamentary trusts under Wills executed on or before such date. Code §642(c)(2); *see also* Acker BNA at A-45. With respect to these trusts, such trusts may receive a deduction for gross income permanently set aside for charitable purposes, but then only for gross income earned on amounts transferred to the inter vivos trust before Oct. 9, 1969 or to a testamentary trust under a grandfathered Will. *Id.* Note that this restriction does not apply to estates. *Id.* However, estates have some time period restrictions after which no set aside deduction will be allowed. *See Estate of Berger v. Comm'r*, T.C. Memo 1990-554 (holding that an estate was not entitled to a charitable deduction for amounts permanently set aside for distribution to a residuary trust for charitable purposes because the estate administration was unduly prolonged).

(2) **History of set aside deduction**. In 1969, the law changed because, if all trusts were allowed set aside charitable deductions, charitable trusts could avoid the (then new) private foundation rules requiring 5% minimum annual distributions since it would be possible to avoid making annual distributions to charities but obtain an income tax deduction.

2. **Scope of estates' and nongrantor trusts' miscellaneous itemized deductions**.

a. **Background.**

(1) **In general.** Code §67(a) generally provides that a taxpayer can deduct miscellaneous itemized deductions only to the extent that such expenses exceed 2% of the taxpayer's adjusted gross income (the "2% floor"). Code §67(g) provides that no deductions under Code §67(a) will be allowed through the end of 2025. As described below, certain deductions of trusts and estates addressed in Code §67(e)(1) and Treasury Regulation §1.67-4 are not subject to the 2% floor. Notice 2018-61 clarifies that these deductions of trusts and estates will not be disallowed through the end of 2025. ("Therefore, the suspension of the deductibility of miscellaneous itemized deductions under section 67(a) does not affect the deductibility of payments described in section 67(e)(1).")

(2) **Definition of miscellaneous itemized deductions.** Miscellaneous itemized deductions are defined as all allowable deductions except for those listed under Code §67(b). Investment advisory fees are deductible under Code §212 but are not listed under Code §67(b), therefore, they are generally considered miscellaneous itemized deductions.

(3) **Calculating adjusted gross income.** Code §67(e)(1) provides that adjusted gross income for trusts and estates is computed in the same manner as for an individual except that costs paid in connection with the administration of an estate or trust, which would not have been incurred if the property were not held in such trust or estate, are allowable in determining adjusted gross income. In addition, Code §67(e)(2) also allows for the distribution deductions under Code §§651 and 661 when calculating the adjusted gross income for trusts and estates. Thus, the distribution deduction reduces the base against which the 2% floor applies.

(4) **History.** Before the *Knight* case and the IRS final regulations under Treas. Reg. §1.67-4, the scope of Code §67(e)(1) was unclear with regard to which miscellaneous itemized deductions, like investment advisory fees, paid in connection with the administration of an estate or trust would avoid the 2% floor.

(a) **Pre-*Knight* case Proposed Regulations.** In Proposed Regulations issued by the IRS in July of 2007, the IRS adopted the reasoning of the Second Circuit in *Knight v. Commissioner*, 467 F.3d 149 (2d Cir. 2006) and limited the Code §67(e)(1) exception to costs which were "unique" to a trust or estate (*i.e.,* costs that could not be incurred by an individual). Therefore, if a cost could be incurred by an individual, such cost was subject to the 2% floor.

(b) **Pre-*Knight* case Circuit Court split.** Before 2008, a circuit court split arose regarding whether investment advisory fees paid by a trust were considered miscellaneous itemized deductions subject to the 2% floor. The Sixth Circuit held that the 2% floor did not apply to such investment advisory fees, *see O'Neil Irrevocable Trust v. Commissioner,* 994 F.2d 302 (6th Cir. 1993), while other circuit courts, including the Fourth Circuit, the Federal Circuit, and the Second Circuit, disagreed, holding that the 2% floor applied to such fees. *See Scott v. U.S.,* 328 F.3d 132

(4th Cir. 2003); *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001); and *Knight v. Commissioner*, 467 F.3d 149 (2d Cir. 2006).

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

(1) **Facts.** In *Knight, supra,* the trustee of a testamentary trust, established in Connecticut in 1967, hired an investment advisory firm to provide advice with respect to investing the Trust's assets. The trustee had fully deducted the fees on its fiduciary income tax return for year 2000. The IRS found that the fees were miscellaneous itemized deductions subject to the 2% floor and assessed a deficiency.

(2) **Holding.** The U.S. Supreme Court rejected the IRS's narrow interpretation of Code §67(e)(1) in its 2007 proposed regulations (and the Second Circuit reasoning). The Court also rejected the trustee's test that an expense would not be subject to the 2% floor if the trustee had a fiduciary obligation to incur the expense as circular and pointed out that such a test would swallow the rule. Instead, the Court adopted the standard set forth by the Fourth and Federal Circuits, holding that estate and trust expenses should not be subject to the 2% floor if they are not "customarily or commonly incurred" by an individual. The Court held that investment advisory fees paid by a trust are generally deductible only to the extent that they exceed the 2% floor. The Court, however, further noted that additional investment fees could be fully deductible for expert advice provided where a trust had unusual investment objectives or if the trustee had to balance the interests of various beneficiaries. Since none of these special circumstances applied, the court held that the investment advisory fees incurred by the trust in *Knight* were subject to the 2% floor.

c. **Treas. Reg. §1.67-4 -- the 2011 Proposed Regulations and the 2014 Final Regulations.**

(1) **Proposed Regulations.** The IRS then issued Notice 2008-32 (as well as other later Notices) followed by proposed regulations in September of 2011 (REG-128224-06), which fell within the Supreme Court's holding in *Knight*.

(2) **Final Regulations.** The IRS issued final Treas. Reg. §1.67-4, effective for taxable years after December 31, 2014, which largely tracked the 2011 proposed regulations with some modifications and additions. In general, under Treas. Reg. §1.67-4, the 2% floor applies to a cost incurred by an estate or nongrantor trust if it is (A) included in the definition of miscellaneous itemized deduction and (B) "commonly or customarily would be incurred by a hypothetical individual holding the same property." Treas. Reg. §1.67-4(a). Whether a cost is commonly or customarily incurred by a hypothetical individual owning the same property depends on "the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service." Treas. Reg. §1.67-4(b). The Regulations specify that costs that are commonly or customarily incurred by individuals include, but are not limited to, "costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust" in addition to the items listed in paragraph (a) below. *Id.*

(a) **List of fiduciary expenses that generally will be subject to the 2% floor.** The final Regulations provide a non-exhaustive list of fiduciary expenses that generally will be subject to the 2% floor, provided that such cost listed below would be commonly or customarily incurred by a hypothetical individual owner of such property:

i. **Ownership costs.** Ownership costs are costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property, including partnership costs deemed to be passed through to and reportable by a partner, condo fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs. Treas. Reg. 1.67-4(b)(2).

ii. **Tax preparation fees.** Costs relating to the preparation of tax returns (including gift tax returns) other than those incurred for the preparation of estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedents' final income tax returns. Treas. Reg. 1.67-4(b)(3).

iii. **Investment advisory fees**. Fees for investment advice other than certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor. An incremental cost is defined as a "special, additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual or attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper." Treas. Reg. 1.67-4(b)(4).

iv. **Appraisal fees.** Appraisal fees other than those required to determine the fair market value of assets at decedent's date of death (or alternative valuation date), to determine value for the purposes of making distributions, or to properly prepare estate or trust tax returns or generation-skipping transfer tax returns. Treas. Reg. 1.67-4(b)(5).

(b) **List of fiduciary expenses not subject to the 2% floor.** The final Regulations also provide a non-exhaustive list of fiduciary expenses not subject to the 2% floor: (i) probate court fees, (ii) fiduciary bond premiums, (iii) fees for publishing notices legally required in the administration of a decedent's estate, (iv) costs of certified copies of a death certificate, and (v) costs of preparing fiduciary accountings. Treas. Reg. 1.67-4(b)(6).

(c) **Bundled fees.** A bundled fee is a "single fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's fee)" that includes costs, some of which are subject to the floor and others that are not subject to the floor. Treas. Reg. 1.67-4(c)(1). For instance, a trustee commission may include compensation for the trustee's investment services (subject to the floor) and administrative services (not subject to the floor). In general, an estate or trust must allocate a bundled fee between costs subject to the floor and other costs by a "reasonable method." Facts that may be considered to determine whether a method is reasonable include, but are not limited to, (1) the percentage of the value of the corpus subject to investment advice, (2) whether a third party advisor would have charged a comparable fee for similar advisory services, and (3) the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealing with beneficiaries and distribution decisions and other fiduciary functions. Treas. Reg. 1.67-4(c)(4).

i. **Exceptions.** If a bundled fee is not computed on an hourly basis, only the portion of that fee attributable to investment advice is subject to the 2% floor. Treas. Reg. 1.67-4(c)(2). Also, out of pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee. Treas. Reg. 1.67-4(c)(3).

E. **Other special income tax rules for trusts and estates.**

1. **Payable in less than three installments rule under Code §663(a)(1)**.

a. **General rule.** Code §663(a)(1) provides that "any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments" is not included as amounts falling within the distribution deduction under Code 661(a) and beneficiary inclusion under Code 662(a). *See also* Treas. Reg. 1.663(a)-1(b).

(1) **Example**. As an example, an outright bequest of $10 million to a child in a Will (payable in less than 3 installments) does not result in the distribution (or inclusion) of taxable income to such child. Rather, the residuary beneficiaries of the estate will pay the income tax. This rule most frequently affects estates.

(2) **Intestacy**. An amount distributed to a beneficiary as a result of intestate succession does not qualify under Code §663(a)(1) because distribution is not made pursuant to the terms of a governing instrument.

(3) **Basis**. If a gift is satisfied in kind, the basis of the gifted asset generally is the donor's basis or, in other words, carryover basis. Code §1015. If a bequest is satisfied in kind, the basis of the bequeathed asset generally is the fair market value of the assets at the time of the death of the decedent or, in other words, stepped-up basis. Code §1014.

(4) **Practice note.** It is prudent to include specific bequests of tangible personal property and residential property so that DNI is not carried out to the beneficiary of such property who might otherwise need to liquidate such property to pay for the income tax.

b. **Requirements under Code §663(a)(1).** To satisfy the requirements under Code §663(a)(1), a gift or bequest must be:

(1) **Properly paid under terms of instrument.** Properly paid or credited as a gift or bequest under the terms of the governing instrument.

(2) **Specific sum or property.** A payment of a specific sum or specific property.

(3) **Ascertainability.** Ascertainable at death or inception of the trust. *See* Treas. Reg. §1.663(a)-1(b).

(a) **Ascertainable.** Gifts or bequests that satisfy the ascertainability requirement include the following.

i. **Specific property.** Bequests of specific property.

ii. **Specific dollar amount.** Cash bequests of a specified dollar amount.

(A) Even if such bequest is capped at a percentage of the gross value of the estate, it is ascertainable. However, if such bequest is capped at a percentage of net value of the estate after expenses, it likely is not ascertainable (because the net amount is dependent on the payment of administrative expenses, which is not identifiable at the time of the decedent's death). Treas. Reg. §1.663(a)-1(b).

iii. **Other cash bequests.** Cash bequests equal to the value of certain property (such as an equalization clause) and cash bequests of a dollar amount at a certain age (even if subject to a condition).

iv. **Regs example.** "[B]equests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively." *See* Treas. Reg. §1.663(a)-1(b).

(b) **Not ascertainable.** Gifts or bequests that do not satisfy the ascertainability requirement include the following.

i. **Residue.** Gifts of the residue of an estate or shares of the residue of an estate (since the residue typically bears the burden of administration).

ii. **Share of inter vivos trust.** An irrevocable gift in trust of a fraction of the trust's principal, payable when the beneficiary attains a certain age.

iii. **Pecuniary marital or credit shelter formulas.** A bequest to a surviving spouse of a pecuniary amount equal to the smallest amount that can be funded with no estate tax is not ascertainable as of the decedent's death (because it depends on factors such as deductible administration expenses). Treas. Reg. §1.663(a)-1(b). Satisfying a pecuniary marital or credit shelter formula will result in *Kenan* gain if the bequest is funded with appreciated property. *See* discussion of *Kenan* gain below at Section (II)(E)(4)(a)(1).

iv. **Regs example.** "[A] bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's 'adjusted gross estate' is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it)." *See* Treas. Reg. §1.663(a)-1(b).

(4) **Not more than 3 installments**. Paid (under the terms of the governing instrument) in no more than three installments. *See* Treas. Reg. §1.663(a)-1(c).

(a) **Bright line Rule.** If not payable in more than 3 installments, then a gift or bequest is treated as a specific bequest. The governing instrument determines the number of installments (as opposed to the actual timing of the payments).

(b) **Example**. If a trust instrument provides for payments to a beneficiary of $10,000 at ages 25, 30, 35 and 40, each payment will carry out DNI to the beneficiary (since it is treated as an annuity).

(c) **Definition of installment.** All gifts or bequests, even of different property, payable at the same time count as one installment.

(5) **Not required to be paid from income (FAI).** "[A]n amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money." Code §663(a)(1).

2. **65 day rule under Code §663(b)**.

a. **General rule.** If a (complex) trust or estate makes a distribution within 65 days after the end of the prior year, the (complex) trust or estate can elect for such distribution to be treated as if it were paid in the prior year. Code §663(b).

(1) **Limitation on 65 day rule.** Although there is no limitation on the amount that may be subject to such election in the Code, since August 24, 1972, the Regulations include a limit on the election. The limit provides that the amount subject to the 65 day rule election cannot exceed *the greater of* FAI or DNI (reduced by any amounts paid, credited or required to be distributed in the preceding year other than amounts treated as paid or credited in the preceding year by virtue of the 65-day rule election). *See* Treas. Reg. §1.663(b)-1(a)(2). In addition, a distribution deduction for a trust or estate in a given year is limited to DNI (so, if a 65 day election is made with respect to FAI where FAI is greater than DNI, the trust or estate would pay the income tax on such distribution). Code §661. Note that this Regulation has never been challenged by a taxpayer but it appears that the Code does not authorize such limitation. *See* Acker BNA at A-113 ("The limitation imposed by the regulations appears to be an improper extension of the statute and not merely an interpretation of its language. There seems to be no rationale for this limitation, but because the regulation dates from 1956, a successful challenge to it is unlikely").

(2) **Purpose of limitation.** The purpose of the limitation is to prevent beneficiaries from receiving tax free distributions in prior years where DNI was already exhausted. *See* Treas. Reg. §1.663(b)-1(a)(2)(Ex).

(3) **Application of 65 day rule.** The 65 day election is not available for a distribution of fiduciary accounting income that is required to be distributed since such amount always is treated as if it were paid in the year it was required to be paid even if it is not distributed until the following year. Therefore, the 65 day rule is inapplicable to simple trusts. However, if principal is required to be distributed in a given year but the payment is actually made the following year, the principal is not automatically deemed distributed in the prior year. Treas. Reg. 1.651(a)-3(b). In addition, with respect to discretionary distributions of income or principal, the year of payment generally will be the year of deduction and inclusion unless a 65 day election is made.

b. **Requirements under Code §663(b).** The 65 day rule will apply if the following requirements are satisfied:

(1) **Amount properly paid within 65 days of end of prior year.** An amount is properly paid or credited during the first 65 days of any taxable year of an estate or (complex) trust Code §663(b)(1).

(2) **Election.** The executor or trustee must elect to treat this payment as being paid or credited in the preceding taxable year. Code §663(b)(2). Note that the executor or trustee need not make the election for all distributions made in the first 65 days but may designate particular distributions. *See* Bittker & Lokken, Sec. 81.4.6, Sixty-Five-Day Rule for Estates and Complex Trusts, Federal Taxation of Income, Estates, and Gifts (WG&L).

(3) **Limitation.** The amount elected shall not exceed (1) *the greater of* FAI or DNI for the preceding year, reduced by (2) any amounts paid, credited or required to be distributed in the preceding year other than amounts treated as paid or credited in the preceding year by virtue of the 65-day rule election. Treas. Reg. §1.663(b)-1(a)(2).

(4) **Time and Manner of Election**. Although any distributions must be made within the first 65 days after the end of the prior year, the Executor or Trustee has until October 2 to make the election. The Regulations require the election to be made on the trust return for the year which the election is made by the time prescribed to file the return (April 15) plus any extensions (trust returns are eligible for a 5 and ½ month extension, bringing the date to October 2). Treas. Reg. §1.663(b)-2(a)(1).

c. **Practice note.** If a beneficiary is in a lower tax bracket than the estate or trust, a fiduciary may wish to make a 65 day election in order to distribute more DNI to the beneficiary in a prior year so that a lower tax rate would apply (a higher threshold for the net investment income tax applies for individuals, so a fiduciary may make a distribution to a beneficiary to avoid this tax as well). Also, if there is a foreign beneficiary of a U.S. trust resident in a non-tax jurisdiction, a fiduciary may wish to make a 65 day election to the beneficiary in order to distribute all of the DNI each year to the beneficiary to avoid U.S. imposition of income tax. Additionally, a fiduciary could exercise his or her power to adjust and could distribute more FAI to the beneficiary (in excess of DNI) so that there would be a tax-free distribution to the beneficiary in the prior year.

3. **Separate share rule under Code §663(c)**.

a. **General rule.** Where a single trust has more than one beneficiary and the trust instrument provides for a separate share for each beneficiary, DNI is subdivided per share, so that the amount of gross income resulting from distributions to a beneficiary of a share is determined by the DNI allocated to such shares. *See* Code §663(c); Acker BNA at A-126. Also, the trust's distribution deduction is allocated per share, based on the distributions and DNI per share. *Id.* After the distribution deduction is computed per share, the total is the distribution deduction that applies to the entire trust. *Id.* The trust computes its taxable income for the entire trust by aggregating the taxable income of the shares. *Id.* The separate share rule is mandatory (not elective). Code §663(c).

(1) **Applies to estates as of 1997.** As of August 5, 1997, a second sentence was added to the separate share rule under Code §663(c) so that it applies to estates.

b. **Requirements under Code §663(c).** The separate share rule applies as follows.

(1) **Definition of separate shares of a trust.** Separate shares of a (complex) trust exist when beneficiaries have "substantially separate and independent shares" and distributions will be made in substantially the same manner as if separate trusts had been created. Treas. Reg. §1.663(c)-1(a).

(2) **Definition of separate shares of an estate.** Separate shares of an estate exist when "the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust" such that their economic interests are not affected by the economic interests

accruing to another separate beneficiary or class of beneficiaries. Treas. Reg. §1.663(c)-4(a).

(a) **Examples.** Examples of separate shares of an estate include fractional shares of the estate's residue, the elective share of a surviving spouse, a qualified revocable trust (defined in Code §645(b)(1)), any pecuniary formula bequest that is entitled to income and that shares in appreciation and depreciation, a pecuniary formula bequest that is not entitled to income or to share in appreciation and depreciation if it must be paid or credited in no more than three installments. *See* Treas. Reg. §1.663(c)-4(b). The same person may be a beneficiary of more than one separate share. *See* Treas. Reg. §1.663(c)-4(c). There may be multiple beneficiaries of a separate share. *Id.* A specific bequest under Code §663(a) is not considered a separate share since it does not carry out DNI. *See* Treas. Reg. §1.663(c)-4(a).

(3) **Not elective.** The separate share rule is not elective. Treas. Reg. §1.663(c)-1(d).

(4) **Only affects DNI.** The separate share rule only affects the computation of DNI (not filing obligations or the amount of the personal exemption). *See* Treas. Reg. §1.663(c)-1(b) ("The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of [DNI]").

c. **Rules for allocating DNI among shares.**

(1) **Method.** In calculating each share's DNI, the fiduciary must use "a reasonable and equitable method" to make the allocations, calculations and valuations. Treas. Reg. §1.663(c)-2(c).

(2) **General allocation rule.** "The amount of [DNI] for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its [DNI] based upon its portion of gross income that is includible in [DNI] and its portion of any applicable deductions or losses." Treas. Reg. §1.663(c)-2(b)(1).

(3) **Special allocation rules.**

(a) Gross income included in both DNI and FAI is allocated in accordance with the amount of FAI to which each share is entitled. Treas. Reg. §1.663(c)-2(b)(2).

(b) IRD is allocated among the separate shares that could potentially be funded with these amounts based on the relative value of each share that could potentially be funded with such amounts. Treas. Reg. §1.663(c)-2(b)(3).

(c) Phantom income (*e.g.,* gross income flowing through from a partnership) is allocated in the same proportion as FAI. Treas. Reg. §1.663(c)-2(b)(4).

(d) Deductions and losses applicable solely to one share are not available to the other shares. Treas. Reg. §1.663(c)-2(b)(5).

d. **Practice Note.** Partial distributions to fund one share but not another require recomputation of the shares. If an executor makes a partial distribution in satisfaction of a share of a residuary estate, the executor must recompute the fractions of the estate when making future distributions.

4. **Distributions in kind and Code §643(e)**.

a. **Realization of gain or loss on in kind distributions.** An estate or trust realizes gain or loss when an estate or trust satisfies a pecuniary bequest in kind. That is, if the fiduciary uses appreciated or depreciated property to satisfy an obligation to distribute money, income or other specific property, then gain or loss is realized by the estate or trust. However, if the fiduciary distributes the exact property that the beneficiary was entitled to receive, then there is no realization of gain or loss.

(1) ***Kenan v. Comm'r,*** 114 F.2d 217 (2d Cir. 1940). **Facts**. The trustee of a testamentary trust was required to pay $5 million to the decedent's niece at age 40. The trustee had the power (without the consent of the niece) to make the payment in cash or in kind. The trustee exercised this power to fund the bequest in part with appreciated securities. **Holding**. The court held that the distribution of securities was in satisfaction of the $5 million bequest, which constituted a "sale or other disposition" of the securities within the meaning of the predecessor statute of Code §1001. Therefore, the trust realized a gain at the time of the satisfaction of the bequest. *See also Suisman v. Eaton,* 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936).

(2) **Examples of in-kind distributions triggering gain or loss**. Examples of in-kind distributions triggering gain or loss include:

(a) **Specific dollar amount.** A distribution of property in kind in satisfaction of a bequest of a specific dollar amount. Treas. Reg. §1.661(a)-2(f). Note that gain may be recognized even if the pecuniary bequest does not meet the requirements of the Code §663(a)(1) exclusion and therefore carries out DNI.

(b) **Specific property other than that distributed.** A distribution of property in kind in satisfaction of a bequest of specific property other than that distributed. Treas. Reg. §1.661(a)-2(f).

(c) **Right to FAI.** A distribution of property in kind in satisfaction of a right to FAI that is required to be distributed currently. Treas. Reg. §1.661(a)-2(f); Treas. Reg. §1.651(a)-2(d).

(d) **Election.** Gain or loss is realized if the fiduciary makes the election to recognize gain or loss under Code §643(e). Treas. Reg. §1.661(a)-2(f).

(3) **Examples of in-kind distributions not automatically triggering gain or loss.** Examples of in-kind distributions not automatically triggering gain or loss include:

(a) A distribution of the exact property that is specifically bequeathed to a beneficiary.

(b) A distribution of property to a discretionary beneficiary.

(c) A pro rata distribution of each asset in kind to beneficiaries entitled to fractional shares of an estate or trust.

(d) A non-pro rata distribution of each asset in kind to beneficiaries entitled to fractional shares of an estate or trust, if the non-pro rata distributions are authorized under local law or the governing instrument.

(e) A bequest of $x worth (but not more than all) of y stock owned by the decedent at his death, the valuation to be made on the date of distribution, was not a right to receive a specific dollar amount or specific property. Rev. Rul. 72-295.

(4) **Transfers when liability exceeds basis**. If an estate or trust distributes property to a beneficiary which is subject to liabilities and the liabilities exceed the basis of the property, then the estate or trust may recognize gain pursuant to Code §1001 (irrespective of Code §643(e)). *See* Acker BNA at A-121; Zaritsky, Section 11.02, Transfers of Encumbered Property, Tax Planning for Wealth Transfers During Life (WG&L). Gain from the sale or "other disposition" of property is the amount realized (*i.e.*, the amount of liabilities from which the transferor is discharged) in excess of the adjusted basis of the property. *Id.; see* Code §1001.

(a) **Unclear result.** It is unclear whether there would be a gain event upon the distribution of encumbered property to a beneficiary from an estate or non-grantor trust based on the available guidance. Under Code §643(e), gain generally is not recognized on a distribution of appreciated property from a non-grantor trust unless an election is made. Therefore, under this general rule, arguably no gain should be recognized on a distribution of appreciated property to a beneficiary. On the other hand, in *Crane v. Comm'r,* 331 U.S. 1 (1947), the U.S. Supreme Court held that a taxpayer's amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged. Based on *Crane*, the IRS has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts. *See, e.g.*, Treas. Reg. § 1.1001-1(e) (example 5); Tech. Adv. Mem. 200010010 (March 13, 2000); Madorin v. Comm'r, 84 T.C. 667 (1985).

b. **Disallowance of loss.** With the exception of a distribution in kind in satisfaction of a pecuniary bequest from an estate, a trust or estate may not deduct losses from any sale or exchange (including a distribution in kind) with a beneficiary. *See* Code §267(a)(1) and §267(b).

(1) **Code §267(a)(1).** "No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b)."

(2) **Code §267(b).** "The persons referred to in subsection (A) are: (1) Members of a family, as defined in subsection (c)(4)... (4) A grantor and a fiduciary of any trust; (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) *A fiduciary of a trust and a beneficiary of such trust;* (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts... (13) *Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate*." (emphasis added).

(3) **Code §267(d)**. A beneficiary who later sells or exchanges property, with respect to which a loss deduction was disallowed under Code §267(a)(1), may offset the gain realized against the disallowed loss.

(a) **Practice note.** In essence, under Code §267, the loss is deferred and ultimately may be wasted if the beneficiary does not sell the in kind property for more than the transferor's basis. With respect to marketable securities, one solution includes that a fiduciary should consider whether to sell the marketable securities, which have declined in value, rather than distributing them to a beneficiary, so that the estate or trust may utilize the loss. The fiduciary then would distribute the cash proceeds to the beneficiary.

c. **Basis of property distributed in kind.** "The basis of any property received by a beneficiary in a distribution from an estate or trust shall be — (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) any gain or loss recognized to the estate or trust on the distribution." Code §643(e)(1).

(1) **Tacking of holding period.** The holding period of the estate or trust is tacked on to the beneficiary's holding period since the beneficiary takes the basis of the estate or trust. Code §1223(2).

(2) **Limit on amount of tier two distribution.** If appreciated property is distributed to a tier two beneficiary, the property's basis will limit the amount of DNI carried out to the tier two beneficiary in order to avoid double taxation of the unrealized gain. Code §643(e)(2).

d. **Election to recognize gain.** If an estate or trust makes a discretionary distribution of property other than cash to a tier two beneficiary, the estate or trust may elect to recognize gain or loss on the distribution instead of passing the unrealized gain or loss on to the beneficiary. Specifically, Code §643(e)(3) provides:

(1) "(A) In general. In the case of any distribution of property (other than cash) to which an election under this paragraph applies — (i) paragraph (2) shall not apply, (ii) gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and (iii) the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the fair market value of such property."

(2) "(B) Election. Any election under this paragraph shall apply to all distributions made by the estate or trust during a taxable year and shall be made on the return of such estate or trust for such taxable year."

(3) "Any such election, once made, may be revoked only with the consent of the Secretary."

(4) **Requirements.**

(a) If the Code §643(e)(3) election is made, the full amount of the gain must be recognized.

i. **Practice note.** As noted above, if a Code §643(e)(3) election will be made, property that has declined in value should be sold and not distributed to a beneficiary since a loss deduction will be disallowed under Code §267 and may not end up being used by the beneficiary.

(b) The Code §643(e)(3) election must be made for all distributions during the taxable year (other than distributions described in Code §663(a)). Code §643(e)(3)(B), (e)(4).

(c) A Code §643(e)(3) election can be made in one year and not in another year.

5. **Election to treat revocable trust as part of the estate under Code §645**.

a. **General rule.** The executor of the decedent's estate and the trustee of a qualified revocable trust are permitted to make an irrevocable election on Form 8855 to treat the trust as part of the estate for federal income tax purposes. Code §645; Treas. Reg. §1.645-1(e)(1)(irrevocability).

b. **Qualified Revocable Trust**. A qualified revocable trust ("QRT") is a trust that on the date of the decedent's death was treated as owned by the decedent under Code §676 (power to revoke) by reason of a power held by the decedent (determined without regard to Code §672(e)). Code §645(b)(1). A trust that was treated as owned by the decedent under Code §676 by reason of a power that was exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent's spouse is a QRT. A trust that was treated as owned by the decedent under Code §676 solely by reason of a power held by a nonadverse party or by reason of a power held by the decedent's spouse is not a QRT. Treas. Reg. §1.645-1(b)(1).

c. **Manner and timing of the election**. The election form must be filed not later than the time prescribed for filing the Form 1041 (determined with regard to extensions) for the first tax year of the estate. Code §645(c). An election is effective until two years after the decedent's date of death (if no estate tax return is required to be filed) or until six months after the final determination of estate tax liability (if an estate tax return is required to be filed). Code §645(b)(2).

d. **Ongoing filing**. The executor (if one has been appointed) files a single income tax return annually for both the electing trust and estate.

e. **Electing trust treated as separate share**. As mentioned above in Section (II)(E)(3)(b)(2)(a), the electing qualified revocable trust will be considered a separate share of the estate (and it may have separate shares within the trust). Treas. Reg. §1.663(c)-4(a).

f. **Benefits of Code §645 election – treating a revocable trust as an estate**. There are several benefits to making the Code §635 election, which include:

(1) **Fiscal year v. calendar year.** Trusts must use a calendar year as their taxable year under Code §644(a) while estates may select a fiscal year as their taxable year. Code §441; Treas. Reg. §1.441-1. Since the beneficiary will include gross income from the estate in the year in which the estate's or trust's fiscal year ends (Code §662(c)), it is possible to achieve tax deferral for beneficiaries.

(2) **Estimated taxes**. Estates are not required to pay estimated taxes for the first two years after the decedent's date of death. Code §6654(l)(2).

III. Grantor Trusts

A. Introduction to the grantor trust rules

1. **"Subpart E"**. The grantor trust rules are found in Code §§671–679. These sections comprise subpart E of part I of subchapter J of chapter 1 of the Code ("Subpart E").

a. **Basic operation of Subpart E**. There are two basic steps to the operation of the grantor trust rules. Step 1 operates through Code §§673 to 679, which identify persons as "owners" of "portions" of trusts with respect to which they have certain interests or powers. Step 2 operates through Code §671, which describes the consequences of being treated as an "owner."[2] Code §672 provides definitions and rules of application relevant to steps 1 and 2.

2. **Brief history of the grantor trust rules**

a. **Congressional purpose**. The present form of Subpart E was enacted by Congress in 1954. In enacting Subpart E, Congress intended to stem abuses resulting from income shifting by taxpayers in very high income tax brackets to beneficiaries in lower brackets in situations where high bracket taxpayers retained control or enjoyment of the property at issue. When Subpart E was enacted in 1954, incentives for high-bracket taxpayers to shift income to lower-bracket taxpayers were significant, as there were 24 individual federal income tax brackets at tax rates ranging from 20% to 91%.

b. **Foundational cases**. Several cases are foundational to current Subpart E.

(1) ***Helvering v Clifford***, 309 U.S. 331 (1940). *Helvering v. Clifford* concerned a taxpayer who funded a trust for the "exclusive benefit" of his wife but who retained "absolute discretion" to make distributions to his wife and extensive powers over the trust assets, including the power to vote the shares of stock transferred to the trust and the power to sell, exchange, mortgage or pledge trust assets. The trust was to terminate at the end of five years, at which time the accrued but unpaid income was to be paid to the taxpayer's wife, and the principal returned to taxpayer. The Supreme Court held that the trust's income was table to the taxpayer, as the facts demonstrated that the trust arrangement was "no more than a temporary reallocation of income within an intimate family group."[3]

(a) **"Clifford Regulations."** In response to *Helvering v. Clifford*, Treasury adopted the so-called "Clifford Regulations" in 1946.[4] The Clifford Regulations formed the basis for Congressional codification of the grantor trust rules in current Subpart E in 1954.

(2) ***Mallinckrodt v Nunan***, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945). *Mallincrkrodt v. Nunan* concerned a beneficiary of a trust who was entitled to receive as much of the otherwise undistributed income of a trust created by his father as the beneficiary requested. The 8th Circuit held that the beneficiary was to be treated as owner of the trust, whether or not he actually demanded income in a given year, in view of his "position of power over the disposition of trust income." *Mallinckrodt* has been codified in Code §678, described below.

3. **Estate Planning Benefits of Grantor Trust Status**. Much has been written about the benefits of grantor trust status for estate planning purposes.[5] The federal income tax law imposes on the deemed owner of a grantor trust an obligation to pay the income taxes attributable to the trust's assets. This obligation essentially permits the grantor of an "intentionally defective grantor trust" (*i.e.*, a trust that is a grantor trust for income tax purposes the trust fund of which will not be includible in the grantor's gross estate for estate tax purposes) to make a tax-free gift to the trust each year in an amount equal to the income tax liability attributable to the trust's assets. The payment of income taxes attributable to the trust's assets removes assets from grantor's estate and allows the trust's assets to grow unburdened by the payment of income taxes. Over time, with compounding, the

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[2] These steps are described in further detail in M. Carr Ferguson, James J. Freeland, and Mark L. Ascher, *Federal Income Taxation of Estates, Trusts & Beneficiaries*, Aspen Publishers (3rd. ed.), § 10.03.

[3] 309 U.S. at 336.

[4] *See* T.D. 5488, 1946-1 C.B. 19.

[5] *See e.g.,* Samuel A. Donaldson and M. Read Moore, The Expanded Role of (Defective) Grantor Trusts, 41st Annual Southern Federal Tax Institute (2006); Louis S. Harrison, All Along the Drafting Watchtower: Heuristics as to the Best Standard Provisions in Your Planning Documents, 43-14 Univ of Miami Law Center on Est Planning P 1407.

difference in the value of a trust that is a grantor trust and a trust that pays its own income taxes can be dramatic.

In addition, a grantor who is the deemed owner of a grantor trust can engage in transactions with the trust free of income tax consequences. For example, the grantor can sell an appreciated asset to the trust without triggering the recognition of any built-in gain.[6] Future appreciation in the asset that is sold to the trust can then be removed from the grantor's gross estate for estate tax purposes.

B. **Key Terms and Concepts**

The terms "grantor," "income," "portion," "adverse party," "nonadverse party," "related or subordinate party" and "spouse" have special meaning and significance for purposes of the grantor trust rules:

1. **"Grantor"**

a. **Basic definition of "grantor"**. The term "grantor" is not defined in the Code. Rather, "grantor" is defined in Treas. Reg. §1.671-2(e)(1), which provides that for purposes of part I of subchapter J of chapter 1 of the Code, *a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust*.

b. **Transfer to a trust by a partnership or corporation**. When a partnership or a corporation makes a transfer to a trust, the identity of the grantor turns on whether or not the transfer is for a business purpose of the partnership or corporation.

(1) **Gratuitous transfer is for a business purpose of the partnership or corporation**. If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.[7]

(2) **Gratuitous transfer is not for a business purpose of the partnership or corporation**. If a partnership or corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles, and the partners or shareholders will be treated as the grantors of the trust.[8]

c. **Transfer from one trust to another trust**. Under Treas. Reg. §1.671-2(e)(5), if a trust makes a gratuitous transfer of property to another trust (*e.g.*, pursuant to trust instrument or pursuant to a state "decanting statute", the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

(1) **Exception – GPOA**. Under Treas. Reg. §1.671-2(e)(5), if a person with a general power of appointment over a transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under Subpart E.

2. **"Income"**

a. **Generally, means taxable income**. The term "income" is used throughout Subpart E. When used in Subpart E, the term generally refers to taxable income. However, in certain instances, it is not clear whether "income" refers to taxable income or fiduciary accounting

[6] *See* Rev. Rul. 85-13, 1985-1 CB 184.
[7] *See* Treas. Reg. §1.671-2(e)(4).
[8] *See id.*

income. The lack of clarity stems in part from the different meaning given to "income" in Treas. Reg. §1.671-2(b) and Code §643(b).

(1) **Treas. Reg. § 1.671-2(b)**. Treas. Reg. §1.671-2(b) provides, "[W]hen it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in §1.643(b)-1) is meant, the phrase "ordinary income" is used."

(2) **Code §643(b)**. Code §643(b) provides that for purposes of subparts A through D of part I of Subchapter J, "the term 'income', when not preceded by the words 'taxable', 'distributable net', 'undistributed net', or 'gross', means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Accordingly, while Code §643(b) makes it clear that "income" refers to fiduciary accounting income, the definition of "income" in Code §643(b) appears to apply only to the Code provisions pertaining to simple and complex trusts (which are found in subparts A through D of part I of Subchapter J) and not to the Code provisions pertaining to grantor trusts (which are found in Subpart E).

3. **"Portion"**

a. **Background**. If any of Code §§ 673 to 679 identify a grantor (or another person) as owner of any "portion" of a trust, the items of income, deductions and credits attributable to that portion are taken into account in computing the grantor's taxable income.[9] Any portion of a trust not treated as owned by the grantor (or another person) will be taxable under subparts A through D of part I of Subchapter J.[10]

b. **"Portions" that a grantor (or other person) may be treated as owning**. The term "portion" is not defined in the Code or the Treasury Regulations. However, Treas. Reg. §1.671-3(a) identifies several ways in which a grantor (or other person) may be treated as owning a portion of a trust:

(1) The grantor (or other person) can be treated as owner of the entire trust.

(2) The grantor (or other person) can be treated as owner of all items attributable to specific trust assets.

(3) The grantor (or other person) can be treated as owner of a pecuniary share of all items of trust income and principal.

(4) The grantor (or other person) can be treated as owner of the principal portion of the trust.

(5) The grantor (or other person) can be treated as owner of a fractional share of all items of trust income and principal.

(6) The grantor (or other person) can be treated as owner of a pecuniary amount of all items of trust income and principal.

4. **"Adverse party"**

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[9] *See* Code §671; Treas. Reg. §1.671-3.
[10] *See* Treas. Reg. §1.671-3(a)(2).

a. **Definition**. Code §672(a) provides that for purposes of Subpart E, an "adverse party" is any person who has a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which such person possesses respecting the trust.

(1) **"Beneficial interest"**. In order for a party to be an adverse party, he or she must have a beneficial interest in a trust. A person having a ***general power of appointment*** over trust property is deemed to have a beneficial interest in the trust.[11] A trustee is not an adverse party merely because of his or her role as trustee. (A trustee does not have a beneficial interest in a trust.)

(2) **"Substantial"**. In order for a party to be an adverse party, his or her beneficial interest in a trust must be "substantial." Treas. Reg. §1.672(a)-1(a) states that a person's interest is "substantial" if its "value in relation to the total value of the property subject to the power is not insignificant." It is possible for more than one beneficiary of a trust to have a beneficial interest that is "substantial."

(3) **"Adversely affected"**. In order for a party to be an adverse party, his or her substantial beneficial interest in a trust must be adversely affected by the exercise or nonexercise of a power that he or she possesses with respect to the trust.

5. **"Nonadverse party"**. Code §672(b) provides that for purposes of Subpart E, a "nonadverse party" means any person who is not an adverse party.

6. **"Related or subordinate party"**

a. **Basic definition**. Code §672(c) provides that for purposes of Subpart E, the term "related or subordinate party" means any ***nonadverse*** party who is in any of the following relationships with the grantor:

(1) the grantor's spouse, but only if such spouse is "living with the grantor",

(2) the grantor's father or mother,

(3) the grantor's issue,

(4) the grantor's brother or sister

(5) an employee of the grantor,

(6) a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or

(7) a subordinate employee of a corporation of which the grantor is an executive

b. **Relationships excluded from basic definition**. Persons holding any of the following relationships with the grantor are not considered to be related or subordinate to the grantor: nieces, nephews, grandparents, spouses of children, spouses of grandchildren, partners, attorneys,[12] accountants and financial advisors. A director of a corporation is not an

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[11] *See* Code §672(a), Treas. Reg. §1.672(a)-(1)(a).

[12] *See*, *e.g.*, *Estate of Hilton W. Goodwyn*, TC Memo 1976-238, where lawyers serving as trustees allowed the grantor to make almost all decisions affecting a trust, including decisions about how much income was to be distributed to each beneficiary. The Tax Court concluded that the lawyer-trustees were not "related or subordinate" parties as to the grantor and held that the grantor was not a trustee even though he exercised control over fiduciary decisions. *But see Securities Exchange Commission v. Wyly*, 2014 WL 4792229 (S.D.N.Y. September 25, 2014).

employee by reason of his or her directorship, and therefore is not a related or subordinate party by reason of the directorship.[13]

c. "**Subservient to the grantor**". In certain cases, grantor trust status can turn on whether a "related or subordinate" party is "subservient to the grantor."[14] Code §672(e) provides that a related or subordinate party is *presumed to be subservient* to the grantor in respect of the exercise or nonexercise of the powers conferred on him or her, unless such party is shown not to be subservient by the *preponderance of the evidence*.

7. **"Spouse"**. Code § 672(e) provides that for purposes of Subpart E, a grantor is treated as holding any power or interest held by his spouse.

For transfer tax purposes, powers of and interests held by a spouse typically are not attributed to a grantor. Thus, by giving a spouse certain powers or interests, it is possible to cause a trust to be a grantor trust for income tax purposes without causing the trust fund to be includible in the grantor's estate. A trust that is a grantor trust for income tax purposes but is not included in the grantor's estate is sometimes referred to as an "intentionally defective grantor trust."

C. Powers and Interests That Cause a Trust to be a Grantor Trust

In drafting trust agreements, estate planners frequently seek to include powers and interests that will cause a trust to be a grantor trust for income tax purposes without subjecting the trust fund to inclusion in the grantor's gross estate for estate tax purposes. Planners often discuss which powers and interests are optimal to use for these purposes. [15]

This part C of the outline contains a discussion of the powers and interests that will cause a trust to be a grantor trust under Code §673 through $679. This part of the outline also notes which powers and interests can be drafted to have desirable transfer tax consequences and suggests how these powers may be drafted flexibly in order to preserve flexibility to change a trust's income tax status in the future.

1. **Code §673: Reversionary interests**.

a. **General rule – Code §673(a)**. Code §673(a) provides that a grantor will be treated as owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds the value of 5% of that portion.

(1) Rules for determining value of a reversionary interest.

(a) **Valuation tables of Treas. Reg. §20.2031-7 applied at inception of trust**. To determine whether a grantor has a greater than 5% reversionary interest, the value of the grantor's interest is valued at the creation of the trust using the tables in Treas. Reg. §20.2031-7.

i. **Rule of thumb**. Generally, if the reversionary interest of a will not be triggered for 32 or 33 years, the value of the reversionary interest will be less than 5% of the value of the trust fund, and the trust will not be a grantor trust under Code §673(a).

(b) **Assume maximum exercise of discretion in favor of grantor – Code §673(c)**. Code §673(c) provides that the value of a grantor's

[13] *See* Rev. Rul. 66-160 , 1966-1 CB 164

[14] *See e.g.*, Code §§ 672(f)(2), 674(c) and 675(c),

[15] *See e.g.*, Samuel A. Donaldson, Understanding Grantor Trusts, 40-2 Univ. of Miami Law Center on Est. Planning, 2007; Louis S. Harrison, All Along the Drafting Watchtower: Heuristics as to the Best Standard Provisions in Your Planning Documents, 43-14 Univ of Miami Law Center on Est Planning P 1407, 2010. Darin N. Digby, What Powers Can a Donor Retain Over Transferred Property?, Estate Planning Journal (WG&L), Aug/Sep 1997.

reversionary interest is determined by assuming the maximum exercise of discretion in favor of the grantor. In other words, if a trustee or other person holds a discretionary power to revest the trust fund in the grantor, the value of the grantor's reversionary interest must be determined by assuming that such person will exercise his or her power to the greatest extent possible in favor of the grantor. In order for the rule of Code §673(c) to be triggered, it seems that there needs to be a reversionary interest in the grantor prior to the application of Code §673(c).

(2) **Postponement of date specified for reversion – Code §673(d)**. A postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement.[16] However, a grantor will not be treated as the owner of any portion of a trust for any taxable year if he would not be so treated in the absence of any postponement.[17]

b. **Clifford regulations**. As described above on page 32 in response to *Helvering v. Clifford*, Treasury adopted the so-called "Clifford Regulations" in 1946. While the Clifford Regulations ultimately formed the basis for the codification of the grantor trust rules in current Subpart E, there are several ways in which the Clifford Regulations differ from current Subpart E. One of these relates to the circumstances under which a grantor's retention of a reversionary interest will cause the grantor to be taxed as the trust's owner. Under the Clifford Regulations, a grantor was treated a trust's owner if he or she retained a reversionary interest in the trust's income or corpus that would vest within 10 years of the inception of the trust. Certain regulations under Subpart E still refer to reversionary interests in excess of 10 years, concluding that such reversionary interests are insufficient to grantor trust status.[18] Rather than ignoring these regulations entirely, any reference to a 10-year reversionary interest should be read as a reference to a reversionary interest that will take effect far enough in the future that the value of such interest, at the inception of the trust, is worth less than 5% of the value of the trust fund.

c. **Exception for reversionary interest taking effect at death of minor lineal descendant – Code §673(b)**. Code §673(b) provides that a grantor will not be treated as owner of a trust under the general reversionary interest rule of Code §673(a) if the reversionary interest will take effect only upon the death of a beneficiary before the beneficiary reaches age 21 so long as the beneficiary (a) is a lineal descendant of the grantor and (b) holds all present interests in the trust.

(1) **"Present interest"**. For purposes of the Code §673(b) exception for reversionary interests taking effect at the death of a minor lineal descendant, the term "present interest" is defined the same way it is for purposes of Code §2503(c), which allows a gift tax exclusion for certain gifts to minors.[19]

d. **Transfer tax considerations**. It is not common to give a grantor a reversionary interest that will cause the trust to be a grantor trust under Code §673. This is because a reversionary interest that will trigger grantor trust status under Code §673 generally also will cause the trust fund to be includible in the grantor's gross estate under Code §2037.

2. **Code §674: Power to control beneficial enjoyment**.

a. **General rule – Code §674(a)**. Code §674(a) provides that a grantor shall be treated as the owner of any portion of a trust in respect of which beneficial enjoyment of the corpus or

[16] *See* Code §673(d); Treas. Reg. §1.673(d)-1.
[17] *See id.*
[18] *See, e.g.,* Treas. Reg. §1.673(a)-1(b); Treas. Reg. §1.673(b)-1(c) (example).
[19] *See* S Rept No. 99-313 (PL 99-514) p. 871.

the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(1) **"Power to dispose of beneficial enjoyment"**. Code §674(a) does not describe what is meant by a "power to dispose of the beneficial enjoyment" of trust corpus or income. Treas. Reg. §1.674(a)-1(a) provides that any power that can "affect the beneficial enjoyment of a portion of a trust" is a power to dispose of beneficial enjoyment, *regardless of the capacity in which the power is held*. A power held in a fiduciary capacity or a power of appointment held in a non-fiduciary capacity is a power to dispose of beneficial enjoyment.[20]

(2) **General rule of Code §674(a) is broad and sweeping**. The general rule of Code §674(a) and Treas. Reg. §1.674(a)-1(a) is broad and sweeping. Based on this general rule alone, many discretionary trusts would be treated as grantor trusts. The exceptions to the general rule found in Code §§674(b), (c) and (d) and the Treasury Regulations thereunder play an important role in limiting the reach of Code §674.

b. **Overview of exceptions to general rule – Code §§674(b), (c) and (d)**. Code §§674(b), (c) and (d) specify a number of powers that can affect beneficial enjoyment but not trigger grantor trust status. Certain of these powers may be exercised by anyone, and grantor trust status will be avoided. (These powers are described immediately below in paragraph c.) Others of these powers may be exercised only by an "independent trustee" in order for grantor trust status to be avoided. (These powers are described below in paragraph d on page 41.) Finally, one of these powers may be exercised by any person other than the grantor or the grantor's spouse in order for grantor trust status to be avoided. (This power is described below in paragraph e on page 42.)

c. **Powers to affect beneficial enjoyment that can be exercised by any person without triggering grantor trust status – Code §674(b)**. The powers described below in paragraphs (1) through (8) can be exercised by any person without causing a trust to be a grantor trust.

(1) **Power to apply income in support of a dependent – Code §674(b)(1)**. Under Code §674(b)(1), a grantor is not treated as a trust's owner merely because a trustee, the grantor acting as trustee or co-trustee, or another person may apply or distribute income of the trust to discharge a support obligation of the grantor.

(a) **Actual payments or applications of income to discharge support obligations**. Under Code §674(b)(1), a grantor will be treated as a trust's owner to the extent that trust income is actually paid or applied (in the discretion a trustee, the grantor acting as trustee or co-trustee, or another person) to discharge a support obligation of the grantor.

(2) **Postponed power to affect beneficial enjoyment – Code §674(b)(2)**. Code §674(b)(2) provides that a postponed power to affect the beneficial enjoyment of a trust's income will result in grantor trust status under the general rule of Code §674(a), *unless* the power is postponed for a period which, if it were a reversionary interest, would not cause the trust to be a grantor trust under Code §673. As discussed above, Code §673 treats the grantor as owner of any portion of a trust in respect of which he or she has retained a reversionary interest worth, at the time of the transfer to the trust, more than 5% of the property transferred. Accordingly, a grantor will not be treated as owner if there is 5% or less possibility that a power will become effective in the grantor after the transfer of the property to the trust.[21]

[20] *See* Treas. Reg. §1.674(a)-1(a).
[21] *See* S Rept No. 99-313 (PL 99-514) p. 871.

(3) **Power exercisable only by Will – Code §674(b)(3)**. Code §674(b)(3) provides that a power exercisable solely by Will generally does not cause a trust to be owned by its grantor.

(a) **Exception**. Certain powers exercisable by Will will trigger grantor trust status. Specifically, a trust will be a grantor trust under the general rule of Code §674(a) if there is a testamentary power in the grantor to appoint the "income" of a trust in which income is accumulated for testamentary disposition by the grantor or to appoint income which may be accumulated for such distribution without the consent of an adverse party.

(4) **Power to allocate among charitable beneficiaries – Code §674(b)(4)**. Code §674(b)(4) provides that a power to allocate beneficial enjoyment of principal or income among charitable beneficiaries does not cause a trust to be treated as a grantor trust under §674(a). In order for a trust to fall within Code §674(b)(4), the trust's corpus or income must be irrevocably payable for purposes specified in Code §170(c) or for certain other charitable purposes.

(5) **Power to distribute principal – Code § 674(b)(5)**.

(a) **General rule**. Code § 674(b)(5) provides that grantor trust status will not be triggered as a result of (i) a power to distribute corpus to trust beneficiaries that is limited by a reasonably definite standard or (ii) a power to distribute corpus to current income beneficiaries, if such distributions are charged against the current income beneficiaries' respective proportionate shares. Each of (i) and (ii) is discussed further below.

i. **Power to distribute corpus is limited by a "reasonably definite standard."** Under Code §672(b)(5)(A), a power to distribute corpus to or for a beneficiary, beneficiaries or a class of beneficiaries that is limited by a "reasonably definite standard" set forth in the trust instrument will not cause a trust to be a grantor trust.

ii. Power to distribute corpus to current income beneficiaries if distributions charged against their respective proportionate shares. Under Code § 674(b)(5)(B), the ability to make distributions of corpus to a current income beneficiary will not cause a trust to be a grantor trust, so long as such distributions of corpus are required to be charged against a beneficiary's proportionate share of corpus held in trust for the payment of income to such beneficiary as if the corpus constituted a separate trust.

(A) **Single beneficiary**. If a trust has only one beneficiary, the grantor (or the grantor's spouse) or a non-adverse party can have complete discretion to distribute corpus without rendering the trust a grantor trust. This is because if a trust has only a single beneficiary, distributions of corpus will necessarily be charged against such beneficiary's "share" of trust corpus.

(b) **Exception to the Code §674(b)(5) exception to grantor trust status – power to add beneficiaries**. The flush language of Code §674(b)(5) provides that a power will not fall within the Code §674(b)(5) exception to grantor trust status if "any person" has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. The Treasury Regulations clarify that, in order to trigger grantor trust status, a non-adverse party must hold this power.[22] In other words, if a nonadverse party has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be treated as owned by its grantor.

(6) Power to withhold income temporarily – Code §674(b)(6).

(a) **Rule**. Code §674(b)(6) provides that a power to accumulate "income"[23] for the benefit of a current income beneficiary will not result in grantor trust status if the accumulated income must ultimately be paid in one of three ways:

i. Accumulated income is paid to the beneficiary from whom it is withheld, the beneficiary's estate, or the beneficiary's appointees under a broad limited power of appointment;[24] or

ii. Accumulated income is paid to current income beneficiaries (or their appointees or their takers-in-default) in shares irrevocably specified in the trust agreement[25]

(b) **Exception to the Code §674(b)(6) exception to grantor trust status – power to add beneficiaries**. The flush language of Code §674(b)(6) provides that a power will not fall within the Code §674(b)(6) exception to grantor trust status if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. The Treasury Regulations clarify that, in order to trigger grantor trust status, a non-adverse party must hold this power.[26]

(7) Power to withhold income during disability of a beneficiary – Code §674(b)(7).

(a) **General rule**. Code § 674(b)(7) provides that grantor trust status will not result from a power to accumulate income (which means fiduciary income in this case, see immediately below) during (i) the existence of a legal disability of any current income beneficiary or (ii) the period during which any income beneficiary. This means that the power to accumulate fiduciary accounting income is available with respect to beneficiaries who are minors or under a legal disability, even though accumulated income is not ultimately distributed in the ways specified in Code §674(b)(6) (described above).

(b) **Exception to exception – power to add beneficiaries**. A power will not fall within the Code §674(b)(7) exception to if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. However, the regulations clarify that, in order to trigger grantor trust status, a non-adverse party must hold this power.[27] In other words, if any nonadverse party has a power to add beneficiaries (other than after-born or after-

[22] *See* Treas. Reg. §1.674(d)-2(b).
[23] Per Treas. Reg. §1.674(b)-1(b)(6), "income" for this purpose seems to mean fiduciary accounting income.
[24] *See* Code §674(b)(6)(A); Treas. Reg. §1.674(b)-1(b)(6)(a).
[25] *See* Code § 674(b)(6)(B), Treas. Reg. §1.674(b)-1(b)(6)(c).
[26] *See* Reg. §1.674(d)-2(b).
[27] *See* Treas. Reg. §1.674(d)-2(b).

adopted children), the trust will be a grantor trust, taxable to its grantor under the general rule of Code §674(a).

(8) **Power to allocate between income and corpus – Code §674(b)(8)**. Code § 674(b)(8) provides that a power to allocate receipts and disbursements between income and corpus, even though expressed in "broad language," will not cause a trust to be a grantor trust.

d. **Power to accumulate or distribute income and/or pay out corpus that can be exercised by an "independent trustee" without triggering grantor trust status – Code §674(c**). The power described below in paragraph (1) can be exercised by "independent trustees" (described below) without causing a trust to be a grantor trust.

(1) **General rule – Code §674(c)**. Code §674(c) provides that grantor trust status will not be triggered as a result of a power to distribute or accumulate trust income or pay out trust corpus that is solely exercisable (without the approval of any other person, including a trust protector) by "independent trustees." For this purpose, the trustees of a trust are "independent trustees" if none of the trustees are the grantor or the grantor's spouse,[28] and no more than half of the trustees are "related or subordinate parties" who are "subservient of the wishes of the grantor".

(a) **Transfer tax considerations**. A grantor's spouse or a person who is a related or subordinate party who is subservient to the wishes of the grantor can be a trustee with discretionary distribution powers without causing the trust fund to be includible in the grantor's gross estate.[29] This is the case even if the grantor's spouse "splits" the grantor's gift to the trust for gift tax purposes under Code §2513.[30] However, a grantor's spouse or other family member should not be made a trustee of a trust with discretionary distribution powers if he or she has a beneficial interest in a trust, as this could result in the spouse or other family member having a general power of appointment.[31]

(b) **Drafting flexibly to allow for changes in grantor trust status**. In order to preserve flexibility to turn grantor trust status "on" or "off," a drafting attorney may wish to include in trust agreements a mechanism (or mechanisms) by which the lineup of trustees can be changed.[32].

(2) **Exceptions to the Code §674(c) exception to grantor trust status**. If any of the following exceptions to Code §674(c) apply, grantor trust status will be triggered.

(a) **Power to add beneficiaries**. The flush language of Code §674(c) provides that a power will not fall within the Code §674(c) exception to grantor trust status if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. The regulations clarify that, in order to trigger grantor trust status, a non-adverse party must hold this power.[33] In other words, if a

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[28] *See* Code §672(c).

[29] While the grantor's spouse or a party who is related or subordinate to the grantor and subservient to the grantor's wishes can serve as trustee of a trust without causing the trust fund to be included in the grantor's gross estate, care needs to be taken if the grantor is given the power to remove and replace trustees. *See* Rev. Rul. 95-58, 1995-2, C.B. (Aug. 4, 1995).

[30] *See* Rev. Rul. 74-556, 1974-2 CB 300.

[31] In addition, if a person who is related or subordinate to the grantor and who is subservient to the grantor's wishes has a beneficial interest in a discretionary trust, the trust generally will not be a grantor trust under Code §674(a). *See infra* discussion of Code §674(a) at III.C.2.a and discussion of the definition of "adverse party" at III.B.4.

[32] There are of course also non-tax reasons why it may make sense for a trust agreement to provide flexibility for the persons serving as trustees to be modified as circumstances change.

[33] *See* Treas. Reg. § §1.674(d)-2(b).

non-adverse party has a power to add beneficiaries (other than after-born or after-adopted children), a trust will be a grantor trust, taxable to its grantor under the general rule of Code §674(a).

i. **Planning point – power to add beneficiaries**. The Code §674(c) exception to grantor trust status is broad and will cause many trusts that otherwise would be grantor trusts not to be grantor trusts. Where grantor trust status is desired, one power that some estate planners suggest including in a trust instrument is a power in an independent trustee or a "protector" to add beneficiaries. In some cases, grantors may be reluctant to give third parties the power to add beneficiaries, although some may be willing to give a third party a power to add charitable beneficiaries or certain charitable beneficiaries.

(b) **Power to remove and replace trustees**. Treas. Reg. §1.674(d)-2 provides that a power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions that do not exist during the taxable year, such as the death, or resignation, or breach of fiduciary duty of an existing trustee) *may* prevent a trust from falling within the Code §674(c) exception to grantor trust status.

i. For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person, including himself, as trustee, the trust will not qualify for the exception to grantor trust status in Code §674(c).

ii. On the other hand, if the grantor's power to remove, substitute or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify the trust from satisfying the Code §674(c) exception to grantor trust status, the power will not cause the trust to be a trust. Thus, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not cause a trust to fail to qualify for the Code §674(c) exception to grantor trust status.

e. **Powers to accumulate or distribute income based on a standard that can be exercised by any trustee other than grantor or grantor's spouse – Code §674(d)**. The power described below in paragraph III.C.2.e(1) can be exercised by persons specified in Code §674(c) without causing a trust to be a grantor trust.

(1) **General rule – Code §674(d)**. Code §674(d) provides that a grantor is not taxable as a trust's owner merely because a nonadverse trustee has the power (exercisable without the consent of another person) to distribute, apportion or accumulate income to or for a beneficiary or the beneficiaries of a trust, so long as such power is limited by a reasonably definite external standard set forth in the trust agreement. The exception of Code §674(d), however, is not available if the grantor or the grantor's spouse, if living with the grantor, is a trustee.

(a) **"If living with the grantor"**. It is not clear whether the requirement of Code §674(d) that the grantor's spouse be living with the grantor is overridden by Code §672(c), which, for purposes of Subpart E, imputes all powers of a grantor's spouse to the grantor.[34]

[34] The "if living with the grantor" clause has been in Code §674(d) since Subpart E first came into the Code in 1954. Section 672(e) was added to the Code in 1986, as part of the Tax Reform Act of 1986.

(2) Exceptions to general rule of Code §674(d).

(a) **Power to add beneficiaries**. The flush language of Code §674(d) provides that a power will not fall within the Code §674(d) exception to grantor trust status if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. The regulations clarify that, in order to trigger grantor trust status, a non-adverse party must hold this power.[35] In other words, if a non-adverse party has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor.

(b) **Power to remove and replace trustees**. As described above on page 38, Treas. Reg. §1.674(d)-2 provides that an unrestricted power in the grantor to remove, substitute, or add trustees may prevent a trust for qualifying for the Code §674(d) exception to grantor trust status and cause the trust to be a grantor trust.

3. **Code §675: Administrative powers**.

a. **Overview/purpose**. Code §675 treats a grantor as owner of any portion of a trust if administrative control of the trust is exercisable primarily for the benefit of the grantor, rather than for the beneficiaries of the trust.[36] Code §675 identifies four categories of powers (discussed below in subsections b through e) that can trigger grantor trust status.

b. **Power to deal for less than adequate and full consideration – Code §675(1)**. Under Code §675(1) and Treas. Reg. §1.675-1(b)(1), a grantor will be treated as owner of a trust, or portion of a trust, if the grantor or any nonadverse person (or both), has a power exercisable without the approval or consent of any adverse party, to purchase, exchange or otherwise deal with or dispose of trust principal or income for less than adequate consideration in money or money's worth.

(1) **Exception – general trustee power**. The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange or otherwise deal with or dispose of the trust property for less than adequate and full consideration. However, such authority may be indicated by the actual administration of the trust.[37]

(2) **Transfer tax considerations**. The trust agreement of an "intentionally defective grantor trust" typically would not allow a grantor or a nonadverse party to deal with trust assets for less than adequate and full consideration. If the grantor were given such a power, the assets of the trust could be included in the grantor's estate.

c. **Power to borrow without adequate interest and security – Code §675(2)**. Under Code §675(2), a grantor generally will be treated as owner of a trust, or portion of a trust, over which the grantor or a nonadverse party has the power to borrow the trust principal or income, directly or indirectly, without <u>both</u> adequate interest and adequate security.

(1) **Exception – general lending power**. Grantor trust status will not result merely because a trustee (other than the grantor is authorized under a general lending power to make loans to any person without regard to interest or security.[38]

[35] *See* Treas. Reg. §1.674(d)-2(b).
[36] *See* Treas. Reg. §1.675-1(a).
[37] *See* Treas. Reg. §1.675-1(c).
[38] *See* Code §675(2), Treas. Reg. §1.675-1(b)(2).

However, grantor trust status may result from an actual lending of the trust fund to the grantor on such terms.[39]

(2) **Transfer tax considerations**. The ability of a grantor to borrow trust principal or income without adequate interest could be viewed as a retained power in the grantor that could cause estate inclusion. Accordingly, if a grantor is given a power to borrow the trust fund, adequate interest (as determined by the trustee) should be required. As long as adequate security is not also required, the grantor's power to borrow the trust fund should be sufficient to trigger grantor trust status.

(a) **Life insurance policies and §2036(b) stock**. If a grantor has the power to borrow shares of voting stock of a "controlled corporation"[40] within the meaning of Code §2036(b), those shares could be includible in the grantor's gross estate under Code §2036(a). Similarly, if a grantor has the power to borrow a life insurance policy held in a trust, such power could be considered an incident of ownership resulting in estate inclusion under Code §2042.

(3) **Drafting flexibly to allow for changes in grantor trust status**. In order to preserve the ability to turn grantor trust status "off," a lawyer who drafts a trust agreement that allows a grantor to borrow the trust fund also may wish to consider including a provision that allows the grantor to release this power.

d. **Actual borrowing of trust fund – Code §675(3)**. Most of the powers described in this part III.C of the outline will cause a trust to be a grantor trust based on the mere existence of the powers, rather than on their exercise. If a trust agreement is not drafted to include these powers and cannot be modified to incorporate them but grantor trust status is desirable, a grantor may be able to cause a trust to be a grantor trust by actually borrowing the trust fund. This is because Code §675(3) provides that a grantor generally will be treated as owner of any portion of a trust in respect of which the grantor has, directly or indirectly, borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the next tax year. Grantor trust status, however, will not be triggered under Code §675(3) if the loan provides for adequate interest and security and is made by a trustee other than the grantor and other than a person who is related or subordinate to or subservient to the grantor.[41]

(1) **Making a trust a grantor trust retroactive to a date before the date of the loan**. In Revenue Ruling 86-82,[42] the IRS ruled that a grantor-trustee who borrowed the entire trust fund and repaid the loan with interest in the same taxable year would be treated as the owner of the trust for the entire taxable year. In other words, the IRS concluded that the trust would be a grantor trust for the entire taxable year and not just for the portion of the year that the loan was outstanding. The conclusion of Revenue Ruling 86-82 can be useful in a situation where it becomes desirable to cause a trust to be a grantor trust as of an earlier date in the same taxable year. Consider the following example:

(2) **Amount of trust fund that needs to be borrowed – uncertainty in applying the "portion" rules**. As described above in section B.3 (beginning on page 34), Treas. Reg. §1.671-3 provides rules for determining the "portion" of a trust with respect to which a grantor will be deemed owner. The application of the "portion" rules, however, creates some uncertainty in the context of Code §675(3). The IRS

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[39] *See* Treas. Reg. §1.675-1(c).

[40] For purposes of Code §2036(b), a controlled corporation is a corporation in which the decedent owns (directly or through attribution) stock possessing at least 20% of the total combined voting power of all classes of stock.

[41] *See infra* at III.B.6 for a discussion of the term "related or subordinate party" and *infra* at part III.B.6.c for a discussion of the term "subservient to the grantor."

[42] 1986-1 CB 253.

has taken the position that a grantor who borrows any amount from a trust should be treated as owner of the entire trust. In *Benson v. Comm'r*,[43] the Tax Court agreed with this position, holding that a grantor who had borrowed all of the income of a trust should be treated as owner of the entire trust. However, in *Bennett v. Comm'r*,[44] the Tax Court held that a grantor who had borrowed principal should be taxed on the "portion of the current year's trust income which the total unpaid loans at the beginning of the taxable year bear to the total trust income of prior years plus the trust income for the taxable year at issue."[45] Finally, in *Holden v. Comm'r*,[46] the Tax Court took a third approach, holding that a grantor who had borrowed trust principal should be taxed only on income derived from the trust on the sum borrowed.

e. **General powers of administration – Code §675(4)**. Code §675(4) treats the grantor as owner of any portion of a trust over which any person (including, it seems, an adverse party) has certain specified powers of administration that are *exercisable in a nonfiduciary capacity*, without the approval of any person in a fiduciary capacity.

Whether grantor trust status is triggered under Code §675(4) often turns on the question of *whether a power is exercisable in a fiduciary capacity or a non-fiduciary capacity*. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.[47] If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all of the terms of the trust and the circumstances surrounding its creation and administration.[48] The IRS ordinarily will not rule on the question of a whether a power is exercisable in a fiduciary capacity or a nonfiduciary capacity.[49]

The specific powers of administration that can trigger grantor trust status under Code §675(4) are described below in paragraphs (1) through (3).

(1) **Power to vote stocks and securities – Code §675(4)(A)**. Code §675(4)(A) provides that a grantor will be treated as owner of any portion of a trust over which any person has a power, exercisable in a nonfiduciary capacity, to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are "significant" from the view point of voting control, without the approval of any person in a fiduciary capacity.

(a) **"Significant" voting power**. There is no official guidance as to how much voting power the grantor and the trust must together possess in order to be "significant."

(b) **Transfer tax considerations**. Code §2036(b) provides that the retention of the right to vote (directly or indirectly) shares of a corporation in which a decedent owned (directly or constructively) or had the right (either alone or in conjunction with any person) to vote stock possessing 20% of the total combined voting power of all classes of stock will result in inclusion of the value of the shares in the decedent's gross estate.

[43] 76 T.C. 1040 (1981).
[44] 79 T.C. 470 (1982).
[45] *Id*.
[46] 34 T.C.M. 129 (1975).
[47] This power can be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of beneficiaries. *See* Treas. Reg. §1.675-1(b)(4) (flush language). *See also Goodan, May Chandler*, 12 TC 817 (1949), aff'd sub nom *Com. v. Goodan, May Chandler*, 41 AFTR 1085 (1952, CA9); U*.S. v. Morss, Everett*, 35 AFTR 642 (1947, CA1); *Cushman, Lewis A. Jr. v. Com.*, 34 AFTR 900 (1946, CA2); *Hall, Joel E. v. Com.*, 33 AFTR 1529 (1945, CA10).
[48] *See* Treas. Reg. §1.675-1(b)(4) (flush language).
[49] *See, e.g.,* Priv. Ltr. Rul. 9413045 (Jan. 4, 1994).

Accordingly, it is unusual to find a trust agreement under which a grantor retains a right to vote shares of a corporation in which shareholdings are significant.

(2) **Power to control trust investments – Code §675(4)(B)**. Code §675(4)(B) provides that a grantor will be treated as owner of any portion of a trust over which any person has a power, exercisable in a nonfiduciary capacity, without the approval of any person in a fiduciary capacity, to control the investment of the trust fund either by directing the investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust fund consists of stock or securities of corporations in which the holdings of the grantor and the trust are "significant" from the viewpoint of voting control.

(a) Whether investment advisor is a fiduciary depends on state law.

(3) **Power to reacquire trust assets – Code §675(4)(C)**. Under Code §675(4)(C), a power to reacquire trust corpus by substituting property of equivalent value will result in grantor trust status, when such power is exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity.[50]

(a) **Transfer tax considerations**. Rev. Rul. 2008-22 [51] provides that a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire trust property by substituting property of equivalent value will not, by itself, cause the trust fund to be includible in the grantor's gross estate under Code §2036 or §2038, provided that (a) the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of the power by satisfying himself, herself or itself that the properties acquired and substituted by the grantor in fact are of equivalent value and (b) the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

i. **Life insurance policies.** Rev. Rul. 2011-28 [52] provides that a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire a life insurance policy held in a trust by substituting property of equivalent value will not, by itself, cause the trust fund to be includible in the grantor's gross estate under Code §2042, provided that the conditions outlined in Rev. Rul. 2008-22 (described immediately above) are satisfied.

ii. **Code §2036(b) stock**. If a grantor retains a power to reacquire shares of voting stock of a "controlled corporation"[53] within the meaning of Code §2036(b), those shares could be includible in the grantor's gross estate under Code §2036(a).

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[50] The introductory language to Code §675(4) states that the administrative powers enumerated in Code §675(4) will result in grantor trust status if such powers are exercisable by *any person* in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity (emphasis added). Some planners have questioned whether a power to reacquire trust assets, exercisable by a person other than the grantor, can result in grantor trust status. This is because it is not clear how a person other than a grantor can "reacquire" trust assets. *But see* Priv. Ltr. Ruls. 199908002, 9810019 and 9713017, where the IRS ruled that a power to substitute assets given to a third party was sufficient to cause grantor trust status for income tax purposes.

[51] 2008-16, IRB 796 (April 17, 2008).

[52] 2011-49, IRB 830 (December 1, 2011).

[53] For purposes of Code §2036(b), a controlled corporation is a corporation in which the decedent owns (directly or through attribution) stock possessing at least 20% of the total combined voting power of all classes of stock.

(b) **Drafting flexibly to allow for changes in grantor trust status**. In order to preserve the ability to turn grantor trust status "off," a lawyer who drafts a trust agreement that allows a grantor to re-acquire trust assets may wish to include a provision allowing the grantor to release this power.

4. **Code §676: Power to revoke**.

a. **General rule – Code §676(a)**. Code §676(a) provides that a grantor will be treated as owner of any portion of a trust, where at any time the power to revest in the grantor the title to such portion is exercisable by *a grantor or a nonadverse party*, or both.

b. **Exception for certain postponed powers – Code §676(b)**. Grantor trust status will not result if a power to revest title to trust property in the grantor cannot be exercised until after the occurrence of an event or for a long enough period of time long to avoid application of Code §673 if the power were a reversionary interest. However, once the triggering event occurs or period of time expires, the grantor may be treated as the owner unless the power is relinquished.[54]

c. **Transfer tax considerations**. A power to revoke should never be included in a trust agreement if an objective is for the trust fund not to be includible in the grantor's estate. However, where a "revocable trust" is used as a Will substitute, to the extent such trust is funded during grantor's lifetime, the grantor's power to revoke the trust will result in grantor trust status.

5. **Code §677: Income for benefit of grantor of grantor's spouse**.

a. **General rule – Code §677(a)**. Code §677(a) provides that a grantor is treated as the owner of any portion of a trust as to which the grantor or a nonadverse party (or both) has the ability to use the trust income for the benefit of the grantor or the grantor's spouse[55] in one or more specified ways (discussed in paragraphs (1) and (2) below), without the consent or approval of an adverse party.

(1) **Income is or may be distributed to or accumulated for the grantor or grantor's spouse – Code §§671(a)(1) and (2)**. Under Code §677(a)(1) and (2), a grantor is treated as owner of any portion of a trust whose income without the approval or consent of an adverse party is, or in the discretion of the grantor or a nonadverse party (or both) may be, distributed to or accumulated for the grantor or the grantor's spouse.

(a) **Discharge of legal obligations**. Under Code §677, a grantor is, in general treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor or his spouse.[56] There is, however, an exception for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or the grantor's spouse is legally obligated to support.[57] This exception is discussed below at subsection b.b(2)on page 49.

(b) **GRATs and Code §677(a)(1) and (a)(2)**. The IRS has issued several private letter rulings concluding that GRATs are grantor trusts on the

[54] *See* Code §676(b).
[55] The special spousal attribution rule of Code §677 is discussed in below in paragraph III.C.5.c.
[56] *See* Treas. Reg. § 1.677(a)-1(d).
[57] *See* Code §677(b); Treas. Reg. § 1.677(a)-1(d).

basis of Code §677.[58] These rulings aside, the Tax Court has in several cases held that a grantor of a trust who retains an annuity is taxable on the entire income of the trust (including income allocable to corpus, such as capital gains) if the entire corpus of the trust can return to the grantor.[59] If the assets of a GRAT do not increase in value at a rate higher than the relevant §7520 rate, all of the GRAT's assets will return to the grantor.

(c) **Transfer tax considerations**. The ability of a trustee (other than the grantor) to make distributions to the grantor's spouse will not in and of itself cause the trust fund to be includible in the grantor's gross estate. Making a grantor's spouse a discretionary beneficiary of a trust is a popular technique to cause a trust to be a grantor trust for income tax purposes without subjecting the trust fund to inclusion in the grantor's gross estate for estate tax purposes.

(2) **Income may be applied to pay premiums on a life insurance policy on the life of grantor or grantor's spouse – Code §677(a)(3)**. As described above in paragraph a.(1) on page 47, the Treasury Regulations provide that for purposes of Code §677(a), distributions to the grantor or his or her spouse include constructive distributions, which generally include the payment of premiums on insurance policies on the grantor's, or his or her spouse's life.[60] Code §677(a)(3) specifically addresses the payment of insurance premiums, providing that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of an adverse party is, or, in the discretion of the grantor or a nonadverse party or both, may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a charitable purpose specified in Code §170(c).

(a) **Actual payment of premiums required?** Even though the plain language of Code §677(a)(3) indicates that a mere *ability* to pay life insurance premiums from income should be sufficient to trigger grantor trust status as to a portion of the trust, case law predating Code § 677(a)(3) suggests otherwise.[61] However, recent IRS guidance seems to confirm that a mere ability to pay policy premiums should be sufficient to trigger grantor trust status. In FAA 20062701F the IRS stated that the a trustee power to purchase life insurance on the life of the grantor or the grantor's spouse from trust income was sufficient to trigger grantor trust status under Code §677(a)(3), irrespective of whether a policy was actually acquired by the trust.[62]

b. **Exceptions to grantor trust status under Code §677(a)**.

(1) **Exception for postponed powers**. The flush language of Code §677 provides that a grantor is not treated as owner of the income of a trust if a power to apply income for the benefit of the grantor or his spouse can occur only after an event

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[58] *See* Priv. Ltr. Rul. 9444033 (Aug. 5, 1994); Priv. Ltr. Rul. 9448018 (Aug. 12, 1994); Priv. Ltr. Rul. 9451056 (Sept. 26, 1994); Priv. Ltr. Rul. 9449012 (Sept. 9, 1994) ; Priv. Ltr. Rul. 9449013 (Sept. 9, 1994); Priv. Ltr. Rul. 9504021 (Oct. 28, 1994) .

[59] *See Weigl v. Comm'r*, 84 T.C. 1192, 1228 (1985); *Stern v. Comm'r*, 77 TC 614, 648 (1981), *rev'd on other grounds*, 747 F.2d 555 (9th Cir. 1984).

[60] *See* Treas. Reg. §1.677-1(c).

[61] *See, e.g., Corning v. Comm'r*, 104 F.2d 329 (6th Cir. 1939); *Iverson v. Comm'r*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944), acq., 1944 C.B. 29; *Rand v. Comm'r*, 40 B.T.A 233 (1939), acq. 1939-2 C.B. 30, aff'd, 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941); *Moore v. Comm'r*, 39 B.T.A. 808 (1939), acq. 1939-2 C.B. 25.

[62] See also PLR 8852003 (which held that the mere power to pay for premiums, without reference to the existence of any policies, causes grantor trust status).

that would not cause the grantor to be treated as the owner if the power were a reversionary interest.

(2) **Exception for certain support obligations – Code §677(b)**. As described above in paragraph a.a(1).a(1)(b) on page 47, under Code §677, a grantor is, in general treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor or his spouse.[63] There is, however, an exception for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or the grantor's spouse is legally obligated to support. In such a case, grantor trust status will not result from the mere possibility that income might be distributed to a beneficiary in discharge of the support obligation of the grantor or the grantor's spouse.[64]

(a) **Actual distributions in discharge of support obligations**. Under Code §677(b), the grantor is taxed only if, and to the extent that, trust income is actually used to discharge a legal obligation to support a beneficiary. Whether there is a legal obligation of support depends on applicable state law. If income is applied or distributed to a beneficiary in discharge of a support obligation of the grantor or the grantor's spouse, the grantor is treated as owner of such income under Code § 677. If corpus is used to discharge a support obligation of the grantor or the grantor's spouse, amounts used to discharge the support obligation are treated as constructive distributions to the grantor, who will be taxed as if he or she is a beneficiary of the trust and as if the amounts so used were paid to him or her within the meaning of Code §§ 661(a)(2) and 662.[65]

c. **Special spousal attribution rule of Code §677**. The references to the grantor's "spouse" in Code §677(a) seem unnecessary, given that Code §672(e) attributes to the grantor any power or interest held by his or her spouse. However, the references to "spouse" in §677 predate the enactment of the spousal attribution rule of Code §672(e).[66]

(1) **Conflict between spousal attribution rules of §677 and §672(e) in the case of divorce**. As described below, conflict may arise between the spousal attribution rules of Code §§677 and 672(e) in the case of spouses who divorce. There appear to be no authorities resolving this conflict.

(a) **Code §672(e) – spousal attribution turns on marital status at time of creation of power**. Code §672(e) provides that a grantor is treated as holding any power or interest held by an individual who was the grantor's spouse *at the time of the creation of the power or interest*. The legislative history of §672(e) indicates that if grantor and his spouse are married at the time the transfer to the trust occurs, the spouse's interests in and powers over the trust are attributed to the grantor even if the couple divorces. This means that if an ex-spouse remains a beneficiary of a trust created when the spouses were married, the spouse who created the trust may continue to be treated as deemed owner of the trust.

i. **Treatment of legal separation under Code §672(e)**. Code §672(e)(2) provides that an individual legally separated from

[63] *See* Treas. Reg. § 1.677(a)-1(d).
[64] *See* Code §677(b); Treas. Reg. § 1.677(a)-1(d); Treas. Reg. § 1.677(b)-1.
[65] *See* Treas. Reg. § 1.677(b)-1(b).
[66] The references to "spouse" were added to Code §677 in 1969. The spousal attribution rule of Code §672(e) was not enacted until 1986.

his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(b) **§677(a) – spousal attribution turns on marital status at time of accumulation or distribution of income**. Treas. Reg. §1.677(a)-1(b)(2) (flush language) provides, "With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, Code §677(a) applies to the income of a trust solely during the period of the marriage of the grantor to the beneficiary. In the case of divorce or separation, see Code §§71 and 682 and the Treasury Regulations thereunder."[67]

i. **Treatment of legal separation under Code §677**. Per §1.677(a)-1(b)(2) (flush language), individuals who are legally separated are not treated as married.

6. **Code §678: Person other than grantor treated as substantial owner**.

a. **Background – *Mallinckrodt*.** As described above in section I.A.2.b.ii, Code § 678 is a codification of the 8th Circuit's decision in *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945). *Mallincrkrodt* concerned a beneficiary of a trust who was entitled to receive as much of the otherwise undistributed income of a trust created by his father as the beneficiary requested. The 8th Circuit held that the beneficiary was to be treated as owner of the trust, whether or not he actually demanded income in a give year, in view of his "position of power over the disposition of trust income."

b. **General rule – Code § 678(a)**. A person other than the grantor of a trust is treated as the owner of any portion of the trust with respect to which:

(1) Such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself, or

(2) Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Code §§ 671 through 677, subject a grantor of a trust to treatment as the owner thereof.

(a) **"Partially released or otherwise modified"**. The Code and the Treasury Regulations do not provide a definition of "partially released or otherwise modified." However, in at least one private letter ruling, the IRS indicated that a "lapse" for purposes of Code § 2514(e) constitutes

[67] Code §682 provides that, despite grantor trust status (for any reason, whether or not due to Code §677), the amount of income of the trust that the grantor's spouse "is entitled to receive" is includible in such spouse's income, and not the grantor's income, if the parties are divorced or legally separated. The Treasury Regulations appear to expand this rule to apply not only to mandatory distributions, but also to any amount paid or credited to the spouse. *See* Treas. Reg. §1.682(a)-1(a)(1)(i). The Treasury Regulations distinguish between the tax treatment of payments pursuant to a divorce decree, which are taxable under the rules of Code §71, and the tax treatment of trust distributions under the rules of Code §682. Code §71 applies only if the creation of the trust or payments from a previously created trust are in discharge of an obligation imposed upon or assumed by one spouse under a divorce or separation decree. If Code §71 applies, it requires inclusion in the recipient spouse's income of the full amount of periodic payments received that are attributable to trust property. *See* Treas. Reg. §1.682(a)-1(a)(2). Code §682(a) does not apply in any case in which Code §71 applies. *See id.* If Code §682 applies, the amounts paid, credited or required to be distributed to the spouse are to be included in income only to the extent they would be includible in the taxable income under subpart A through D of part I of Subchapter J (i.e., under the general rules for income taxation of trusts and their beneficiaries not applicable to grantor trusts). In other words, under Code §682, the spouse is treated as a beneficiary receiving a distribution under Code §652 or 662. *See id*.

a "release" for purposes of Code § 678 and ruled that a beneficiary holding a 5% annual withdrawal right over a trust that she fails to exercise should be treated as if she partially released a power to withdraw under Code § 678(a)(2).[68]

(b) **Retained "control"**. A requirement for §678(a)(2) to be triggered is that after the 'partial release or other modification' of a power, the beneficiary retains some interest or control under the principles of Code §§671 through 677 (inclusive) that would cause the trust's grantor to be taxed as its owner. In other words, any power or interest that would cause the grantor to be taxed as a trust owner, whether retained personally or by a non-adverse party, should trigger grantor trust ownership under §678(a)(2).

c. **Minors and withdrawal rights/ §678 powers**. A minor can be a deemed owner of a trust under Code §678 (e.g., if the minor has withdrawal rights) even though the minor doesn't know of his or her rights and does not have any way of exercising such rights absent appointment of a legal guardian.[69]

d. **Exception where grantor treated as owner under another provision of Subpart E – Code § 678(b)**. Code §678(b) provides that Code § 678(a) does not apply "with respect to a power over income" if the grantor is treated as owner under another provision of Subpart E.

(1) **Rationale**. As described above in section III.A.2.a, the grantor trust rules were enacted at a time when there was a concern that high bracket taxpayers were setting up trusts in order to shift income to lower tax brackets. Code § 678(b) was likely intended to prevent grantors otherwise treated as owners under Subpart E from shifting the tax consequences of their trusts merely by granting another individual a power described in Code § 678.[70]

(2) **"Powers over income"**. Even though the general rule of Code § 678(a) applies to powers over income or corpus, the exception in Code §678(b) applies only to trump third parties' powers over income. However "[i]t has been suggested that the 'over income' language [in Code § 678(b)] was an error in drafting and should be disregarded."[71] Many practitioners agree with the approach of disregarding the words "over income." Moreover, in a number of private letter rulings, the IRS has in fact read the words "over income" out of Code §678(b).[72]

7. **Code §679: Foreign trusts having US grantor and one or more US beneficiaries**.

a. **Background**. Code §679 was added to the Code in 1976 and was amended significantly in 1995. The section was further amended in 2010, but the 2010 amendments basically just codified portions of existing Treasury Regulations under Code §679. The purpose of Code §679 is to prevent U.S. grantors from establishing foreign trusts in low tax jurisdictions, which would accumulate income for eventual distribution to U.S. beneficiaries.

b. **Basic rule and overview of requirements**. If a *U.S. person* makes a gratuitous *transfer* (including an indirect gratuitous transfer) to a *foreign trust* that has one or more *U.S. beneficiaries*, §679 treats the trust as a grantor trust owned by the U.S. person to the extent

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[68] *See* Priv. Ltr. Rul. 9034004 (May 17, 1990); *But see* Rev. Rul. 67-241, 1976-2 C.B. 225, both of which are discussed in section VII.F.4.b. at page 57.
[69] *See* Rev. Rul. 81-6.
[70] *See* Ferguson, et. al., supra note 2, at § 10.16[C].
[71] *See* Early, Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status, 62 J. Taxn, 198, 200 (1985).
[72] *See e.g.*, Priv. Ltr. Rul. 8326074 (Mar. 29, 1983); Priv. Ltr. Rul. 8308033 (Nov. 23, 1982); Priv. Ltr. Rul. 8142061 (July 21, 1981); Priv. Ltr. Rul. 81303074 (Oct. 23, 1980).

of her transfer.[73] These requirements for a trust to be a grantor trust under Code §679 are described further below.

c. **Requirement 1 – Transferor is a "US person"**. One requirement for a trust to be a grantor trust under Code §679 is that the transferor to the trust is a U.S. person.

(1) **Who is a "U.S. person" – general rule**. A "U.S. person" includes *either* a citizen or resident of the U.S.[74]

(2) **Special rule for nonresident alien transferors who become U.S. persons within 5 years of transfer**. Code §679(a)(4) provides that a nonresident alien who transfers property to a foreign trust and becomes a U.S. resident within 5 years of the transfer will be treated as if she made the transfer to the foreign trust on the date that she became a U.S. resident.

(a) **Amount treated as transferred to foreign trust**. A nonresident alien who makes a transfer to a foreign trust and within 5 years of the transfer becomes a U.S. resident will be treated as transferring to the trust on his/her "residency starting date" (as defined in §679(a)(4)(C)) an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer, plus undistributed net income, attributable to the property deemed transferred.[75] In other words, the transferor is not immediately taxable on the accumulated income; rather, the accumulated income is just deemed to be part of the property transferred to the trust.

(3) **Caveat – Code §684 gain recognition upon death of U.S. transferor of a foreign trust subject to Code §679**. If a U.S. person who is treated as the owner of a foreign trust dies (and no other person is treated as owner of the trust – *e.g.*, under §678), the trust will become a foreign nongrantor trust. At this time, there generally will be a deemed transfer from the U.S. person to the foreign non-grantor trust, resulting in the recognition of any built-in gain in the trust assets under Code §684.[76]

d. **Requirement 2 - "Direct, indirect or constructive transfer" of property to a foreign trust**.

(1) **General rule**. In order for a U.S. transferor to be considered the owner of a foreign trust under Code §679, there needs to be a direct, indirect or constructive transfer by the U.S. transferor to the foreign trust.[77]

(a) **Indirect transfers through an intermediary**. A transfer to a foreign trust by a person (an "intermediary") to whom a U.S. person has transferred property is treated as an indirect transfer by a U.S. person to the foreign trust if such transfer is made to a plan one of the principal purposes of which is tax avoidance.[78]

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[73] *See* Code §679(a)(1).
[74] *See* Treas. Reg. §1.679-1(c)(2), which cross-references Code §7701(a)(30).
[75] *See* Treas. Reg. §1.679-5, which refers to a foreign trust to which a nonresident alien transfers property within 5 years of becoming a U.S. resident as a "pre-immigration trust."
[76] *See* Treas. Reg. §1.684-2(e). *See also* Treas. Reg. §1.684-3 for certain exceptions to the general deemed transfer rule of Code §684.
[77] *See* Code §679(a)(1), Treas. Reg. §1.679-3.
[78] *See* Treas. Reg. §1.679-3(c).

(b) **Constructive transfers**. A constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party.[79]

(2) **Transfers from trusts treated as owned by U.S. persons**. If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the U.S. person treated as owner of that portion to the foreign trust.[80]

(3) **Exceptions** – The following are not considered "transfers" to a foreign trust for purposes of Code §679.

(a) **Exception for transfer to foreign trust by reason of transferor's death**. A transfer by a U.S. person to a foreign trust that occurs by reason of the death of the U.S. person is not subject to grantor trust treatment based on Code §679.[81]

(b) Exception for transfer to foreign trust for fair market value.

i. **General rule**. If a U.S. transferor transfers property to a foreign trust in exchange for consideration at least equal to the fair market value of the transferred property, Code §679 will not be triggered.[82] Consideration other than cash is taken into account at its fair market value.[83]

ii. **Loans by U.S. person to foreign trusts**. If in consideration for a transfer to a foreign trust, a U.S. transferor receives an obligation of the foreign trust or of certain related persons,[84] the obligation will not be treated as consideration that enables the transfer to qualify for the transfer for fair market exception to Code §679, unless the obligation is a so-called "qualified obligation."

e. **Requirement 3 - Transfer is to a "foreign trust"**.

(1) **Foreign trust – definition**. A foreign trust is any trust that is not a domestic trust.[85]

(2) **Domestic trust – definition**. A trust is a domestic trust if it satisfies both the "court test" and the "control test." If either test is not satisfied, the trust will be a foreign trust.[86] In order to determine whether these tests are satisfied, it is necessary to look to terms of trust instrument and applicable law.[87]

(a) **Court test.** Generally, the "court test" will be satisfied if a court within the United States is able to exercise primary supervision over the administration of the trust.[88]

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[79] *See* Treas. Reg. §1.679-3(d).
[80] *See* Treas. Reg. §1.679-3(b).
[81] *See* Code §679(a)(2)(A).
[82] *See* Code §679(a)(2)(B), Treas. Reg. §1.679-4(b).
[83] *See* Code §679(a)(2)(B).
[84] *See* Code §679(a)(4)(C) and Treas. Reg. §1.679-1(c)(f).
[85] *See* Code §7701(a)(31).
[86] *See* Code §7701(a)(30).
[87] *See* Treas. Reg. §301.7701-7(b).
[88] *See* Code §7701(a)(30), Treas. Reg. §301.7701-7(c).

(b) **Control test**. The "control test" will be satisfied if one or more U.S. persons have the authority to control *all* substantial decisions of the trust. If *any* substantial decision rests with a foreign person, the control test is flunked, and the trust is a foreign trust.[89]

(3) **Outbound migration of domestic trust can trigger grantor trust status under §679**. If a U.S. citizen or resident transfers property to a domestic trust, and the trust later becomes a foreign trust while the U.S. transferor is still alive, the U.S. transferor is deemed to transfer property to a foreign trust on the date the domestic trust becomes a foreign trust.[90]

f. **Requirement 4 - Trust has at least one "US beneficiary**."

(1) **Rule**. For purposes of Code §679, a trust is presumed to have a U.S. beneficiary unless, under the terms of the trust, (i) no income or corpus can be paid to or accumulated for a U.S. person during the tax year and (ii) if the trust were terminated at any time during the tax year, no part of the income or corpus could be paid to or for the benefit of a U.S. person.[91]

(a) **Determination of whether a foreign trust has a U.S. beneficiary is made annually**. This means that a foreign trust to which a U.S. person has transferred assets can be treated as owned by the U.S. person in one year but not in the next.[92]

(b) **Determination of whether there's a U.S. beneficiary made without regard to actual distributions**. The mere possibility that income may be paid to or accumulated for to a U.S. person during a taxable year is significant for purposes of Code §679.[93]

(c) **Contingent beneficiaries**. If a U.S. person is a contingent beneficiary, then the trust is considered to have a U.S. beneficiary unless it can be demonstrated that the contingent interest in the trust is so remote as to be negligible. In order to be able to demonstrate that a contingent beneficiary's interest is so remote as to be negligible, the contingent beneficiary cannot be individually named in the trust agreement and cannot be a member of a class of beneficiaries as defined under the trust agreement (*e.g.*, "A's descendants", one of whom is a US beneficiary).

(d) **Trust agreement need not explicitly forbid distributions to or accumulations for U.S. beneficiaries**. A trust will not be treated as having a U.S. beneficiary simply because the trust agreement does not forbid the distribution of trust income or corpus for, or accumulation of income or corpus for, a U.S. person. Rather, it must be the case that the persons with beneficial interests under the terms of the trust agreement cannot in fact be U.S. persons in the year in question.

(e) Changes in a beneficiary's status.

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[89] *See* Code §7701(a)(30), Treas. Reg. §301.7701-7(d).
[90] *See* Code §679(a)(5), Treas. Reg. §1.679-6. *See* also Treas. Reg. §1.7701-7(d)(2), which provides a one-year "grace period" for inadvertent outbound migrations due to a change in any person who has the power to make substantial decisions with respect to the trust.
[91] *See* Code §§679(c), (d).
[92] *See* Treas. Reg. §1.679-2(a).
[93] *See* Treas. Reg. §1.679-2(a)(2).

i. Possibility that a non-U.S. beneficiary could become a U.S. person.

(A) **General rule**. The possibility that a person who is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person until the tax year of the U.S. transferor in which that person actually becomes a U.S. person.[94]

(B) **Special rule if a beneficiary who is not a U.S. person becomes a U.S. person more than 5 years after transfer to trust**. If a person who is not a U.S. person becomes a US person for the first time more than 5 years after the date of a transfer to a foreign trust by a U.S. transferor, that person is not treated as a U.S. person for purposes of Code § 679.[95]

ii. **Possibility that a U.S. beneficiary could become a non-US person**. If a trust that can accumulate income simply prohibits distributions to U.S. persons (and nothing more), the trust will be considered to have a U.S. beneficiary. This is because a U.S. person could become a non-US person, and a distribution could then be made to this person. This distribution could include income that was accumulated during the period when the person was a U.S. person. Accordingly, to avoid triggering grantor trust status based on Code §679, a trust instrument should preclude distributions to both U.S. persons and to persons who were U.S. persons.

iii. **Treatment of a trust that was subject to §679 and ceases to have a U.S. beneficiary**. If a trust that is subject to Code §679 ceases to have a U.S. beneficiary, the U.S. transferor ceases to be treated as owner of the trust (assuming that the transferor is not treated as grantor based on Code §§673 - 677), and the transferor is treated as making a transferor to foreign non-grantor trust, which triggers recognition of built-in gain in the trust assets under Code §684 (described above in paragraph III.C.7.c.III.C.7.c(2) on page 52).[96]

g. **Affirmatively causing a trust to be a foreign trust to trigger grantor trust status under Code §679**. As described above, Code §679 is intended to cause a foreign trust that would not otherwise be a grantor trust (because it does not contain any of the powers or interests that would cause a domestic trust to be a grantor trust under Code §§673-678) to be deemed owned by a U.S. person. Grantor trust status under Code §679 often is viewed as undesirable because it prevents U.S. grantors from establishing trusts in low tax jurisdictions and having income accumulate for eventual distribution to U.S. beneficiaries free of U.S. tax. If, however, grantor trust status becomes advantageous for a trust with a U.S. grantor and at least one U.S. beneficiary, it should be possible to cause the trust to be a grantor trust simply by making the trust a foreign trust. It is possible to convert a domestic

[94] *See* Treas. Reg. §1.679-2(a)(3)(i).
[95] *See* Treas. Reg. § 1.679-2(a)(3)(i).
[96] Specifically, the U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amt of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer to which Code §679 applied. *See* Treas. Reg. §1.679-2(c)(2).

trust into a foreign trust simply by giving a foreign person control over any substantial decision of the trust.[97]

(1) **Deemed disposition if trust becomes a non-grantor trust**. As described above at III.C.7.c.c(3) on page 52, if a foreign trust deemed owned by a U.S. person becomes a non-grantor trust, there will be a deemed transfer of the assets of the trust by the U.S. person to the foreign non-grantor trust, resulting in the recognition of any built in gain in the trust assets under Code §684. A deemed disposition under Code §684 always will be an risk if the settlor dies while the trust is a foreign trust. To mitigate this risk, it has been suggested that the trust remain invested in high basis assets or regularly sell assets to generate basis (which would coincide with a plan to have the grantor pay taxes on the trust's income).[98] It has also been suggested that a foreign person be given a power to control a substantial decision of a trust for only a limited period.[99]

8. **§672(f): Circumstances under which Subpart E will not result in ownership of trust assets by foreign person**.

a. **General rule**. Subpart E applies only to the extent its application results in income being taken into account in computing the income of a U.S. citizen or resident individual or a domestic corporation.[100]

(1) **Rationale**. It is relatively easy to make a trust a grantor trust under the rules of Subpart E addressed in the preceding portions of this outline. If a trust could easily be made a grantor trust deemed owned by a foreign person, the U.S. fisc could lose significant tax revenue. This is because distributions to beneficiaries would not carry out distributable net income, and the foreign grantor or other person treated as owner would be taxed only on US source income and income effectively connected to a U.S. trade or business.

b. **Exceptions**. Following are the limited circumstances in which a trust can be a grantor trust as to a non-U.S. person:

(1) **Exception 1 – Foreign grantor retains power to revoke trust and revest title to trust assets**. A foreign grantor will be treated as owner of any portion of a trust if the power to revest title to the trust property in the grantor is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf), either without approval of another person or with the consent of a related or subordinate party who is subservient to the grantor.[101]

(2) **Exception 2 – The only amounts distributable during grantor's lifetime are to grantor or grantor's spouse**. A foreign grantor will be treated as the owner of any portion of a trust from which the only amounts distributable (whether

[97] A trust is a domestic trust if it satisfies both the "court test" (described below) and the "control test") (described below). If either test is not satisfied, the trust will be a foreign trust. The court test generally will be satisfied if a court within the United States is able to exercise primary supervision over the administration of the trust. The control test will be satisfied if one or more U.S. persons have the authority to control all substantial decisions of the trust. If any substantial decision rests with a foreign person, the control test will be flunked, and the trust will be a foreign trust. *See* Code §§7701(a)(30) and 7701(a)(31) and Treas. Reg. §§301.7701-7.
[98] *See* Donaldson and Moore, *infra* at footnote 5.
[99] *See id*.
[100] *See* Code §672(f)(1).
[101] *See* Code §672(f)(2)(A)(i); Treas. Reg. §1.672(f)-3(a)(1).

income or corpus) during the grantor's lifetime must be to the grantor or the grantor's spouse.[102]

(3) **Exception 3 – Grandfather status**. If a trust was in existence on Sept. 19, 1995 and was treated as owned by the foreign grantor on that date either under Code §676 (revocable trust) or Code §677 (income may distributed to the grantor or the grantor's spouse, or accumulated for the benefit of grantor or grantor's spouse), other than Code §677(a)(3) (relating to payment of premiums on life insurance policy on life of grantor or grantor's spouse), the trust will be "grandfathered" and will continue to be treated as a grantor trust, deemed owned by a foreign person notwithstanding Code §672(f). The new Code § 672(f) rules, however, will apply to any gratuitous transfer made to the grandfather trust after Sept. 19, 1995.[103]

c. **Special rule where U.S. beneficiary made transfers to foreign grantor – Code §672(f)(5)**. If a foreign trust that would otherwise be treated as a grantor trust treated as owned by a foreign person has a U.S. beneficiary who has made (directly or indirectly) a transfer of property (other than in a sale for full and adequate consideration) to the trust, then such U.S. beneficiary will be treated as grantor of foreign trust to the extent of his gift to foreign transferor (with an exception for annual exclusion gifts).[104]

D. **Income Tax Consequences of Grantor Trust Status.**

1. **Items of income, deduction and credit taken into account by deemed owner**. A person who is identified as the deemed owner of a portion of a trust must take into account in computing his, her or its own taxable income the items of income, deduction and credit attributable to the portion of the trust.[105] The trust itself does not take these items of income, deduction and credit into account.

2. **Transactions between deemed owner and grantor trust disregarded**.

a. **Rev Rul 85-13**. In Rev. Rul. 85-13, the IRS ruled that a grantor who acquires the corpus of a trust (that prior to the transaction was not a grantor trust[106]) in exchange for the grantor's unsecured promissory note will be considered to have indirectly borrowed the trust corpus. As a result, the grantor is treated as owner of the trust under Code §675(3) (direct or indirect borrowing of the trust fund). The transfer of the trust's assets to grantor is not treated as a sale for federal income tax purposes.[107]

(1) Consequences of disregarding sale.

(a) **Realization of gain**. Because there is not considered to be a sale for federal income tax purposes, there is no realization of gain (or loss).

(b) **Basis**. Because the transaction is not a sale and no gain or loss is recognized, the grantor takes a carry-over basis in the assets acquired from the trust. (In the perhaps more common situation of a sale by grantor of assets to trust, the trust would take a carry-over basis in the assets transferred to it.)

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[102] *See* Code §672(f)(2)(A)(ii).

[103] *See* Pub. L., No. 104-188, §1904(d)(2); Treas. Reg. §1.672(f)-3(a)(3).

[104] *See* Code §672(f)(5).

[105] *See* Code §671; Treas. Reg. §1.671-2.

[106] In Rev. Rul. 85-13, the trust was not a grantor trust prior to the grantor's acquisition of the trust's corpus because Code § 674(b)(5)(B). This section provides that if a trust has a single beneficiary, the grantor (or the grantor's spouse) or a non-adverse party can have complete discretion to distribute corpus without rendering the trust a grantor trust. If a trust has only a single beneficiary, distributions of corpus will necessarily be charged against such beneficiary's "share" of trust corpus.

[107] *Cf. Rothstein v. United States,* 735 F.2d 704 (2d Cir. 1984).

(c) **Interest payments**. Interest payments made on the note given as consideration for the trust corpus are disregarded (*e.g.*, no inclusions to recipient of interest and no deductions to payor).

(2) **Transaction that renders the trust a grantor trust is itself disregarded**. One significant aspect of Rev. Rul. 85-13, is that the transaction that rendered the trust a grantor trust (*e.g.*, grantor's acquisition of corpus) is itself disregarded. It is not that this transaction is itself treated as a sale and then subsequent to this sale the trust is treated as a grantor trust.

b. **Examples of estate planning techniques where it is important for transaction between grantor and grantor trust to be disregarded**.

(1) **Sale of asset to grantor trust**. A grantor may sell an asset to a grantor trust for a number of reasons – *e.g.*, the grantor believes that the asset will appreciate, and the grantor wishes to remove future appreciation from her estate.

(2) **GRAT making in-kind annuity payments**. If a GRAT lacks sufficient liquid assets to make an annuity payment, the trustee may choose to make the annuity payment in-kind (rather than borrowing to make the annuity payment). If a GRAT was not a grantor trust and an annuity payment were made with appreciated property, gain would be recognized under Subchapter J.[108]

(3) **Transfers of life insurance policies**. If a grantor holds a life insurance policy, she may wish to transfer this policy to a life insurance trust in order to save estate taxes. In order to avoid application of the three-year rule of Code §2035, the grantor may wish to sell the policy to a life insurance trust. If the trust is not a grantor trust as to grantor, the grantor's sale of the life insurance policy to the trust could trigger the "transfer for valuable consideration" rule of Code §101(a)(2), in which case the proceeds of the life insurance policy (or a portion thereof) would not be tax-free to their recipient. However, in a case where grantor sells an insurance policy to a grantor trust, the sale will not trigger tax under Code §101.[109]

3. **Extent to which grantor trust is completely disregarded as to grantor**.

a. **Post-Rev. Rul. 85-13 Guidance**. In guidance following Rev. Rul. 85-13, the IRS has given expansive interpretation to Rev. Rul. 85-13, suggesting that a grantor trust should be disregarded as to its grantor for all federal income tax purposes.

(1) **CCA 201343021**. CCA 201343021 cites Rev. Rul. 85-13 for the proposition that, by retaining one or more powers over or interests in a trust described in Code § 671 *et seq*, the grantor has treated the property as their own. The CCA further notes that "Rev. Rul. 85-13 should be read broadly" and that a grantor trust should be disregarded if there is a "single identity of interest between the trust and the owner." It goes on to say:

"When a grantor or other person exercises dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the owner's benefit…the owner has treated the trust property as though it were the owner's property…*Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes*…" (emphasis added).

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108 While gain is generally not recognized when there is an in-kind distribution of appreciated property from a trust, a distribution in-kind made in satisfaction of a right to receive a specific dollar amount (*e.g.*, an annuity) would trigger recognition of gain. *See* Treas. Reg. §1.661(a)-2(f).

109 *See* Rev. Rul. 2007-13.

(2) **PLR 200228019**. PLR 200228019 addresses Section 101(a)(2), which denies favorable treatment for insurance policies that have been "transferred" for valuable consideration. In the PLR, the trustees of two grantor trusts (with the same grantor) proposed a sale between them of three policies on the grantor's life. In ruling the transfer for value rules did not apply to the transaction, the Service specifically noted that "the transfer of the policies is disregarded for federal income tax purposes." [110]

b. **Legislative Proposal**. A proposal released on September 13, 2021 by the House Ways and Means Committee would have caused sales and other exchanges between a grantor and a grantor trust (other than a revocable trust) to be regarded for income tax purposes, overturning Rev. Rul. 85-13 legislatively. The proposal was not included in a corresponding 2021 Senate bill or in the Inflation Reduction Act of 2022, which incorporated certain provisions of the 2021 bills and was signed into law in August 2022.

4. **Income tax consequences of terminating grantor trust status**.

a. **Termination of grantor trust status during grantor's lifetime**.

(1) **Recognition of gain if debt in excess of basis**. If a trust that is a grantor trust becomes a non-grantor trust during the grantor's lifetime (*e.g.*, because one of the actions described above is taken to turn grantor trust status "off"), there is a deemed transfer of the assets held by the grantor trust to a non-grantor trust. If, at the time of the deemed transfer, the trust or its assets are encumbered by liabilities in excess of the trust's basis in its assets or partnership interests with negative capital accounts, the deemed transfer will result in taxable gain. This is because the grantor will be considered to be relieved of these liabilities upon the deemed transfer (based on the principles of *Crane v. Comm'r*[111] and *Comm'r v. Tufts*[112]), and the debt relief exceeds the basis in the trust's assets.[113].

(a) **GRAT termination**. Just as turning "off" the grantor trust status of a trust likely will result in gain recognition if the trust has liabilities in excess of its basis in its assets, an actual transfer of assets from a grantor trust to a non-grantor trust likely will result in gain recognition if the transferor trust has liabilities in excess of the basis of its assets. The IRS has ruled that the transfer of assets from a GRAT to a remainder trust that was not a grantor trust resulted in gain recognition where the GRAT's annuity payments had been funded with loans from another trust, and, at the termination of the GRAT, the amount of these loans exceeded the GRAT's basis in its assets.[114]

b. **Termination of grantor trust status by reason of grantor's death**.

(1) **In general**. If an irrevocable grantor trust becomes a non-grantor trust by reason of the grantor's death and, at the time of the grantor's death, the trust's assets are encumbered by liabilities in excess of basis, the tax consequences are not clear.

[110] Cf. Rev. Rul. 78-175. In Rev. Rul. 78-175, a grantor trust and its deemed owner were not treated as one and the same for purposes of the Section 465 at-risk rules. The ruling addressed a grantor trust that purchased an oil and gas interest from a third party in exchange for (i) cash originally contributed by the grantor and (ii) a promissory note providing for full recourse against the trust's assets. The IRS concluded that the grantor could deduct losses from the oil and gas interest only to the extent of the cash originally contributed to the trust. The IRS reasoned that the grantor had no personal liability on the note and therefore was not "at risk" with respect to those amounts. While Rev. Rul. 78-175 predates the more favorable guidance in Rev. Rul. 85-13, it has not been withdrawn by the IRS.
[111] 331 US 1 (1947).
[112] 461 US 300 (1983).
[113] *See* Treas. Reg. §1.1001-1(e) (example 5), *Madorin v. Comm'r*, 84 T.C. 667 (1985) and Rev. Rul. 77-402, 1977-2 C.B. 222.
[114] *See* Tech. Adv. Mem. 200010010 (March 13, 2000).

The authorities described above do not specifically address the cessation of grantor trust status by reason of the grantor's death, and commentators have different views about whether gain is recognized in such a case.[115] Commentators also disagree about whether the grantor's death gives rise to a basis step up under Code §1014.[116]

(a) **Cf revocable trust**. If a revocable trust (a grantor trust under Code §676 during the grantor's lifetime) becomes a non-grantor trust by reason of the grantor's death and, at the time of the grantor's death, the trust's assets are encumbered by liabilities in excess of basis, gain should not be recognized. Any deemed transfer from a grantor trust to a nongrantor trust should be a testamentary transfer, not subject to income tax.[117] In addition, the basis in the assets held by the trust will be entitled to a basis step up under Code §1014.[118]

(2) Special issues related to installment sales.

(a) **Installment sale technique**. One popular estate planning technique is an installment sale to a grantor trust. Typically, a grantor will sell an asset that he or she expects to appreciate to a grantor trust, in exchange for a promissory note. Based on Rev. Rul. 85-13, the sale will not be a recognition event for income tax purposes, and there will be no income tax consequences to interest payments on the promissory note.[119] The goal of an installment sale to a grantor trust is to "freeze" the value of the assets in the grantor's estate at the principal amount of the note, plus interest, with appreciation in the asset that is sold inuring to the benefit of the irrevocable trust.

(b) **Additional income tax issues**. If a grantor who undertakes an installment sale to a grantor trust dies while the promissory note is outstanding, as described above, there is uncertainty as to whether gain will be recognized and whether the trust assets will be entitled to a step up in basis.[120] In addition, although the transfer of the note held by the grantor to her estate will not itself be a taxable disposition,[121] there is some uncertainty regarding the tax treatment of payments that are made on the note. Specifically, it is unclear whether payments on the note made to the grantor's estate or its beneficiaries are IRD.[122]

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[115] *See e.g.*, Carol A. Cantrell, Gain is Realized at Death, *Trusts & Estates* (February 2010); Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, *Journal of Taxation*, (September 2002); and Deborah Dunn and David Handler, Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates, *Journal of Taxation* (July 2001). For example, Blattmachr, Gans and Jacobson believe that *Crane v. Comm'r*, *infra* at footnote 111 and that language in the preamble to Treasury Regulations under Code §684 support the position that gain is not recognized if grantor trust status terminates by reason of the grantor's death. Cantrell, on the other hand, believes that Rev. Rul. 77-402, *infra* at footnote 113, supports the position that gain may be recognized if grantor trust status ends as a result of the grantor's death. See also CCA 200923024 (June 5, 2009), which indicates that death generally is not treated as an income tax event.

[116] *See id*. *See also* CCA 200937028 (Sept. 11, 2009), which indicates that property held in an irrevocable trust that is not includible in the grantor's gross estate is not entitled to basis step up under Code §1014.

[117] *See e.g., Crane v. Comm'r, infra* at footnote 111.

[118] *See* Code §1014(b)(9); Treas. Reg. §1.1014-2(a)(1).

[119] 1985-1 CB 184.

[120] Such gain may equal to the amount by which the outstanding liability on the note exceeds the trust's basis in its assets, as described above in part . Alternatively, in a case of an outstanding installment sale, commentators have posited that other amounts of gain may be recognized. *See* Cantrell, *infra* at footnote 113.

[121] *See* Code §453B(c).

[122] *See* Cantrell; Blattmarchr, Gans and Jacobson; and Dunn and Handler, all *infra* at footnote 113.

IV. Decanting [123]

A. Introduction.

The term "decanting" generally refers to the distribution by the trustee of an irrevocable trust of trust property to a new trust which contains terms different from the original trust. There is some basis for decanting in common law.[124] However, the authority of a trustee to decant trust property more often comes from a state statute. At present, at least 26 states have decanting statutes, including states that have adopted the Uniform Trust Decanting Act.[125] In some cases, a provision in a trust agreement or Will creating a trust also can provide the authority to decant. Decanting can be a useful tool in a variety of situations, including to modify trustee succession provisions, change the termination date of a trust, respond to changes in tax law and fix a scrivener's error.

B. IRS guidance on tax consequences of decanting.

1. **IRS Notice 2011-101**. On December 20, 2011, the IRS issued Notice 2011-101, requesting comments regarding the income, gift, estate and generation-skipping transfer tax consequences of decanting. According to the Notice, the IRS is studying the tax implications of decanting distributions that result in changes in beneficiaries' interests and plans to issue published guidance. Pending the release of this published guidance, the IRS will not issue private letter rulings in connection with decanting transactions that change beneficiaries' interests in a trust.

2. **IRS Priority Guidance Plan**. Decanting was included on the 2011-2012 IRS Priority Guidance Plan but has not been included on more recent versions of the Priority Guidance Plan. According to Treasury representatives, decanting was removed from the Priority Guidance Plan given that guidance will take time to prepare and is not reasonably expected to be issued within the current plan year.[126]

C. Expected income tax consequences of decanting.

Until Treasury issues guidance, there will be uncertainty regarding the tax consequences of decanting. Following is a discussion of the expected income tax consequences of decanting based on guidance that has been issued in other contexts and general tax principles. For purposes of this discussion, the trust from which assets are distributed is referred to as the "Distributing Trust," and the trust receiving the assets is referred to as the "Receiving Trust."

Part 1 below addresses issues relating to the fiduciary income tax consequences of a decanting distribution. Part IV.C.2 addresses gain recognition by the beneficiaries of the Distributing Trust or by the Distributing Trust itself. Part 3 addresses the identity of the grantor following the distribution.

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[123] Two of the authors of this outline were involved in the preparation of the New York State Bar Association Tax Section and Trust and Estate Law Section Report on Notice 2011-101 (April 26, 2012) (the "NYSBA Report") and were the principal drafters of the parts of the NYSBA Report dealing with the income tax consequences of decanting. Portions of section IV of this outline are taken from the NYSBA Report.

[124] *See e.g., Phipps v. Palm Beach Trust Co*, 196 So. 299 (Fla. 1940); *In re Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975); *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969); *Morse v. Kraft*, 466 Mass. 92 (2013); and *Ferri v. Powell-Ferri*, 476 Mass 651 (2017).

[125] States that have adopted decanting statutes include the following (listed in the order in which the statutes first were adopted): New York, Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, Arizona, North Carolina, Nevada, Indiana, Missouri, Ohio, Virginia, Kentucky, Rhode Island, Michigan, Illinois, Wyoming, Texas, South Carolina, Wisconsin, Minnesota, New Mexico, Colorado and Washington.

[126] Comments of Catherine V. Hughes at American Bar Association section of Real Property Trust & Estates Law meetings in May 2013 and September 2013, as reported by Marie Sapirie in Tax Notes Today (May 13, 2013) and by Diane Freda in the BNA Daily Tax Report (September 23, 2013), respectively.

1. **Fiduciary income tax consequences**.

a. **Application of general rules of Subchapter J to a decanting distribution**. Under the rules of Subchapter J of chapter 1 of the Code, a distribution from a complex trust generally will carry out a share of the trust's distributable net income, or DNI, to the beneficiary to whom the distribution is made.[127] The beneficiary, in turn, generally will be required to include in gross income an amount equal to the share of the DNI carried out from the trust.[128] If the trust making the distribution is a foreign trust, the distribution also may carry out a share of the trust's undistributed net income, or UNI, which will be taxed to the beneficiary as an accumulation distribution, subject to an interest charge.[129]

There does not appear to be any authority that specifically provides that the rules of Subchapter J apply to a decanting distribution from a Distributing Trust to a Receiving Trust. However, the Treasury Regulations and case law indicate that a trust can be a beneficiary of another trust, with the rules of Subchapter J applicable to a distribution to the beneficiary trust.[130] As a general rule, it seems logical for the rules of Subchapter J to apply to a decanting distribution from one trust to another trust.

b. **Exception if all assets of Distributing Trust are distributed to Receiving Trust**. An exception to the application of the general rules of subchapter J to a decanting distribution may be appropriate when all of the assets of a Distributing Trust are distributed to a Receiving Trust having substantially similar terms. In this case, it seems appropriate to view the Receiving Trust simply as a continuation of the Distributing Trust, such that the distribution to the Receiving Trust does not carry out DNI (or UNI if the Distributing Trust is a foreign trust). This result is consistent with the conclusion reached by the IRS in Private Letter Ruling 200607015.[131]

(1) **Tax attributes**. If all of the assets of a Distributing Trust are distributed to one or more Receiving Trusts, there also is a question as to whether the Receiving Trust or Trusts should succeed to the Distributing Trust's tax attributes, such as its net operating loss carryovers, its capital loss carryovers and its foreign tax credit carryovers. The Code specifically provides that on the termination of a trust, unused net operating loss carryovers and capital loss carryovers pass out to the trust's beneficiaries.[132] There does not appear to be specific authority addressing the transfer of other tax attributes to beneficiaries upon the termination of a trust. At a minimum, if all of the assets of a Distributing Trust are distributed to a Receiving Trust that has substantially similar terms and that is viewed as a continuation of the Distributing Trust, it would seem appropriate for the Receiving Trust should succeed to all of the Distributing Trust's tax attributes.[133]

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[127] Code § 661.
[128] Code § 662.
[129] Code §§ 665-668.
[130] *See* Treas. Reg. § 1.643(c)-1, (providing that for purposes of Part I of Subchapter J (which includes the fiduciary income tax rules described above), a beneficiary includes an "heir, legatee or devisee (*including an estate or trust*)" (emphasis added)). *See also Duke v. Comm'r*, 38 BTA 1264, 1269 (1938); *Comm'r v. Bishop Trust Co.*, 136 F2d 390 (9th Cir. 1943) (affirming 42 BTA 1309 (1940)); *Harwood Estate v. Comm'r*, 3 TC 1104 (1945); *White Estate v. Comm'r*, 41 BTA 525 (1939); *Lynchburg Tr. & Sav. Bank v. Comm'r*, 68 F2d 356 (4th Cir. 1934).
[131] (Feb. 17, 2006). *See also* Priv. Ltr. Rul. 200723014 (June 8, 2007); Priv. Ltr. Rul. 200527007 (July 8, 2005).
[132] Code § 642(h); Treas. Reg. § 1.642(h)-3(d).
[133] Allowing a Receiving Trust to succeed to the tax attributes of a Distributing Trust, even if the terms of the trusts are not substantially similar, would be consistent with other areas of the tax law. For example, if a private foundation transfers all of its assets to one or more private foundations that are effectively controlled by the same persons that control the transferor private foundation, the transferee private foundation is treated as if it were the transferor for purposes of Chapter 42 of the Code. *See* Treas. Reg. § 1.507-3(a)(9). Similarly, in the case of a corporate reorganization, a successor corporation generally succeeds to the tax attributes of a terminating corporation. *See* Code § 381.

2. **Gain recognition** . In a number of Private Letter Rulings, the IRS has addressed whether a distribution from one trust to another trust causes gain to be recognized under Code §1001.[134] In considering possible gain recognition on such a distribution, there are two separate issues – first, whether gain should be recognized by the beneficiaries of the Distributing Trust, and second, whether gain should be recognized by the Distributing Trust itself.

a. **Gain recognition by beneficiaries.**

(1) ***Cottage Savings***. As a general matter, gain or loss is realized under Code §1001 upon the conversion of property into cash or upon the exchange of property for other property that differs materially in either kind or extent.[135] In *Cottage Savings v. Comm'r*,[136] the U.S. Supreme Court adopted a liberal test for when property received in an exchange would be considered to be materially different from the property transferred. The Court determined that "properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or in extent."[137]

(2) **Private Letter Rulings released after *Cottage Savings***. A number of Private Letter Rulings released after the *Cottage Savings* decision suggest that a distribution from one trust to another might constitute a taxable exchange of an interest by each beneficiary of a Distributing Trust for an interest in a Receiving Trust if the beneficiary's new interest is "materially different" from its old interest.[138] In each of these rulings, the IRS found that the beneficiary's interests in the two trusts were not materially different and therefore that the beneficiary did not recognize gain. Even in a situation where a beneficiary's interests in a Distributing Trust and a Receiving Trust do differ materially, a decision by a trustee to decant trust property should not result in gain recognition to the beneficiary. Unlike a holder of securities in *Cottage Savings*, a beneficiary of a trust that is decanted by a trustee has not exchanged any interest. Rather, the trustee has taken the action that causes the property to be distributed from the Distributing Trust to the Receiving Trust.

Other Private Letter Rulings issued by the IRS have been consistent with this view. These rulings indicate that a beneficiary will not recognize gain in the case of a distribution to another trust that is authorized by the trust instrument or by local law.[139] These rulings also are consistent with Treas. Reg. §1.1001-1(h), which provides that a non-pro rata severance of a trust does not constitute an exchange of property for other property differing materially either in kind or extent if applicable state law or the governing instrument authorizes the severance and the non-pro rata funding.

(3) ***Rev. Rul. 69-486***. The only authority that suggests that gain may be recognized by a beneficiary on a distribution from one trust to another is Rev. Rul. 69-486.[140] This Revenue Ruling indicates that a distribution may result in gain recognition to a beneficiary in a narrow set of circumstances, specifically where the distribution (1) occurs as a result of an agreement by the beneficiaries and, in

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[134] *See also* Priv. Ltr. Rul. 200227020 (July 7, 2002); Priv. Ltr. Rul. 9450036 (Dec. 16, 1994); Priv. Ltr. Rul. 9332014 (May 14, 1993).
[135] *See* Treas. Reg. § 1.1001-1(a).
[136] 499 U.S. 554 (1991).
[137] *Id*. at 565.
[138] *See, e.g.*, Priv. Ltr. Rul. 201207001 (Feb. 17, 2012); Priv. Ltr. Rul. 201136014 (Sept. 9, 2011); Priv. Ltr. Rul. 199951028 (Sept. 28, 1999).
[139] *See, e.g.*, Priv. Ltr. Rul. 201204001 (Jan. 27, 2012); Priv. Ltr. Rul. 201133007 (Aug. 19, 2011); Priv. Ltr. Rul. 201134017 (Aug. 26, 2011).
[140] 1969-2 CB 159.

addition, (2) is not authorized under the terms of governing instrument or applicable state law.[141] Accordingly, based on Rev. Rul. 69-486, even in a situation where beneficiaries act to effectuate a distribution from one trust to another or where their consent to the distribution is required as a matter of law, gain should not be recognized as long as the distribution is authorized under the terms of the governing instrument or local law. This conclusion is consistent with *Cottage Savings*, given that, in such a situation, the beneficiaries' legal entitlements in the Distributing Trust include the right to have assets distributed to the Receiving Trust.[142]

b. **Gain recognition by Distributing Trust**. In addition to the question of whether gain may be recognized by beneficiaries in connection with a decanting (discussed above), there also is a question as to whether a Distributing Trust recognizes gain when appreciated trust assets are distributed to a Receiving Trust.

(1) **In general, no gain recognition**. As a general matter, for the reasons described below, no gain should be recognized by a Distributing Trust when it transfers appreciated assets to a Receiving Trust. If both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person for income tax purposes,[143] no gain should be recognized on the distribution based on principles of Revenue Ruling 85-13.[144]

Regardless of whether the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, no gain should be recognized for the same reason that no gain is recognized when a settlor transfers property to a domestic non-grantor trust. There is no amount realized by the settlor, because the settlor is considered to receive nothing in exchange for the transfer. Nonrecognition treatment also is consistent with CCA 200923024[145] and PLR 201730012[146], both of which conclude that the conversion of a nongrantor trust to a grantor trust is not a transfer of property that requires gain to be recognized.

(2) **Exceptions to general nonrecognition rule**. There are two possible exceptions to the general result of nonrecognition when a Distributing Trust transfers appreciated property to a Receiving Trust.

(a) **Receiving Trust is a foreign nongrantor trust**. Under Code §684, if a U.S. person transfers property to a foreign nongrantor trust, the transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred, with the transferor recognizing gain. Accordingly, a distribution of appreciated assets from a Distributing Trust that is a domestic trust to a Receiving Trust that is a foreign nongrantor trust will result in gain recognition under Code §684. The existence of Code §684 is consistent with a general rule that gain should not be recognized on a transfer of appreciated property to a Receiving

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[141] Even in a situation where a distribution from one trust to another occurs as a result of an agreement by beneficiaries and is in contravention of the terms of a trust agreement or local law, if the beneficiaries' interests in the Distributing Trust and the Receiving Trust are discretionary rather than fixed, it would be difficult to conclude that the beneficiaries' legal entitlements have been modified. A discretionary beneficiary generally has no legal entitlement to trust distributions.

[142] *See also* Treas. Reg. § 1.1001-3(c)(1)(ii), which provides that an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument generally is not a modification of the instrument that will cause recognition under Code § 1001, whether the alteration occurs automatically by operation of the terms of the debt instrument or whether it occurs as a result of the exercise of an option provided to an issuer or a holder to change the terms of the instrument.

[143] *See* Code §§ 671-679.

[144] 1985-1 CB 184.

[145] June 5, 2009.

[146] July 28, 2017.

Trust. If such a transfer were generally to result in the recognition of gain, the special rule of Code §684 would not be necessary.

(b) **"Negative basis" or negative capital account property**. Another possible situation in which gain may be recognized on a transfer of property from a Distributing Trust to a Receiving Trust is where the property that is transferred is encumbered with debt in excess of basis or is a partnership interest with a negative capital account. In this case, gain may result based on principles of *Crane v. Commissioner*.[147] In *Crane v. Commissioner*, the Supreme Court held that a taxpayer's amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged.[148] Based on *Crane*, the IRS has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts.[149]

i. **Code §643(e)**. It is not clear, however, that *Crane* and its progeny apply to cause gain to be recognized on a distribution of "negative basis" or negative capital account property from a nongrantor trust. This uncertainty is created by Code §643(e), which provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust.[150] There does not appear to be any authority as to whether *Crane* overrides Code §643(e).[151] However, regardless of whether *Crane* trumps Code §643(e), if all of the assets of a Distributing Trust are distributed to a Receiving Trust that is viewed as a continuation of the Distributing Trust (as described above in part 1.b) or if both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, gain should not be recognized on the distribution.

3. **Identity of the Grantor**. If property is distributed from one trust to another trust, it is important to be able to identify the "grantor" of the Receiving Trust for income tax purposes. Among other reasons, identifying the grantor of the Receiving Trust may be necessary in order to determine whether the Receiving Trust is a grantor trust under Code §§671 through 679.

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[147] 331 U.S. 1 (1947).

[148] *See also* Treas. Reg. § 1.1001-2(a)(1) ("the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.")

[149] *See, e.g.*, Treas. Reg. § 1.1001-1(e) (example 5); Tech. Adv. Mem. 200010010 (March 13, 2000); *see also Madorin v. Comm'r*, 84 T.C. 667 (1985).

[150] Code § 643(e) is not applicable in a case where the Distributing Trust is a grantor trust. This is because Code § 643(e) applies for purposes of Subparts A, B, C and D of Part I of Subchapter J. The grantor trust rules are found in Subpart E of Part I of Subchapter J. Accordingly, in the case of a distribution of property encumbered with debt in excess of basis or negative capital account partnership interests from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under principles of *Crane*.

[151] Under Code § 643(e), gain is recognized on a distribution of appreciated property from a trust if an election is made to recognize gain under Code § 643(e)(3) or if the distribution of appreciated property is made in satisfaction of a pecuniary amount. Code § 643(e)(1) provides that "the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) *any gain* or loss *recognized by the* estate or *trust on the distribution*" (emphasis added). It is not clear whether the basis increase in respect of gain recognized on the distribution relates only to a basis increase resulting from gain that is recognized as a result of the application of Code § 643 (*e.g.*, because an election is made to recognize gain under Code § 643(e)(3)).

Similar uncertainty exists in other situations, such as where an installment note is transferred from a Distributing Trust to a Receiving Trust that is not a grantor trust deemed owned by the same person. In such a case, it is not clear whether Code § 453B(a) would override Code § 643(e) and cause gain to be recognized.

a. **Grantor of Distributing Trust generally remains grantor of Receiving Trust**. Treas. Reg. §1.671-2(e)(5) provides that if a trust makes a transfer to another trust, the grantor of the Distributing Trust generally will be treated as the grantor of the Receiving Trust.

b. **Exception**. If property is distributed from a Distributing Trust to a Receiving Trust pursuant to the exercise of a general power of appointment, the person exercising the power of appointment will become the grantor of the Receiving Trust. See Treas. Reg. §1.671-2(e)(5). This result is consistent with Code §2514, which provides that a person who exercises a general power of appointment will be treated as making a transfer of property for gift tax purposes. Because a decanting distribution is not made pursuant to the exercise of a general power of appointment by the trustee of a Distributing Trust, in the case of decanting distribution, the grantor of the Distributing Trust generally should continue to be the grantor of the Receiving Trust.

V. Charitable Lead Trusts.

A. In general.

A charitable lead trust ("CLT") refers to a trust which has a charitable lead interest of a guaranteed annuity or a unitrust amount and a noncharitable remainder interest. There are two types of CLTs – non-grantor CLTs and grantor CLTs. The requirements for a charitable lead interest generally are similar to the CRT requirements with some exceptions. (1) There is no minimum 5% payout requirement for a CLT. (2) The permissible term of the charitable lead interest may refer to one or more measuring lives plus a term of years. *See* Rev. Proc. 2007-45; Treas. Reg. 25.2522(c)-3(c)(2)(vi)(a) (limitation on who may be used as a measuring life to prevent abuse). (3) A prepayment clause in a CLT is not permitted. Rev. Rul. 88-27.

Practice note. Rev. Proc. 2007-45 and Rev. Proc. 2007-46 are very important when preparing a CLT, which provide safe harbors for practitioners. Rev. Proc. 2007-45 provides annotated, sample inter vivos (grantor or nongrantor) CLAT instruments while Rev. Proc. 2007-46 provides an annotated, sample testamentary CLAT. Both Revenue Procedures provide practitioners with a blueprint on how to properly design a CLAT.

B. Non-grantor CLT.

1. **General income tax consequences.** The general income tax consequences of a non-grantor CLT are as follows:

a. **CLT.**

(1) A CLT is its own taxable entity.

(2) A CLT is allowed an ongoing deduction to the extent that the annuity or unitrust payments are made to charity, satisfying the requirements of Code §642(c). Note that there is no limitation on the amount that may be deductible by the CLT under Code §642(c), meaning that the CLT can deduct 100% of the income to the extent it is paid to charity.

(3) Unlike for CRTs, there is no tier system to determine the nature of the income recognized by the CLT which is distributed to the lead charitable beneficiary. In the absence of specific provisions in the governing instrument or local law that determine the makeup of each annuity payment (which have independent economic effect), payments to charitable lead beneficiaries consist of the same proportion of each class of the items of income of the CLT as the total of each class bears to the total of all classes. Treas. Regs. §§1.643(a)-5(b), 1.662(b)-2 and 1.642(c)-2(b)(2). Therefore, to the extent the payment is deemed to be made up of capital gain or tax-exempt income, the trust may lost the benefit of the charitable deduction. *See* Zaritsky, Section 5.05[3][g], Charitable Lead Trusts, Tax Planning for Wealth Transfers During Life: Analysis with Forms (WG&L).

(4) Under Code §681, the charitable distribution deduction under Code §642(c) does not apply with respect to income of the taxable year which is allocable to the CLT's UBTI as calculated under Code §512 as if the CLT were tax exempt under Code §501.

b. **Donor.** There is no upfront charitable income tax deduction for the donor.

2. **Purposes of non-grantor CLTs.** Although there is no income tax charitable deduction for a donor's gift to a non-grantor CLT, the advantages are as follows:

a. The donor receives a gift tax charitable deduction equal to the actuarial value of the charitable lead interest, which is based on the Code §7520 rates. Therefore, a donor may employ a CLT where the donor wishes to make a lifetime or testamentary transfer while paying little or no gift or estate tax. In general, a lower Code §7520 interest rate results in a larger charitable gift tax or estate tax deduction because the annuity or unitrust interest is more likely to need to invade principal for the benefit of the charity.

b. The appreciation of the trust principal and income not used to pay the charitable lead interest is excluded from the donor's estate (although the remainder beneficiary does not have access to the property until years later).

c. Even where the donor has reached the limit on income tax deductibility from other charitable gifts, the donor can obtain an income tax advantage from funding the CLT since the income of a CLT is not included in the donor's gross income.

3. **Disadvantages of non-grantor CLTs.** The disadvantages of a non-grantor CLT are as follows:

a. There is no income tax charitable deduction for the contribution of the charitable lead interest in a CLT.

b. A charitable lead trust is its own taxable entity, which is not tax-exempt. Any taxable income in excess of the charitable annuity or charitable unitrust amount is subject to income tax.

c. The noncharitable remainder interest is a gift of a future interest (which does not qualify for the gift tax annual exclusion), which will use up a donor's gift tax exemption or, if the donor's exemption is exhausted, require the payment of gift tax (unless the charitable deduction is equal to the value of the trust corpus).

d. There are strict technical requirements for a CLT.

e. A CLT is subject to the private foundation rules on self-dealing, taxable expenditures and, if the charitable deduction allowed at inception of the trust exceeds 60 percent of the value of the trust assets, excess business holdings and jeopardy investments. Code §4947(a)(2), (b)(3).

C. **Grantor CLTs.**

1. **General income tax consequences.** The general income tax consequences of a grantor CLT are as follows:

a. **CLT.** The CLT is transparent for income tax purposes, meaning that all CLT income is attributed to the donor.

(1) There is no charitable contribution deduction as the annuity or unitrust amount is paid to charity. Therefore, income earned by the trust is fully reported by the donor as taxable income.

(2) The donor will have phantom income every year because the CLT income will be paid to charity to satisfy the annuity or unitrust payment, which will be reported as taxable income on the donor's income tax return.

b. **Donor.** The donor receives an upfront charitable income tax deduction in an amount equal to the present value of the charitable lead interest. Code §170(f)(2)(B); Treas. Reg. §1.170A-6(c)(1). Such charitable income tax deduction is subject to the Code §170(b) limitations for individuals. The 30% limitation under Code §170(b) would apply because the contribution to the CLT is "for the use of" charity, but if the CLT is funded with long-term capital gain property, then the 20% limitation under Code §170(b) would apply.

c. **Upon the donor's death during the CLT term.** If the donor dies during the term of the CLT, the donor must recapture some of the charitable contribution deduction by reducing the upfront deduction. *See* Code §170(f)(2)(B); Treas. Reg. §1.170A-6(c)(4). Note that there is a conflict between the Code and the Regulations regarding the description of the recapture. Code §170(f)(2)(B) provides that the upfront deduction should be recaptured "by the discounted value of all amounts of income earned by the trust and taxable to [the donor] before the time at which [the donor] ceases to be treated as the owner of the interest" whereas Treas. Reg. §1.170A-6(c)(4) provides that the upfront deduction should be "reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest" (which would include tax free income even if the grantor did not pay tax on it). After the donor dies, the CLT falls under the non-grantor CLT regime.

2. **Drafting considerations in forming a grantor CLT**.

a. **Estate tax inclusion.** When drafting a CLT, use caution to avoid estate tax inclusion of the CLT. As an example, if the grantor of a CLT is the trustee and the grantor-trustee has the power to add charitable beneficiaries of the CLT, then such power would cause estate tax inclusion under Code §2036. *See e.g., Rifkind v. U.S.*, 5 Cl. Ct. 362 (1984) (The court held that the CLT assets were includible under Code §2036 where the grantor of CLT was not a trustee but the CLT made mandatory charitable payments to the grantor's foundation and the grantor was a director of the foundation and could participate in selecting charitable recipients. Note that the grantor had renounced his directorship of the foundation but had died within three years, so Code §2035 applied).

b. **Grantor trust status - power over the entire trust.** The CLT must qualify as a grantor trust under Subpart E over the entire trust for the donor to receive a charitable income tax deduction for the lead charitable interest.

c. **Grantor trust status - power to substitute assets.** A CLT cannot include a power to substitute assets by the grantor in order to trigger grantor trust status. *See* Code §675(4); Rev. Proc. 2007-45. If a charity's interest exceeds 60% in the CLT, then it is treated as a private foundation for all of the excise taxes including self-dealing under Code §4941. If the donor substitutes assets out of the CLT, then this results in self-dealing since it is considered a transaction between a private foundation and a disqualified person. Rev. Proc. 2007-45 supports that the CLT may give someone besides the grantor or disqualified person a power to substitute assets out the CLT, which will trigger grantor trust status. As an alternative, a grantor may be granted powers triggering grantor trust status only with respect to the remainder interest as long as remainder interest's value is at least 5% of entire trust corpus so that the power over the remainder interest is considered to apply to the entire trust.

d. **Shark fin CLAT.** Rev. Proc. 2007-45, referenced above, expressly notes that the annuity amount may be an "increasing amount for which the value is ascertainable at the creation of the trust." *See also* Treas. Reg. §20.2055-2(e)(2)(vi)(a). However, unlike with grantor retained annuity trusts ("GRATs"), where there is a specific rule that the GRAT annuity payments cannot increase by more than 20% each year (*see* Treas. Reg. §25.2702-3), there is no guidance on how much the annuity amounts can vary with respect to a CLAT. Therefore, arguably, there is more flexibility with respect to the variability of the annuity amounts for a CLAT. Shark fin CLATs take this flexibility to the extreme by providing for very low annuity payments for a long term or life interest and then provide for a large payment at the end of the CLAT term.

VI. Charitable Remainder Trusts (Code §664).

A. In general.

In general, a charitable remainder trust ("CRT") is a form of split interest trust where at least one beneficiary of the lead interest is noncharitable and the remainder interest benefits charity. Specifically, a CRT must distribute an amount, not less than annually, to one or more persons, at least one of which is a noncharitable beneficiary, for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. All other amounts (*i.e.*, the remainder interest) must pass to a charitable beneficiary or be held in a continuing trusts for charitable purposes.

B. Two types of CRTs.

There are two types of CRTs – charitable remainder annuity trusts and charitable remainder unitrusts. A charitable remainder annuity trust pays out a fixed amount each year while a charitable remainder unitrust pays out a percentage of the trust assets each year, meaning that this amount fluctuates over time. In order to qualify as a CRT, the trust must meet the definition of a CRT from the creation of the trust. *See* Treas. Reg. §1.664-1(a)(4).

1. **Charitable remainder annuity trust ("CRAT").** A charitable remainder annuity trust must meet the following requirements under Code §664(d)(1):

   a. **Annuity amount.** The annuity amount (a sum certain or sum certain stated as a fraction or percentage) must not be less than 5% or more than 50% of the initial net fair market value of the property placed in trust initially. *See* Code §664(d)(1)(A).

   b. **Timing of annuity payments.** The annuity amount must be paid at least annually. *See* Code §664(d)(1)(A).

   c. **Term of annuity**. The annuity term cannot extend for more than 20 years **or** for the life or lives of an individual(s) living at the time of the creation of the trust. *See* Code §664(d)(1)(A). As an example, the governing instrument may not allow the payment of an annuity to A for his life and then to B for a term of years because it is possible for the period to last longer than (i) either of the lives of the beneficiaries in being at the inception of the trust or (ii) a term of years not to exceed 20 years. Treas. Reg. §1.664-2(a)(5)(i). On the other hand, the governing instrument may allow the payment of an annuity to A for his life and then to B for his life or a term of years not to exceed 20 years, whichever is shorter (but not longer), if both A and B were in being at the inception of the trust since it is not possible for the period to last longer than the lives of the beneficiaries in being at the inception of the trust. *Id.*

   d. **Permissible beneficiaries of the annuity.** There must be at least one noncharitable beneficiary of the annuity interest. *See* Code §664(d)(1)(A). Besides the annuity payments, the trust cannot make payments to anyone other than Code §170(c) organizations. *See* Code §664(d)(1)(B).

   e. **Remainder interest.** The remainder interest must be transferred to or held for the use of Code §170(c) organizations. *See* Code §664(d)(1)(C).

   f. **Value of the remainder interest**. The charitable remainder interest must be at least 10% of the net fair market value of the property placed in trust initially**.** *See* Code §664(d)(1)(D).

g. **Additional contributions prohibited.** A donor cannot make an additional contribution to a CRAT after the initial contribution. *See* Treas. Reg. §1.664-2(b). All property passing to a CRAT by reason of the death of the grantor is considered one contribution. *Id.*

2. **Charitable remainder unitrust ("CRUT").** In addition to meeting the requirements under paragraph 1(b)-(e) of this Section above, a charitable remainder unitrust must meet the following requirements under Code §664(d)(2):

a. **Unitrust amount**. A CRUT must pay a fixed percentage which is not less than 5 percent or more than 50 percent of the net fair market value of its assets, valued annually**.** *See* Code §664(d)(2)(A).

b. **Additional contributions are permitted.** Unlike with respect to a CRAT, a donor can make additional contributions to a CRUT. Treas. Reg. §1.664-3(b).

c. **Value of the remainder interest**. With respect to each contribution of property to the trust, the value of the charitable remainder interest in such property must be at least 10% of the net fair market value of such property on the date of contribution to the trust**.** *See* Code §664(d)(2)(D).

d. **Two additional types of CRUTs.** There are two types of CRUTs – a net income CRUT ("NICRUT") and a net income with makeup CRUT ("NIMCRUT").

(1) **NICRUT**. A NICRUT refers to where the trustee is directed to pay the net trust income to the lead beneficiary if the amount of the net income is less than the unitrust amount (*i.e.*, it pays the lesser of the unitrust amount or net income of the trust). *See* Code §664(d)(3)(A).

(2) **NIMCRUT**: A NIMCRUT refers to where the trustee is directed to pay the lesser of the unitrust amount or net income of the trust, but when the net income of the trust exceeds the unitrust amount, the trustee may pay over that excess amount to the lead beneficiary to the extent that the amounts paid in prior years were less than the aggregate of the unitrust payments (*i.e.*, the lesser of the unitrust amount or net income of the trust with an extra payment out of the income in a later year to make up for the earlier year shortfall where the trust income was less than the unitrust amount). *See* Code §664(d)(3)(B).

(3) **Flip CRUT**. A flip CRUT is a trust that begins as a NICRUT or NIMCRUT and flips to a regular CRUT upon a triggering event. Treas. Reg. §1.664-3(a)(1)(i)(c). The conversion to the regular CRUT must be "triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons." *Id.* In addition, the conversion to the regular CRUT is required to occur at the "beginning of the taxable year that immediately follows the taxable year during which [the triggering date or event occurs]." *Id.* When a trust converts to a regular CRUT, any make-up amount in a NIMCRUT is forfeited. *Id.*

(a) **Permissible triggering events.** The Regulations list permissible triggering events, including the sale of unmarketable assets, marriage, divorce, death or birth of a child. *See* Treas. Reg. 1.664-3(a)(1)(i)(d). An unmarketable asset is defined as "assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents," which includes real property and closely held stock. Treas. Reg. §1.664-1(a)(7)(ii).

(b) **Impermissible triggering events.** The Regulations also list impermissible triggering events, such as the sale of marketable assets. *See* Treas. Reg. §1.664-3(a)(1)(i)(e)(ex. 3).

(c) **Impermissible conversions**. If a CRAT converts to a CRUT, it will lose its status as a CRT. Likewise, a CRUT cannot convert to a NICRUT or a NIMCRUT without losing its status as a CRT. *See* Henkel, Section 33.02, Types of Charitable Remainder Trusts, Estate Planning and Wealth Preservation: Strategies and Solutions (WG&L).

(4) **Practice note.** If A transfers assets to a NIMCRUT where the trust invests in assets with the potential to produce substantial income in later years (when A has retired and is in lower income tax bracket), the NIMCRUT will pay the net income in earlier years (an amount less than the unitrust amount) and, in later years, the NIMCRUT can pay make-up amounts for earlier years to A.

C. **Tax consequences to CRT.**

If a trust qualifies as either type of CRT, the following tax consequences result:

1. **Income tax exempt.** A CRT is not subject to income taxation. *See* Code §664(c)(1).

2. **Net investment income tax does not apply**. Code §1411(a)(2) applies a 3.8% net investment income tax to trusts and estates. However, this tax does not apply to CRTs. *See* Treas. Reg. §1.1411-3(b)(1)(iii).

3. **UBTI**. If a CRT has UBTI under Code §512 (including debt financed income under Code §514), an excise tax will be imposed. *See* Code §664(c)(2)(A).

a. **Amount of the excise tax.** The excise tax is "equal to the amount of such unrelated business taxable income," meaning that there is a 100% tax on UBTI. *Id*.

b. **History of the excise tax**. Prior to December 20, 2006, if a CRT received UBTI, as defined in Code §512, the CRT would lose its tax exemption. *See* Henkel, Section 33.05 Income Taxation of the Noncharitable Beneficiary, Estate Planning and Wealth Preservation: Strategies and Solutions (WG&L). It would be taxed under Subchapter J as though it were a nonexempt complex trust. *Id.* The Tax Relief and Health Care Act of 2006 changed the tax treatment of UBTI received by a CRT for tax years ending after 2006. *Id.* Now, a CRT, which receives UBTI, will pay an excise tax of 100% of the UBTI (rather than losing its tax exempt status). Code §664(c)(2)(A).

c. **Issues arising with 100% excise tax.** There are several issues with the 100% excise tax on UBTI, including the following:

(1) **Potential violation of fiduciary duty.** It would not be prudent for a trustee to make an investment with a 0% return (given that all income is paid as an excise tax). Therefore, a trustee of a CRT should consider whether accepting a contribution of an asset that generates UBTI, such as a private equity fund interest, is prudent.

(2) **Double taxation.** The excise tax does not reduce the income carried out to the lead beneficiary. Specifically, the "excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary." Treas. Reg. §1.664-1(c)(1), (2)(Ex. 1&2). Therefore, the 100% excise tax is paid by the CRT and then the UBTI is distributed to the lead beneficiary and taxed again at the beneficiary's marginal tax rate.

(3) **UBTI may exceed cash distributed to CRT**. As an investor in a pass-through entity, such as a partnership, the CRT may receive a K-1, which reports an amount of UBTI that exceeds the actual cash distributed to the CRT by the partnership (*i.e.*, it may have phantom UBTI). Therefore, the CRT would need to have other assets to pay the 100% excise tax arising from the phantom UBTI.

d. **Practice note – how to avoid UBTI.** One potential way to avoid UBTI is to invest trust assets through a corporate blocker so that unrelated business investment income, which passes through to a U.S. shareholder, is characterized as dividend income (rather than UBTI).

D. **Character of distributions from CRTs.**

Although the CRT pays no tax on its taxable income (besides UBTI), the noncharitable lead beneficiary receives income from the CRT, which is subject to income tax. Unlike the other income characterization rules of Subchapter J, a beneficiary is not taxed on the basis of a pro rata share of the various classes of income earned by the trust. Rather, Code §664(b) provides ordering rules for the tax character of distributions to a lead beneficiary, which generally deems the least desirable types of income being distributed first. Under Code §664(b), the ordering rules provide as follows:

1. **Ordinary income.** The first category is ordinary income, which includes current year income and undistributed prior year income. Code §664(b)(1); Treas. Reg. §1.664-1(d)(1)(i)(a)(1). If the trust has different classes of ordinary income, the distribution is treated as being made from each class, in turn, until exhaustion of the class, beginning with the class subject to the highest income tax rate and ending with the lowest income tax rate. Treas. Reg. §1.664-1(d)(1)(ii)(b). An ordinary loss for the current year reduces ordinary income from prior years first and any excess is carried forward to future years. An ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss and the excess is used to reduce current and undistributed ordinary income from other classes, beginning with the class subject to the highest income tax rate and ending with the lowest income tax rate. Treas. Reg. §1.664 - 1(d)(1)(iii)(a).

2. **Capital gain.** The second category is capital gains, which includes current year capital gain and undistributed prior year capital gain. Code §664(b)(2); Treas. Reg. §1.664-1(d)(1)(i)(a)(2). The following rules apply:

   a. **Long-term and short-term capital gains.** If the trust has short-term and long-term capital gain, the distribution is treated as being made first from the short-term capital gain and then from each class of long-term capital gain. Treas. Reg. §1.664-1(d)(1)(ii)(b).

   b. **Netting of capital gains and losses.** First, net long-term capital loss is used to offset net gain from long-term capital gain. Second, either (a) net long-term capital loss is used to offset net gain from short term capital gain or (b) net short-term capital loss is used to offset net gain from long-term capital gain. Treas. Reg. §1.664-1(d)(1)(iv).

   c. **Net capital gain or loss**. Any net capital gain or loss that is not treated as distributed is carried over to succeeding tax years and retains its character as gain or loss from its particular class. Treas. Reg. §1.664-1(d)(1)(v).

3. **Other income, such as tax-exempt income.** The third category is other income, which includes tax-exempt income. Such undistributed other income or loss is carried forward and keeps its character. *See* Code §664(b)(3); Treas. Reg. §1.664-1(d)(1)(ii)(a)(3), -1(d)(1)(iii)(b).

4. **Trust corpus (tax free).** The fourth category, trust corpus, is defined as the net fair market value of the trust assets less the total undistributed income (but not loss) in each of the three foregoing distribution categories. *See* Code §664(b)(4); Treas. Reg. §1.664-1(d)(1)(ii)(a)(4).

E. **Distributions of net investment income by CRTs under Code §1411.**

1. **General rule.** If an annuity or unitrust distribution from a CRT carries out net investment income (as defined under Code §1411) to a noncharitable beneficiary, then such items retain their character as net investment income in the hands of the recipient. Treas. Reg. §1.1411-3(d)(1)(i). Accumulated net investment income of a CRT means "the total amount of net investment income received by a CRT for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after

December 31, 2012." Treas. Reg. §1.1411-3(d)(1)(iii). Current and accumulated net investment income are deemed distributed prior to items of income which are not net investment income under Code §1411. *See* Fox, Section 25.50, Taxation of Beneficiaries on Receipt of Annuity or Unitrust Payments, Charitable Giving: Taxation, Planning, and Strategies (WG&L).

2. **Apportionment among multiple beneficiaries.** If there are multiple noncharitable beneficiaries, the net investment income is apportioned among such beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the CRT for that taxable year. Treas. Reg. §1.1411-3(d)(1)(ii).

F. **Practice notes.**

1. **Transfer of appreciated property to CRT.** CRTs often are used when an individual wishes to diversify an investment which has appreciated. Upon contribution of the appreciated property to a CRT, there is no taxation event. Thereafter, the CRT may sell the property in order to diversify its holdings and the CRT may avoid the recognition of gain. The CRT can invest the tax-free sales proceeds. The non-charitable beneficiary of the lead interest will be taxed on any CRT income and then on the capital gains as the annuity distributions are made. As result, the capital gains taxes are largely deferred.

2. **Sale of income right of CRT**. Several PLRs from the early 2000s ruled that the income interest in a CRT may be sold and described the tax consequences. *See Unzelman and Navarro*, New Opportunities for Old Charitable Remainder Trusts, Estate Planning Journal (July 2017) (citing PLR 200739004). As opposed to terminating a CRT by splitting the CRT's assets between the income beneficiary and the charitable remainderman using the Code §7520 rules, a sale may provide the non-charitable income beneficiary with more cash and may be less time-consuming and burdensome. *Id.* Common motivations for the sale of an income right in a CRT include (A) maximizing the value of the income interest (they may receive more by selling the interest income than waiting for future income), (B) added flexibility by receiving a lump sum cash payment over a future income stream and (C) reduced complexity by avoiding the costs of administering an CRT. *Id.*

3. **GST considerations**. If a CRT includes grandchildren as non-charitable income beneficiaries, the CRT itself is not considered a skip person and the termination of the income interest is not a taxable termination for GST purposes (even if the only remaining noncharitable beneficiaries are skip persons). *See* Westfall & Mair, Section 19.06[4][c], Charitable Remainder Trusts, Estate Planning Law and Taxation (WG&L). Distributions to skip persons are subject to the GST tax, except to the extent that GST exemption is allocated to the CRT. *Id.*

4. **Self-dealing rules**. Code §4941 imposes an excise tax on each act of self-dealing between a disqualified person and a CRT. Acts of self-dealing are broadly defined and include any transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a CRT, irrespective of whether the transaction benefits or disadvantages the charitable beneficiary. Code §4947 and the related Regulations provide an exception to the self-dealing rules for amounts payable under the terms of the trust to the income beneficiary (including payments of unitrust amounts). Code §4947(a)(2)(A); Treas. Reg. 53.4947-1(c)(2)(ii)(Ex. 1).

VII. **Subchapter S Trusts.**

A. **Overview of subchapter S trusts**. The term "subchapter S trusts" is used to refer to trusts that are eligible to own S corporation stock.

1. **S corporations – in general**. An S corporation is a domestic corporation that generally is treated as a pass-through entity for federal income tax purposes. In order to qualify for this treatment, a corporation must elect to be treated as an S corporation and must meet a number of requirements, both at the shareholder level and at the corporate level, which are set forth in Code §1361 and the

corresponding Treasury Regulations.152 If a corporation does not satisfy any of these requirements, it will be treated as a C corporation.

2. **Shareholder requirements for S corporations.**

   a. An S corporation can have no more than 100 shareholders.[153]

   b. Each shareholder must consent to the S election in order for the election to be valid.[154]

   c. Only individuals who are U.S. citizens or residents, their estates and certain domestic trusts and exempt organizations are permitted shareholders.

      (1) Corporations, partnerships and limited liability companies (with the exception of single member LLCs that are disregarded for income tax purposes) generally are not permitted shareholders.[155]

      (2) Nonresident aliens are not permitted shareholders.[156]

3. **Types of trusts that can qualify to hold stock of an S corporation.**

   a. Code §1361(c)(2) sets forth the types of trusts that are permitted shareholders of an S corporation.

      (1) Grantor trusts;

      (2) Trusts previously treated as grantor trusts, following the death of the grantor, but only for a limited period of time;

      (3) Certain testamentary trusts, but only for a limited period of time;

      (4) Qualified Subchapter S Trusts ("QSSTs");

      (5) Electing Small Business Trusts ("ESBTs"); and

      (6) Voting trusts.

   b. All of these trusts must be domestic trusts in order to qualify of shareholders of S corporation stock.[157]

   c. Grantor trusts, QSSTs and ESBTs as shareholders of S corporation stock are discussed in further detail below.

B. **Grantor trusts.**

1. **History**. Grantor trusts became permissible S corporation shareholders in 1976.

2. **Requirements for grantor trust to qualify as a permissible shareholder.** In order to qualify as a permissible shareholder of an S corporation, a grantor trust must be meet the following requirements:

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152 Code §§1361(a)(1) ; 1361(b)(1)(B); 1362(a).
153 Code §1361(b)(1)(A).
154 Code §1362(a)(2).
155 Code §1361(b)(1)(B).
156 Code §1361(b)(1)(C).
157 Code §1361(c)(2)(A) (flush language).

a. **Deemed owned by a single individual.** All of the trust must be treated as owned by one individual under the grantor trust rules of Subpart E, whether it is the grantor or another person under Code §678(b).

b. **Deemed owner must be a U.S. citizen or resident.** The deemed owner must be a U.S. citizen or resident.[158]

3. **Practice note.** The following are examples of trusts that are may not qualify as subchapter S trust shareholders based on their grantor trust status alone:

a. A trust that is not a grantor trust deemed owned by the grantor and that gives one or more beneficiaries Crummey powers or "5 and 5" powers..

b. A grantor trust deemed owned by a U.S. citizen or resident.

c. A foreign trust deemed owned by a U.S. citizen or resident.

4. **Income tax treatment of grantor trust holding stock of a subchapter S corporation.**

a. The deemed owner of the trust takes into account in computing his or her income the trust's pro rata share of the corporation's items of income, loss, deduction and credit.[159]

5. **Death of deemed owner.**

a. **Two year "grace period" following death of deemed owner.** A grantor trust remains a permissible shareholder of an S corporation without further action following the death of the deemed owner for a period of two years beginning on the date of the deemed owner's death[160].

b. **Qualification after termination of the two-year period.** At end of the two-year period, the corporation's S election will terminate unless the trust qualifies as a QSST or an ESBT.[161]

C. **Qualified Subchapter S Trust (QSST).**

1. **History.** QSSTs became permissible shareholders pursuant to the Subchapter S Revision Act of 1982, which added Code §1361(d).

2. **Definitional requirements for a trust to qualify as a QSST.**

a. **Single current income beneficiary.** There must be only one current income beneficiary of the trust.[162]

(1) **Separate shares treated as separate trusts.** A substantially separate and independent share of a trust within the meaning of Code §663(c) is treated as a separate trust for purposes as applying the QSST requirements.[163]

(2) **Exception for husband and wife as sole income beneficiaries.** If a husband and wife are the sole current income beneficiaries, the trust may still qualify as a QSST despite the fact that there is more than one current income beneficiary, if (i) they

[158] Code §1361(c)(2)(A)(i). . Treas. Reg. 1.1361-1(h)(1)(i).
[159] Treas. Reg. §1.1361-1(h)(3)(i)(A).
[160] Code §1361(c)(2)(A)(ii).
[161] Treas. Reg. §1.1361-1(h)(3)(ii)(A); Code §1361(d)(2)(D); Treas. Reg. §1.1361-1(m)(2)(iii).
[162] Code §1361(d)(3)(A)(i).
[163] Code §1361(d)(3) (flush language).

file joint income tax returns, (ii) they are both U.S. persons, and (iii) they both elect to have the trust treated as a QSST[164].

b. Current distributions of corpus must be made only to the current income beneficiary.[165]

c. **Termination of income interest.** The terms of the trust must mandate that if trust or the income interest in the trust terminates during the current income beneficiary's lifetime, the remaining trust assets are to be distributed to that beneficiary.

(1) The income interest of the current income beneficiary is to terminate upon the earlier of such beneficiary's death or the termination of the trust.[166]

(2) If the trust terminates during the life of the current income beneficiary, all of the trust assets must be distributable to that beneficiary.[167]

(3) Thus, if that distribution is contingent or subject to discretion of the trustees, the trust is not a QSST.

d. **Current income beneficiary must be a U.S. person.** The current income beneficiary must be an individual U.S. citizen or resident.[168]

e. All income must be distributed currently.[169]

(1) For purposes of this provision, "currently" means at least annually and "income" means FAI. The 65-day rule applies in determining whether or not income has been distributed annually.[170]

(2) This requirement can be satisfied by one of two methods: (i) the trust instrument can require distributions of all income, at least annually, or (ii) the trustee of the trust can in fact distribute income on a current basis.

3. **Practice note.** The requirements to qualify as a QSST are interpreted narrowly and even the possibility that a person other than the current income beneficiary could receive distributions of income or corpus from the trust during his or her lifetime is sufficient to disqualify the trust from treatment as a QSST. The following are some examples of trust provisions that would not qualify as a QSST:

a. The trust instrument does not mandate current income distributions to the income beneficiary and the trustee fails to make current income distributions.

b. The trust instrument gives the income beneficiary a broad lifetime limited power of appointment.

c. The trust instrument provides that the trust will terminate if the trust ceases to hold S corporation stock, with the remaining trust assets to be distributed to other remainder beneficiaries.[171]

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[164] Treas. Reg. §1.1361-1(j)(2)(i).
[165] Code §1361(d)(3)(A)(ii).
[166] Code §1361(d)(3)(A)(iii).
[167] Code §1361(d)(3)(A)(iv).
[168] Code §1361(d)(3)(B).
[169] Code §1361(d)(3)(B).
[170] Treas. Reg. §1.1361-1(j)(1)(i).
[171] *See* Rev. Rul. 89-55.

d. The trust instrument provides for current income distributions to a single beneficiary, but gives the trustees the power to sprinkle trust corpus among a class of beneficiaries.

e. The trust instrument gives the current income beneficiary an income interest only for a term of years (e.g., 10 years), with the remaining trust assets to be distributed to other remainder beneficiaries.

4. **QSST election.** An election must be made to have the trust treated as a QSST (the "QSST election").[172]

a. **Current income beneficiary makes the election.** The current income beneficiary, and not the trustee, of the trust must make the QSST election.

(1) Rationale. Once the QSST election is made, the current income beneficiary is treated as the owner of the S corporation stock held by the trust under Code §678(a). This means that the income beneficiary will be taxable on all items of income attributable to the trust's interest in the S corporation (including capital gain). Accordingly, it is logical that the income beneficiary, rather than the trustee, should have to consent to QSST treatment.

b. Manner and timing of election.

(1) The election must be made within 2 months and 15 days after date on which the QSST election should be effective (*e.g.,* the date the trust acquires S corporation stock or the date of termination of the 2-year period applicable to testamentary trusts or grantor trusts following the death of the grantor).[173]

(2) The election is made on Form 2553 and a separate election must be made with respect to each S corporation owned by the trust.[174]

c. Elections with respect to successive income beneficiaries.

(1) If, after the death of the income beneficiary, the trust property continues in trust with a successive income beneficiary, it is not necessary to file a new election.[175]

(2) However, a new income beneficiary may affirmatively refuse to consent to the election within 2 months and 15 days after becoming an income beneficiary.[176]

(3) If the new income beneficiary does not refuse to consent, the election with respect to the trust will continue.[177]

(4) On the other hand, if the successive income beneficiary is a beneficiary of a trust that is created on the death of the prior income beneficiary and that trust is considered a new trust under local law, the new income beneficiary's consent is required[178].

5. **Income tax treatment of a QSST.**

a. **Income beneficiary treated as deemed owner**. The income beneficiary of a QSST is treated as the deemed owner of S corporation stock held by the trust under the grantor trust

[172] Code §1361(d)(2)(A).
[173] Code §1361(d)(2)(D).
[174] Code §1361(d)(2)(B)(i).
[175] Code §1361(d)(2)(B)(ii).
[176] Treas. Reg. §1.1361-1(j)(10)(ii).
[177] Treas. Reg. §1.1361-1(j)(9)(i).
[178] *Id.*

rules.[179] The income beneficiary taxes into account on her personal income tax return the trust's pro rata share of items of income, loss, deduction and credit of the S corporation..[180]

(1) **Balance of trust.** If a QSST holds assets other than S corporation stock, the balance of trust is taxed under the subparts A through D of subchapter J.[181]

b. **Disposition of S corporation stock.** The income beneficiary is not treated as the owner of S corporation stock for purposes of attributing any gain or loss on the sale of any S corporation stock held by the trust.[182] Rather, if a QSST sells S corporation stock, the trust is taxable on any gain.

(1) Taxing the income beneficiary on the gain could cause phantom income because the proceeds generally are allocable to corpus under state law, and therefore are not automatically distributable to someone entitled to fiduciary accounting income.

(2) Initially, the IRS ruled that the income beneficiary, and not the trust, recognized gain or loss when the trust sold its S corporation stock.[183] The IRS confirmed that this result followed even though the gain is allocated to corpus under state law. The IRS changed its position in 1995.[184]

6. **Death of income beneficiary with no successive income beneficiaries.**

a. **Two year grace period following death of current income beneficiary.** If, following the death of the current income beneficiary, the trust continues in existence and continues to hold S corporation stock, the trust can remain a shareholder of the S corporation stock without further action for a period of two years following the death of the income beneficiary. [185]

D. **Electing Small Business Trust (ESBT).**

1. **History.** ESBTs became permissible shareholders pursuant to the Small Business Job Protection Act of 1996, which added Code §1361(e). ESBTs are more flexible that QSSTs, the addition of ESBTs as permissible shareholders expanded the types of trusts that could qualify to hold stock of S corporations.

2. **Definitional requirements for a trust to qualify as an ESBT.**

a. **Trust can have only certain types of beneficiaries.** Although a trust can have multiple beneficiaries and still qualify as an ESBT, the trust is only permitted to have the following types of beneficiaries: (i) individuals, (ii) certain trusts, and (iii) certain charitable organizations.[186]

(1) **Definition of "beneficiaries".** For this purpose, the term "beneficiaries" is defined very broadly to include any person who has a present, remainder or reversionary interest in the ESBT.[187]

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179 Code §§1361(c)(2)(A)(i), 1361(d)(1)(A), (B).
180 Treas. Reg. §§1.1361-1(j)(7)(i), (j)(8).
181 Treas. Reg. §1.1361-1(j)(8).
182 *Id*.
183 Rev. Rul. 92-84.
184 T.D. 8600 (7/20/1995).
185 Treas. Reg. §1.1361-1(j)(7)(ii).
186 Code §1361(e)(1)(A)(i); Treas. Reg. §1.1361-1(m)(1)(ii).
187 Treas. Reg. §1.1361-1(m)(1)(ii)(A).

(2) **Look-through rules for distributee trusts.** If a trust is a beneficiary of the ESBT, all beneficiaries of the distributee trust generally are considered beneficiaries of the ESBT.[188]

(a) Exception: If the distributee trust is a tax-exempt entity under Code §170(c)(2) or (3), the distributee trust itself is considered to be the beneficiary of the ESBT.[189]

(3) **Disregard potential appointees until exercise.** Potential appointees under a power of appointment are not considered beneficiaries of an ESBT until the power actually is exercised in favor of any such person.[190]

(4) **Nonresident alien can be a beneficiary.** If a nonresident alien is a beneficiary a trust, this in and of itself will not disqualify the trust as an ESBT, as long as the nonresident alien is not a "potential current beneficiary" (defined immediately below in part b(1)(a)).[191]

b. Each "potential current beneficiary" of the trust must be an eligible S corporation shareholder.

(1) **Definition.** A "potential current beneficiary" is any person who at any time during a particular period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust.

(a) **Number of S corporation shareholders.** For purposes of determining whether an S corporation has more than 100 shareholders (as described above in section A.2.a), each potential current beneficiary of an ESBT is treated as a separate shareholder.[192]

(2) **Contingent beneficiaries disregarded.** A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event is not a potential current beneficiary until such time or the occurrence of the event.[193]

(3) **Disregard potential appointees until exercise.** Potential appointees under a power of appointment are not considered potential current beneficiaries of an ESBT until the power is actually exercised in favor of any such person. For this purpose, it is immaterial whether the power of appointment is a general power or limited power, and includes the power to add beneficiaries.[194]

(4) **Relief if potential current beneficiary becomes an ineligible shareholder.** If an ineligible person (*e.g.,* a nonresident alien) becomes a potential current beneficiary of an ESBT, the S corporation's S election will not terminate if the trust disposes of all of its S corporation stock within one year of the date on which it became disqualified.[195]

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188 Treas. Reg. §1.1361-1(m)(1)(ii)(B).
189 *Id.*
190 Treas. Reg. §1.1361-1(m)(1)(ii)(C).
191 Treas. Reg. §1.1361-1(m)(1)(ii)(D).
192 Treas. Reg. §1.1361-1(m)(4)(i), (vii).
193 Treas. Reg. §1.1361-1(m)(4)(v).
194 Code §1361(e)(2); Treas. Reg. §1.1361-1(m)(4)(vi)(A).
195 Code §1361(e)(2).

c. **No interest in trust may be acquired by purchase.** A trust will not qualify as an ESBT if any person acquires an interest in the trust by purchase and thereby becomes a beneficiary of the trust.[196]

d. **Cannot also be a QSST.** The trust will not qualify as an ESBT if a QSST election has been made with respect to any S corporation stock held by the trust.[197]

e. **The trust cannot be tax-exempt.** The trust cannot be tax-exempt.[198]

f. **The trust cannot be a charitable remainder trust.** The trust cannot be a charitable remainder trust.[199]

3. **ESBT election.** The trustee must make an election must be made to have the trust treated as a ESBT.[200]

a. Manner and timing of election.

(1) Similar to the QSST election, the ESBT election must be made within 2 months and 15 days after the date on which ESBT election should be effective (*e.g.*, the date the trust acquires S corporation stock or the date of termination of the 2-year period applicable to testamentary trusts or grantor trusts following the death of the grantor). [201]

(2) Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT.[202]

(a) <u>Exception</u>: If the ESBT holds stock in multiple S corporations that file in different IRS service centers, the ESBT must file the election with all relevant service centers.[203]

b. **Election statement.** The information required to be included in the election statement is set forth in Treas. Reg. §1.1361-1(m)(2)(ii). The election statement must disclose a variety of information to enable the IRS to determine that the trust qualifies as an ESBT, including:

(a) A list of all potential current beneficiaries, with identifying information (*e.g.*, social security number and address).

(b) Representation by the trustee(s) that the trust meets all of the definitional requirements of an ESBT, and that all of the potential current beneficiaries are eligible S corporation shareholders.

4. **Income tax treatment of ESBT.**

a. **In general.**. If an ESBT holds only S corporation stock and no other assets and if no person has powers or interests that would cause the trust to be a grantor trust, then the ESBT is considered to have only an "S portion" and the taxable income of the trust is determined based on the items of income, deduction and credit allocated to the trust from the S corporation. The trust's taxable income, other than long-term capital gain and qualified

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[196] Code §1361(e)(1)(A)(ii); Treas. Reg. §1.1361-1(m)(1)(iii).
[197] Code §1361(e)(1)(B)(i).; Treas. Reg. §1.1361-1(m)(1)(iv)(A).
[198] IRC §1361(e)(1)(B)(ii); Treas. Reg. §1.1361-1(m)(1)(iv)(B).
[199] IRC §1361(e)(1)(B)(iii). Treas. Reg. §1.1361-1(m)(1)(iv)(C).
[200] Code §1361(e)(3); Treas. Reg. §1.1361-1(m)(2)(i).
[201] Treas. Reg. §1.1361-1(m)(2)(iii); Code §1361(d)(2)(D).
[202] Treas. Reg. §1.1361-1(m)(2)(i).
[203] *Id.*

dividends, is taxed at the highest rate applicable to trusts (39.6%).[204] Long-term capital gains and qualified dividends are taxed at rates described in Code §1(h) (i.e., 20% rate for long-term capital gains).[205] The distribution deduction that generally is a defining feature of simple and complex trusts under subchapter J does not apply to the S portion of an ESBT.

b. **Trust that has multiple "portions".** If an ESBT holds assets other than S corporation stock or if a person has powers or interests that would cause a portion of the trust to be a grantor trust, the following rules apply:[206]

(1) **Three potential portions.** The trust is divided into three potential separate portions, each of which is treated as a separate trust for income tax purposes:

(a) **S portion.** The portion that holds S corporation stock.

(b) **Non-S portion.** The portion that holds all other assets.

(c) **Grantor portion.** The portion over which the grantor or another person is treated as the deemed owner for income tax purposes under the grantor trust rules of Subpart E.

(2) **Grantor portion "trumps" the other portions.** The regulations recognize that a grantor or another person may be deemed to own all or a portion of either the S portion or the non-S portion, or both.[207]

(3) **Single trust for administrative purposes.** While an ESBT may be deemed to be comprised of separate trusts for income tax purposes, it is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[208]

(4) **Income tax treatment of the grantor portion.** All items of income, loss, deductions and credits attributable to the grantor portion are taken into account by the deemed owner in accordance with the grantor trust rules of Subpart E.[209]

(5) Income tax treatment of the "S portion."

(a) **General rule.** The S portion takes into account only the items of income, loss, deduction or credit attributable to the S corporation shares held by the ESBT. The taxable income of the S portion, other than long-term capital gain and qualified dividends, is taxed at the highest rate applicable to trusts (39.6%).[210] Long-term capital gains and qualified dividends are taxed at rates described in Code §1(h) (i.e., 20% rate for long-term capital gains).[211] The distribution deduction that generally is a defining feature of simple and complex trusts under Subchapter J does not apply to the S portion.

(b) **Categories of income taken into account by the S portion**. Three categories of income are taken into account by S portion:

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[204] Treas. Reg. §1.641(c)-1(e)(1).
[205] *Id.*
[206] Code §641(c) and Treas. Reg. §1.641(c)-1.
[207] Treas. Reg. §1.641(c)-1(a).
[208] Treas. Reg. §1.641(c)-1(a).
[209] Treas. Reg. §1.641(c)-1(c).
[210] Treas. Reg. §1.641(c)-1(e)(1).
[211] *Id.*

i. The trust's proportionate share of the S corporation's income, loss, deduction or credit.[212]

ii. Any gain or loss from the disposition of S corporation stock held by the trust.[213]

iii. State and local income taxes and administrative expenses directly attributable to the S portion are deductible by the S portion.[214]

(c) If taxes and expenses relate to more than one portion of the ESBT, they must be allocated between or among the portions using some reasonable method of allocation.[215]

(d) **Aggregation rule.** If the ESBT owns stock in more than one S corporation, items of income, loss, deduction or credit from all of the S corporations are aggregated for purposes of determining the S portion's taxable income.[216]

(e) **Charitable contributions by S corporation.** The proportionate share of charitable contributions made by the S corporation will be deemed to be paid by the S portion and may be deductible in determining the taxable income of the S portion.[217]

(6) **Income tax treatment of the non-S portion.** All items of income, losses, deductions and credits not taken into account in by the grantor portion or the S portion (as described above) are taken into account in accordance with the rules applicable to complex trusts.[218]

c. **Treatment of distributions from ESBT.** The tax treatment of distributions from an ESBT is governed by Treas. Reg. §1.641(c)-1(i).

(1) **Distributions only taken into account for non-S portion.** Distributions from either the S portion or the non-S portion, including distributions of S corporation stock, are:

(a) Deductible under Code §651 or §661 in determining the taxable income of the non-S portion; and

(b) Includible in the gross income of the beneficiaries under Code §652 or §662.

(2) **Limited to DNI of non-S portion.** The amount of the distribution deduction or inclusion is limited to the DNI of the non-S portion.

(a) Items of income, loss, deduction and credit allocable to the grantor portion or the S portion are not taken into account in calculating the DNI of the non-S portion.

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212 Treas. Reg. §1.641(c)-1(d)(2)(i).
213 Treas. Reg. §1.641(c)-1(d)(3).
214 Treas. Reg. §1.641(c)-1(d)(4).
215 Treas. Reg. §1.641(c)-1(h).
216 Treas. Reg. §1.641(c)-1(d)(2)(iii).
217 Treas. Reg. §1.641(c)-1(d)(2)(ii).
218 Treas. Reg. §1.641(c)-1(g).

(b) This means that there is no need to trace the source of distributions (other than with respect to the grantor portion), and the S portion (and not the beneficiaries) bear the entire tax liability with respect to the income of the S portion.

VIII. **Net investment income tax – material participation of trusts and estates under Code §§469 and 1411.**

A. **Background.**

The tax on net investment income ("NII") took effect on January 1, 2013 and is imposed by Code §1411. It constitutes a 3.8% tax on certain NII of trusts, estates and individuals, as described below:

1. **NII Tax on trusts and estates.** For trusts and estates, the NII tax is equal to 3.8% of the lesser of: (i) the trust's undistributed NII for the taxable year and (ii) the excess of (A) the trust's adjusted gross income ("AGI") for the taxable year over (B) the dollar amount at which the highest income tax bracket threshold begins for the taxable year. *See* Code §1411(a)(2); Treas. Reg. §1.1411-3(a)(1)(ii). As previously noted, the highest income tax bracket for trusts in 2022 begins at $13,450.

   a. **AGI of a trust or estate.** The AGI of an estate or trust is determined in the same way as an individual except that an estate or trust also can deduct (1) the deduction in lieu of the personal exemption under Code §642(b), (2) the distribution deduction allowed under Code §§651 or 661 and (3) costs that are paid or incurred in connection with the administration that would not have been incurred if the property were not held in an estate or trust (*i.e.*, expenses that are not subject to the 2% floor). *See* Code §1411(a)(2)(B)(i); see discussion above at Sections (II)(A)-(C), (II)(D)(2).

   b. **Undistributed net investment income.** The undistributed net investment income of an estate or trust is the estate's or trust's NII reduced (A) by distributions of NII to beneficiaries and (B) by amounts paid or permanently set aside for a charitable purpose deductible under Code §642(c). Treas. Reg. §1.1411-3(e)(2). The reduction for distributions of NII made to beneficiaries is the lesser of (A) the deduction allowed to the estate or trust for distributions to beneficiaries under Code §§651 or 661 and (B) the NII of the estate or trust. Treas. Reg. §1.1411-3(e)(3)(i).

   c. **Allocation of NII**. If distributions to beneficiaries include both NII and income excluded from NII, distributions are allocated between NII and excluded income in a manner similar to the method prescribed by Treas. Reg. §1.661(b)-1 as if NII constituted gross income and excluded income constituted amounts not included in gross income. Treas. Reg. §1.1411-3(e)(3)(i). Unless the governing instrument or local law specifically provides otherwise, amounts distributed to beneficiaries are "treated as consisting of the same proportion of each class of items entering into the computation of [DNI] as the total of each class bears to the total [DNI]" of the estate or trust. Treas. Reg. §1.661(b)-1.

   d. **Character of NII distributed to a beneficiary.** A beneficiary will be considered to receive a proportionate amount of NII to the extent that such income is a part of DNI and, under Code §§652 and 662, the character of such income is deemed distributed to the beneficiary. Treas. Reg. §1.1411-4(e)(1)(i); Treas. Reg. §1.1411-3(e)(3)(ii) ("such items retain their character as [NII] under section 652(b) or section 662(b), as applicable, for purposes of computing [NII] of the recipient of the distribution who is subject to tax under section 1411").

   e. **Planning note.** From an NII tax perspective, it may be tax efficient to distribute all of the NII that is included in DNI to the beneficiary of an estate or trust since a beneficiary is only taxable on NII in excess of the individual threshold amount ($250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separate returns, and $200,000 for all other taxpayers), which is substantially higher than the threshold for trusts and estates (currently $12,500).

2. **NII and certain exempt trusts**.

a. **Grantor trusts.** The NII tax does not apply to grantor trusts. Rather, under Treas. Reg. §1.1411-3(b)(1)(v), the grantor is taxed as the owner of the trust's NII.

b. **Charitable trusts or estates.** A trust or decedent's estate "all of the unexpired interests in" which "are devoted to" religious, charitable, scientific, literary, or educational purposes is exempt from the NII tax. Code §1411(e); Treas. Reg. §1.1411-3(b)(1)(i). In addition, a trust exempt under Code §501 is exempt from the NII tax. Treas. Reg. §1.1411-3(b)(1)(ii).

c. **Charitable remainder trust.** A charitable remainder trust is exempt from the NII tax. Treas. Reg. §1.1411-3(b)(1)(iii).

d. **Foreign trusts or estates**. A foreign trust or estate is exempt from the NII tax. Treas. Reg. §1.1411-3(b)(1)(viii), (ix).

3. **Definition of NII.** NII generally includes (A) gross income from interest, dividends, annuities, royalties and rents derived from a trade or business that is a passive activity with respect to the taxpayer or that is a trade or business of trading in financial instruments of commodities, (B) other gross income from a trade or business where the trade or business is a passive activity with respect to the taxpayer or that is a trade or business involving the trading in financial instruments or commodities and (C) gains from the sale of most property. *See* Code §1411(c).

a. **Definition of passive activity.** The term "passive activity" for purposes of Code §1411 is defined under Code §469 as follows:

(1) **General rule.** A passive activity generally includes (i) an activity involving the conduct of a trade or business in which the taxpayer does not materially participate or (ii) rental real estate activity (other than real estate activity of a taxpayer engaged in a "real property trade or business"). Code §469(c).

(2) **Definition of material participation.**

(a) **Code.** Code §469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is "regular, continuous, and substantial."

(b) **Legislative history.** The legislative history for Code §469 states that the individual's involvement must relate to operations, not merely management, and lists several factors that are important to the analysis, but that are not dispositive. It states that the material participation determination shall be based on all relevant facts and circumstances. S. Rep. No. 313, 99th Cong., 2d Sess., at 733 (1986), reprinted at 1986-3 C.B. 735.

(c) **Temporary regulations under Code §469.** The Temporary Regulations under Code §469 provide seven tests to determine whether an individual has materially participated in a trade or business. See Treas. Reg. §1.469-5T(a) (temporary). For example, an individual meets the first test by participating in the activity for more than 500 hours during a year. The facts and circumstances test, articulated in test seven, examines whether the individual participates in the activity on a "regular, continuous, and substantial" basis and further requires that the individual participate in such activity for more than 100 hours during a year. The Temporary Regulations under Code §469 also provide special rules where an individual owns a limited partnership interest, for spousal attribution, for limiting abuses, and for rental real estate activities.

4. **Items not included in NII.** NII generally does not include (A) gross income from an active trade or business, (B) retirement plan distributions under Code §§401(a), 403(b), 408, 408A or 457(b), (C) excluded income, meaning items excluded from gross income (such as tax-exempt interest on state and local bonds under Code §103 and gain from the sale of a principal residence under Code §121).

5. **Reporting.** NII must be computed on the new Form 8960 and it is reported on, and paid with, the form 1041.

B. **Material participation of trusts and estates.**

1. **No guidance in the Regulations.** The Regulations under Code §1411 and Code §469 do not provide additional guidance on how a trust or estate materially participates in a trade or business.

2. **Legislative history.** The legislative history of the Tax Reform Act of 1986 provides limited guidance on how a trust or estate can materially participate under Code §469, noting that an estate or trust materially participates in an activity "if an executor or fiduciary, in his capacity as such, is so participating. . . ." S. Rep. No. 313, 99th Cong., 2d Sess. 735 & n. 287 reprinted at 1986-3 C.B. 735 (emphasis added).

3. **Request for comments.** In December of 2013, the IRS called for comments regarding rules on material participation of trusts and estates to be issued under Treas. Reg. §1.469-5T(g) (temporary). Fed. Reg. Vol. 78, No. 231, p. 72393 (Dec. 2, 2013). Several organizations, including the Tax Section of the NYSBA and the ABA, submitted comments on this topic. The IRS has not taken action since its request for comments.

4. **Case law.** Only two cases, *Mattie K. Carter Trust v. U.S.,* 256 F. Supp.2d 536 (N.D. Tex. 2003) and *Frank Aragona Trust et al. v. Comm'r,* 142 T.C. No. 9 (2014), examine whether a trust has materially participated in an activity under Code §469. Neither case considered the application of Code §1411 but, rather, considered whether a trust's losses could be offset against active income under Code §469. Each case takes a different approach and focuses on different issues relating to material participation by trusts.

5. **IRS position.** The IRS has issued three private rulings that are consistent with its litigating position in Carter Trust and Aragona Trust – namely that only the activities of trustees, acting in their capacity as such, should be considered in determining whether a trust materially participates in an activity – but all such private rulings predate Aragona Trust and explicitly depart from Carter Trust.

C. **Summary of cases and IRS ruling regarding material participation of trusts and estates.**

1. ***Mattie K. Carter Trust v. U.S.*****, 256 F. Supp.2d 536 (N.D. Tex. 2003)**.

a. **Facts.** The Carter Trust owned a cattle ranch and employed ranch employees who managed the ranch subject to the individual trustee's approval.

b. **Holding.** The District Court for the Northern District of Texas held that material participation of trusts should be determined by taking into account the activities of both the trustee and the trust's non-trustee employees and agents.

c. **Reasoning.** The court rejected the IRS's argument that the interpretation in the legislative history that only the activities of trustees, acting in their capacity as such, should be considered in determining whether a trust materially participates in an activity should apply to Code §469. The court found, instead, that the trust – rather than the trustee – was the taxpayer and since the trust could only act through fiduciaries, employees and agents, the determination of material participation by the trust involved an examination of the activities of all such persons. The court held that the activities of such persons acting on behalf of the Carter Trust met the Code §469 material participation standard because they were regular, continuous, and substantial.

2. **Technical Advice Memorandum 201317010 (Apr. 26, 2013)**

a. **Facts.** The trust in this TAM owned stock in an S corporation. The trustee of the trust, the IRS noted, "did not participate in the day-to-day operations of the relevant activities" of the corporation. There was also a Special Trustee, who served as president of a qualified Subchapter S subsidiary of the corporation, but the Special Trustee was only permitted by trust instrument to vote or sell the corporation's stock.

b. **Holding.** The IRS concluded that the trust did not materially participate in the activities of the company.

c. **Reasoning.** The Special Trustee, the IRS determined, mostly performed work as an employee rather than as a fiduciary, which the IRS held did not count for purposes of analyzing material participation. Furthermore, any work that the Special Trustee undertook in a fiduciary capacity — for instance, in voting the stock of the company — would count for material participation purposes, but his time spent performing these functions did not rise to the level of being "regular, continuous, and substantial" as contemplated by Code §469(h)(1).

d. **Note.** The employee-versus-fiduciary distinction is a significant one. For individuals, activities undertaken as employees do count for purposes of determining material participation. Yet, according to the TAM, such activities undertaken by an employee who also is a trustee are not considered in determining material participation of a trust unless such activities are undertaken specifically in a fiduciary capacity. TAM 200733023 and PLR 201029014 also follow this reasoning. *But see Aragona v. Comm'r*, 142 T.C. No. 9 (2014).

3. ***Aragona v. Comm'r*, 142 T.C. No. 9 (2014)**.

a. **Facts.**

(1) The Frank Aragona Trust owned commercial real estate and a management company. The management company, in turn, managed most of the trust's properties, including rental activities.

(2) The trust had six trustees. One trustee was independent and the other five trustees were Frank Aragona's five children. The trustees had formally delegated their powers to the executive trustee, who was one of the children, but the trustees continued to act as a management board for the trust and made all major decisions regarding the trust's property.

(3) During the relevant time period, three of the five children worked as full-time employees of the management company; the other two had very limited involvement in the trust's operations.

b. **IRS position.** The IRS argued that the activities of the trustees as employees should be ignored because (I) the trustees performed their activities as employees of the management company, and (II) it is impossible to disaggregate the activities they performed as employees of the management company, and the activities they performed as trustees. The Tax Court rejected this argument.

c. **Holding.** The Tax Court held that a trust holding rental real estate properties may qualify for the Code §469(c)(7) passive activity exception as a "real estate professional." The trustees, as individuals, may work on a trade or business as part of their trust duties, which work can then be considered "work performed by an individual in connection with a trade or business." The court then found that, considering the activities of all six trustees, the trust materially participated in its real estate activities. The court noted that three of the trustees participated in the trust's real estate operations on a full time basis and that those operations were substantial.

d. **Reasoning.** The Tax Court stated: "Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC [the management company], should be considered in determining whether the trust materially participated in its real-estate operations."

e. **Note.** The Tax Court did not decide whether the activities of the non-trustee employees of the Frank Aragona Trust's management company should be considered in determining whether the trust materially participated in the real estate business.