Ten Things Every Estate Planner Needs to Know About Subchapter J

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Federal Income Tax Rules (pp. 1-2, 6)

- Trusts and estates are not entities
  - Tax laws treat them as though they were
  - Rules applicable to individuals apply to trusts and estates except per Subchapter J
- Conduit theory of taxation:
  - Trusts and estates pay tax on income they retain
  - They receive "distribution deduction" for taxable income distributed to beneficiaries
  - Beneficiaries pay tax on distributed income
  - Character remains unchanged

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What is Trust or Estate Income? (pp. 2-4)

- Taxable Income vs. Fiduciary Accounting Income (FAI) (there is a difference!)
- For general tax rules, "income" means what's taxable
- BUT, for trusts and estates, "income" contrasts with "principal"
  - IRC § 643
  - FAI determines which beneficiary is entitled to a receipt

What is Trust or Estate Income? (pp. 2-4)

- Fiduciary Accounting Income
  - Read the Trust Agreement!
  - UPIA (Uniform Principal and Income Act) or UFIPA*
  - Necessary step to get to DNI
  - Does UPIA apply to executors?

*Uniform Fiduciary Income and Principal Act – may be coming soon to your state

What is Trust or Estate Income? (pp. 3-4)

- Allocating Income
  - Need a receipt
  - Is the receipt principal or is it income?
  - Trust Agreement vs. State Law/UPIA
  - Receipts from entities (corps., partnerships, LLCs, etc.)
  - Receipts from mutual funds
- Allocating Expenses
  - Trust Agreement vs. State Law/UPIA
  - Who bears the expense – income or principal?

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"Fairness" in Determining Income (pp. 4-5)

- Power to Adjust
  - Not the same as allocating principal and income
  - Allows re-allocation IF:
    - Prudent investor rule applies
    - Amount distributed referenced as income (vs. principal)
    - Prescribed allocation is not "fair and reasonable to all"
  - Does it apply to executors?
- Equitable Adjustments
  - To adjust economic or tax effects between income and remainder beneficiaries resulting from fiduciary actions

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Top Ten Things About Subchapter J (pp. 6-23)

1. Simple vs. complex trusts, and estates
2. The carry-out of "distributable net income"
3. The charitable deduction
4. The deductibility of interest on deferred gifts
5. The treatment of trust and estate net losses
6. Recognition of gain by estates and trusts when appreciated assets are distributed
7. Recognition of gain by beneficiaries from unauthorized non-pro rata distributions of assets
8. Income in respect of a decedent (IRD)
9. The deductibility of administration expenses for income vs. estate tax purposes
10. The grantor trust rules

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Simple vs. Complex Trust (pp. 6-7)

- Simple trust:
  - Must be required to distribute all (fiduciary accounting) income at least annually
  - No distributions to charities
  - No current distributions in excess of income
- Trusts that are not simple are complex
- Estates are taxed like complex trusts

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Simple vs. Complex Trusts (Cont.) (pp. 6-7)

- Simple trusts deduct amounts *required to be distributed* annually
  - Beneficiaries must report income in year required to be distributed
  - Character of amounts carry out to beneficiaries
  - Allowance in lieu of personal exemption: $300
- Estates and complex trusts deduct amounts required *or permitted* to be distributed
  - Required (Tier I) distributions carry out income first
  - Permitted (Tier II) distributions carry out any remaining income to extent of actual distributions
  - Complex trusts allowance: $100; estates: $600

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Distributable Net Income (pp. 7-8)

- General Rule: An inheritance is income-tax free
- Exception: Beneficiaries pay tax on receipt of "DNI"
- DNI is a fundamental concept in Subchapter J
- Used to provide rough adjustment to conform notions of taxable and fiduciary accounting income
- DNI = Taxable income (before any distribution deduction or allowance in lieu of personal exemption)
  - Less net capital gains*
  - Plus net exempt income

*Most of the time - capital gains can be included in DNI in limited circumstances

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2 DNI and the Distribution Deduction (pp. 7-8)

- DNI measures amounts *and types* of trust or estate income
- Distributions are generally treated as coming first from DNI, then from corpus
- Distributions to multiple beneficiaries generally carry out DNI to recipients pro rata
- Estates and trusts get to deduct amount of taxable DNI distributed (or required to be distributed)
- Beneficiaries report corresponding amount in income
- Distributions are treated as though made on the last day of the entity's tax year
  - Estates and complex trusts can elect "65-day rule"

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2 DNI – Example 2 (p. 8)

- A and B are beneficiaries of $1,000,000 estate
- Executor distributes $200,000 to A, $50,000 to B
- During same year, estate earns income of $100,000:
  - A must report income of $80,000
    - $100,000 x ($200,000/$250,000)
  - B must report income of $20,000
    - $100,000 x ($50,000/$250,000)
  - Estate gets a distribution deduction of $100,000
- If distributions were $50,000 to A and $25,000 to B:
  - A would report income of $50,000
  - B would report income of $25,000
  - Estate would receive $75,000 distribution deduction
  - Estate would report remaining $25,000 as income on estate's income tax return

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Exceptions to DNI Carry-Out (p. 9)

- Example to understand what's at stake
  - Estate has $50,000 of income in Year 1
  - Estate makes one distribution in Year 1: a painting worth $10,000
  - Does the distribution "carry out" $10,000 of income to the beneficiary of the painting?
- What does not carry out DNI?

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Exceptions to DNI Carry-Out (p. 9)

- Specific sums of money or specific property paid in not more than three installments
  - IRC § 663(a)(1)
  - Requirement of ascertainability
    - Terms of governing instrument on date of death
  - Formula bequests may not qualify
  - Not if payments only from income
- Transfers of real estate when title vests immediately
  - Look to local law (e.g., UNIF. PROB. CODE § 3-101)
  - Specific vs. general bequests

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The Tier Rules (p. 9)

- Amounts required to be distributed (Tier I)
- Other amounts properly distributed (Tier II)
- Tier I distributions carry out DNI first
  - Computed without regard to charitable deduction
  - Generally pro rata among Tier I distributees
- Any remaining DNI carried out to Tier II distributees
  - Computed after considering the charitable deduction
  - Again, generally pro rata among Tier II distributees
  - Distributions in excess of DNI are tax-free as corpus
- *Effect* of these rules is to treat charity as an "intermediate Tier" between Tier I and Tier II

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The Separate Share Rule (pp. 9-10)

- General rule: DNI gets carried out to multiple beneficiaries (within each tier, if any) pro rata
- Exception: Separate Share treatment applies

  When the governing instrument of the trust or estate (e.g., the trust agreement, the will, or applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries
- Applies solely for allocating DNI
- DNI allocated based upon beneficiaries' respective economic shares

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2 The Separate Share Rule–Example 4 (p. 10)

- Will bequeaths IBM stock to X and the balance of the estate to Y
- IBM stock pays $20,000 of post-death dividends to which X is entitled under local law. No other income
- Executor distributes $20,000 to X and $20,000 to Y
- Pre-separate share rule: DNI carried out pro rata (i.e., $10,000 to X and $10,000 to Y)
- But X has economic interest in dividends; Y does not
- Separate Share Rule: Distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y

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2 Other DNI Carry Out Exceptions (pp. 10-11)

- Income from property specifically bequeathed
  - State law/governing instrument directs if income follows the specific bequest
    - More of special application of DNI rules than exception
    - Before separate share rule, pro rata rule caused mismatch between economic benefits and tax rules
- Interest on pecuniary bequests
  - State law/governing instrument directs if bequest bears interest, e.g., one year after date of death
    - Interest payments are not "distributions" carrying out DNI: interest expense to estate/trust; interest income to beneficiary

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Charitable Deductions (p. 11)

- Distributions to charities don't carry out DNI
  - Charity as "intermediate tier" is a fiction describing effect of Tier Rules
- Instead, trusts and estates get charitable deductions
  - Available for *amounts of gross income* paid to charities
  - Estates (and pre-'69 trusts) can deduct amounts "set aside" for charity – look to governing document
- May elect one-year "look-back"
- Not limited to a percentage of AGI like individuals

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Deductibility of Interest (pp. 11-12)

- Interest on pecuniary bequests
  - E.g., UNIF. PRIN. & INC. ACT § 201(3); ARS § 14-3904
  - Interest payments are not "distributions" carrying out DNI
  - Interest income to beneficiary
  - Interest expense to estate or trust
- Taxable as interest income to beneficiary
- "Personal interest" is not deductible
- "Investment interest" can be deducted
  - Investment interest argument
  - *Cf.* Treas. Reg. § 1.663(c)-5, Ex. 7

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5 Net Losses and Excess Deductions (pp. 12-13)

- If estate or trust deductions exceed income:
  - Excess deductions can't normally be carried back or forward
  - Exception for net operating losses
    - Pre-2018 NOLs: carry back 2 years and forward 20 years
    - Post-2017 NOLs: carry forward indefinitely (but not back), limited to 80% of taxable income
  - Exception for net capital losses: Non-corporate taxpayers can carry forward capital losses indefinitely
- Special rule in year of estate or trust termination
  - Excess losses carry out to beneficiaries
  - Itemized deductions carry out to beneficiaries in year entity terminates - not deductible in 2018-2025

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6 Effects of Distributions in Kind (pp. 13-15)

- Distributions of assets carry out DNI (unless a general DNI exception applies) but distributions don't generally cause estate or trust to recognize gain or loss
- DNI carry out is lesser of asset's fair market value or basis (plus any gain recognized on distribution)
- When will distributions of assets cause estate or trust to recognize gain or loss?

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Estate's Recognition of Gain or Loss (pp. 13-14)

- **Exception 1:** Distribution to satisfy obligation
  - Treated as if sold for FMV
  - Ex: Trust owes $10,000; to satisfy, transfers asset worth $10,000 and basis of $8,000; trust recognizes $2,000 gain
- **Exception 2:** Distribution of appreciated property to satisfy bequest of "specific dollar amount"
  - "Specific dollar amount" not the same as "specific sum of money" – most formula bequests cause recognition
  - **Ex. 5**: Specific or formula bequest of $400,000 to Phil, if he survives me; funded with $400,000 of stock with $380,000 date-of-death value; $20,000 gain triggered

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Estate's Recognition of Gain or Loss (p. 15)

- Executor may *elect* to recognize gains (and maybe losses) on distributions of property - IRC § 643(e)
  - All-or-nothing election
  - As if property sold to distributees for FMV on date of distribution
  - Does not apply to IRC § 663 specific bequests
- Reason for election – Example: Estate divided among three kids – all bonds to one
  - Date of death: Estate worth $1.8 million
    - Stocks: $1.1 million; Bonds: $700,000
  - Date of distribution: Estate worth $2.1 million
    - Stocks: $1.4 million; Bonds: $700,000
- Losses generally not recognized due to related party rules, but deferred due to carryover basis
  - Exception: Estates funding pecuniary bequests

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Beneficiaries' Recognition of Gain (p. 15)

- Generally no gain or loss recognized by beneficiaries as a result of trust or estate distributions
- Exception for *unauthorized* non-pro-rata distribution
- Where to find authority:
  - State law (e.g., ARS § 14.10816(22), TEX. ESTS. CODE § 405.0015, TEX. PROP. CODE § 113.027)
  - Language in the governing instrument

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Beneficiaries' Recognition: Example 6 (p. 15)

- Estate passes equally to A and B
- Two assets: stock & farm, each worth $120,000
- Date of death values (equals basis):
  - Stock: $100,000; Farm: $110,000
- Executor gives stock to A and farm to B
- *Neither Will nor local law authorizes non-pro rata distributions*
- ***IRS***: A and B each received one-half of each asset
  - A "sold" her interest in farm (basis of $55,000) for stock worth $60,000: $5,000 gain to A
  - B "sold" his interest in stock (basis of $50,000) for a one-half interest in farm worth $60,000: $10,000 gain to B
- Both A and B are "disappointed"

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Income in Respect of a Decedent (pp. 15-16)

- General Rule: An inheritance is income-tax free
- Exception: Income in Respect of a Decedent (IRD)
  - Income "earned" by decedent but not properly reported by him or her
  - *Est. of Peterson v. Comm'r*:
    - Decedent entered into legally significant transaction
    - Decedent performed substantive tasks required
    - No economically significant contingencies
    - Decedent would have received property but for death
- Major sources of IRD:
  - Retirement accounts (but not ROTH or after-tax contributions)
  - Installment gain obligations

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Income in Respect of a Decedent (pp. 15-16)

- IRD recognition when payment actually received
- Distribution of right to receive IRD typically does not accelerate recognition
  - Specific bequest of IRD asset
  - Residuary disposition of IRD asset
- IRD recognition will be accelerated if estate or trust distributes asset in manner generally causing gain recognition (See Rule 6)
  - Distributions in satisfaction of pecuniary bequest
  - Executor makes § 643(e) election to recognize gain
- IRC § 691(c) allows income tax deduction for estate taxes paid on IRD asset

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8 IRD Acceleration: Example 7 (p. 16)

- X dies with $14,400,000 estate in 2019
- Will makes formula marital gift of $3,000,000 to spouse, leaving the rest to X's kids
- IRD asset worth $3,000,000 (but with basis of $0) is used to fund marital gift
- NO basis adjustment for IRD assets
- Estate recognizes $3,000,000 gain
- Spouse receives $3,000,000 worth of property
- *Estate* owes income tax of $1,108,000
- Kids get $10,292,000 ($14,400,000 - $3,000,000 - $1,108,000), instead of $11.40 million

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8 Deductions in Respect of a Decedent (p. 16)

- Deductions in respect of a decedent ("DRD")
- Analogous to IRD, but on expense side
  - Amount still payable at date of death
  - Would have been income-tax deductible by decedent if paid
- Eligible for estate tax deduction as debt
- Eligible for income tax deduction when paid
- Common Examples:
  - Accrued property taxes
  - Accrued business expenses

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9 Section 642(g) Expense Election (pp. 16-19)

- Executor can elect to deduct administration expenses on estate tax return or on estate's income tax return
- Double deduction disallowed (except for DRD)
- Examples:
  - Executors' fees Attorneys' fees
  - Accountants' fees Appraisal fees
  - Court costs Other admin expenses
- Do the math: Compare estate tax vs. income tax savings
- But also consider other effects (equitable adjustment? marital/charitable deduction?)

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9 Section 642(g) Expense Election (pp. 16-19)

- Deduction of expenses paid from *marital or charitable bequest* on income tax return may reduce those deductions for estate tax purposes
- May deduct estate "management expenses" with no loss of estate tax deduction
  - Investment fees Stock brokerage commissions
  - Custodial fees Interest
- Cannot deduct estate "transmission expenses" without corresponding loss of estate tax deduction
  - Executors' fees Most attorney fees
  - Probate fees Court costs
- Summary of deductible expenses – pages 18-19

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The Grantor Trust Rules (pp. 19-23)

- Not all trusts are subject to the "normal" rules of Subchapter J
- Congressional set of "string" statutes results in income taxation of trust income to grantor of trust (or someone treated as grantor)
- Statute treats grantor as owner of that portion of trust property over which specified power is held
- Similar, but not identical, list of "string" statutes results in estate tax inclusion of trust property in grantor's federal taxable estate
- Statutory list of income tax "strings" is exhaustive
- Note concepts: spousal unity rule, "adverse party," "related or subordinate"

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The Grantor Trust Rules (pp. 19-23)

- Right of Reversion—§ 673
- Power to Control Beneficial Enjoyment—§ 674
- Certain Administrative Powers—§ 675
- Power to Revoke—§ 676
- Retained Right to Income—§ 677
- Right in Beneficiary to Vest Trust in Self—§ 678
- Transfers to Foreign Trusts—§ 679

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Right of Reversion – § 673 (p. 20)

- If income or principal will ultimately revert to grantor, that trust portion treated as owned by grantor unless reversion occurs after "safe period"
- Pre-1986, safe period was 10 years
- Current safe period if actuarial value of reversion at time of trust creation is less than 5%
  - With very low interest rates, virtually all reversions flunk this test
  - At 2.2% 7520 rate, reversion after 60 years=27%; reversion valued at < 5% only after 138+ years!
- Reversion after death of descendant/beneficiary who dies before age 21 is also permitted

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Power to Revoke – § 676 (p. 20)

- Portion of trust that grantor and/or non adverse party have right to revest in grantor
- Like "discretionary" reversion; same "safe period" applies
- Many grantors create revocable trusts for non-tax reason; they are ignored for tax purposes
- Default rule in most states: Trust is irrevocable unless trust instrument says otherwise
- Not universally true (see Texas!), and trusts can change jurisdictions
- Best practice: Explicitly state whether trust is revocable or irrevocable

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Retained Right to Income – § 677 (pp. 20-21)

- Portion of trust whose income is or may be distributed to grantor or spouse by grantor and/or nonadverse party, without approval or consent of adverse party
- May cause capital gains to be taxed to grantor
- Also applies if income may be accumulated for later distribution to grantor or spouse
- Required approval or consent of distribution by adverse party negates rule
- Exs. GRAT/GRIT, QTIP (inter vivos), SLAT, DAPT

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Retained Right to Income – § 677 (pp. 20-21)

- § 677 even applies to indirect use of trust income:
  - Payment of premiums of insurance on life of grantor or grantor's spouse
    - Is it income used or income that "may be" used?
  - Payments that discharge legal or contractual obligations
    - For support obligations = if income actually used
    - For non-support obligations = if income may be used
- Payment for support or maintenance of someone grantor legally obligated to support?
  - Right to have trust income so used doesn't cause automatic grantor trust treatment
  - But grantor is taxed to extent income is actually used

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Right to Control Beneficial Enjoyment – § 674 (p. 21)

- IRC § 674(a): Portion of trust if subject to power of disposition by grantor or nonadverse party without approval of adverse party (i.e., a beneficiary), BUT no grantor trust treatment in certain cases:
  - § 674(d): Independent trustee can have full discretion
  - § 674(c): Anyone other than grantor and spouse can have power limited by ascertainable standard (such as "HEMS")
  - § 674(b): Anyone can have long list of permitted powers
- Generally, exceptions do not apply if someone retains the power to unilaterally add beneficiaries

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Administrative Powers – § 675 (pp. 21-22)

- Hodgepodge of prohibited powers of grantor:
  - Right to deal with trust property without full and adequate consideration
  - Right to borrow trust property without adequate interest and security (unless independent trustee can so loan to anyone), but even then, *actual borrowing* by grantor or spouse causes grantor trust treatment until year following repayment
  - Right to vote closely held stock owned by trust
  - Right to reacquire trust assets by substituting asset of an equivalent value, exercisable in a non-fiduciary capacity
- This last power is often employed to intentionally make trust a grantor trust – the "swap power"

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Right in Beneficiary to Vest Trust in Self – § 678 (pp. 22-23)

- Treats someone *other than the grantor* as owner of the trust's property for income tax purposes
- Applies to someone holding power to vest trust property in him/herself, exercisable solely by him/herself
  - Common examples: GPOA and *Crummey* withdrawal rights
- Also applies to "released or modified" power if by treating power holder as grantor, grantor trust treatment would apply

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Right in Beneficiary to Vest Trust in Self – § 678 (pp. 22-23)

- Examples of uncertainties with § 678
  - *Crummey* powers
    - While a withdrawal power is open, for what part of the year is the beneficiary treated as the grantor?
  - 5-or-5 power exception applies for estate and gift tax purposes but not for § 678
  - No exception in statute for powers limited by ascertainable standard (but courts should apply one)
- If other grantor trust rules apply, those rules override § 678 (Note "income" vs. "principal" in statute)

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State Income Taxation of Trusts (pp. 23-26)

- States frequently impose income tax on trusts if proper "nexus" exists
- States establish nexus based upon:
  - Residence of grantor (or place of grantor's death)
  - Residence of trustee
  - Situs of administration of trust
  - Residence of trust beneficiary
- Income earned within state often forms independent basis of state income taxation
- Trusts may owe tax in more than one state (without receiving offsetting credit for other state's taxes)
- Constitutional limits on notion of "nexus" – Due Process/Commerce clauses – *Kaestner*

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Taxation of Partnerships (pp. 26-28)

- Partnerships are flow-through entities – They pay no tax
  - Congress treats partnerships as aggregation of partners
  - Partners pay the tax based on agreed-upon allocation of partnership income, gain, deductions, and credits
- Partnership basis in property vs. partners' basis in partnership interest
  - Inside basis
  - Outside basis
- Limited Partnership Planning Opportunities
  - Elimination of discounts
  - Other basis planning opportunities

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Taxation of S Corporations (pp. 28-29)

- S corporations are flow-through entities
  - Only eligible small business corporations may elect S status
  - Shareholders pay tax based on per-share allocation of corporate income, gain, deductions, and credits
- S-corp basis in property vs. shareholder's basis in shares
  - Inside basis
  - Outside basis
- Ownership by trusts and estates
  - Estates (until estate terminates)
  - Grantor trusts
  - Testamentary trusts for 2 years from funding
  - Qualified Subchapter S Trusts ("QSSTs") – beneficiary elects
  - Electing Small Business Trusts ("ESBTs") – trustee elects

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What Are QSSTs and ESBTs?

- **Qualified Subchapter S Trusts ("QSSTs")**
  - Beneficiary must elect
  - Only one income beneficiary allowed
  - All FAI to beneficiary at least annually
  - Form 2553
  - Elect by 2 months, 15 days after stock transferred
  - Income tax to beneficiary unless stock sold
- **Electing Small Business Trusts ("ESBTs")**
  - Trustee makes election
  - Multiple trust beneficiaries allowed
  - Election made by letter request
  - Elect by 2 months, 15 days after stock transferred, or after end of 2-year holding period for stock transferred by death
  - Income always taxed to trust at highest rate – no distribution ded.

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Flow-through Entities: Estate Income Tax Issues (pp. 29-31)

- Basis and the Section 754 Election
  - Rationale
  - Manner and timing
  - Application to community property
  - Tax effects
- Fiscal Year End Issues
  - Partnership year end – Majority of the partners rule
  - Selecting year end for maximum deferral
- Closing partnership and S corporation tax years
  - Interim closing of partnership books (unless partners agree otherwise)
  - Per diem allocation among shareholders (unless shareholders agree otherwise)

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Flow-through Entities: Estate Income Tax Issues (pp. 29-31)

- Estate ownership of S corporation stock
  - Estate counts as one shareholder
  - Ignore ineligible beneficiaries
  - Avoid prolonged administration
- Sale of S corporation assets – avoiding gain mismatches
  - No Section 754 election for S corporations
  - Gain on asset sale allocated to shareholders and increases basis
  - Liquidation after basis adjustment in stock may yield loss
  - No capital loss carry-back – Lesson: Liquidate in year of sale
- Funding bequests with flow-through entities
  - Effect of gain or loss on funding bequests
  - Possible (second) Section 754 election

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Flow-through Entities: Trust Income Tax Issues (pp. 33-35)

- Trusts that distribute "all income" – FAI vs. taxable income
- Cash-flow difficulties
- Entities that distribute "enough to pay taxes"
  - Partnerships
  - ESBTs
  - QSSTs
- UPIA changes (ARS § 14-7429)
- UFIPA changes

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