TEN THINGS EVERY ESTATE PLANNER NEEDS TO KNOW ABOUT SUBCHAPTER J

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- Best Lawyers in America, Trusts and Estates; Texas Super Lawyer, *Texas Monthly* and *Super Lawyers Magazine*
- Named *Best Lawyers'* 2013 Houston Trusts and Estates "Lawyer of the Year"
- Named by *Texas Lawyer* as a 2013 "Top Notch Lawyer" for Trusts and Estates
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RECENT SPEECHES AND PUBLICATIONS:

- Author: DAVIS'S TEXAS ESTATE PLANNING FORMS (O'Connor's, 2017, updated annually)
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- Co-Author: Streng & Davis, RETIREMENT PLANNING–TAX AND FINANCIAL STRATEGIES (2nd ed., Warren, Gorham & Lamont, 2001, updated annually)
- Co-Author/Panelist: Ten Things Every Estate Planner Needs to Know About Subchapter J, 54th Annual Southern Federal Tax Institute, 2019; Dallas Bar Association Probate, Trusts & Estates Section, 2019; 44th Annual Notre Dame Tax and Estate Planning Institute, 2018
- Co-Author/Speaker: Income Tax Issues In Estate Planning, State Bar of Texas 43rd Annual Advanced Estate Planning and Probate Course, 2019
- Co-Author/Panelist: Income Tax Issues for Trusts and Estates – But NOT Another Talk About Basis, 25th Annual Advanced Estate Planning Strategies Course, 2019
- Panelist: Hot Topics, ACTEC 2019 Annual Meeting
- Author/Speaker: Drafting Agreements for Failure to Fund a Trust or to Intentionally Not Fund a Trust, State Bar of Texas 29th Annual Estate Planning and Probate Drafting Course, 2018
- Co-Author: Comment letter to Department of Treasury and IRS on behalf of ACTEC on proposed regulations under IRC §§ 199A and 643(f), September 27, 2018
- Author/Speaker: Fiduciary Income Taxation and Subchapter J, American Bar Association Section of Real Property, Trust & Estate Law, Skills Training for Estate Planners – Fundamentals Course, 2015-2018
- Co-Author/Speaker: All About that Basis: How Income Taxes Have Reshaped Estate Planning, Estate Planning Council of Saint Louis, 2017; Philadelphia Estate Planning Council, 2016; 42nd Annual Notre Dame Tax and Estate Planning Institute, 2016; 36th, 37th, 38th and 39th Annual ALI CLE Planning Techniques for Large Estates, 2016-2019
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- Member of the Board of Directors, ACTEC Foundation (Vice Chair, Grant Committee; Member, Nominating Committee)
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- Author/Speaker: *Getting the 411 on 199A: Just the Facts, Ma'am*, 53rd Annual Heckerling Institute on Estate Planning, 2019; IRS Estate and Gift Tax Attorney and Paralegal CPE IVT, 2019
- Co-Author/Co-Presenter: *All About that Basis: How Income Taxes Have Reshaped Estate Planning*, 42nd Notre Dame Tax and Estate Planning Institute, 2016; 36th, 37th, 38th, 39th Annual ALI CLE Planning Techniques for Large Estates, 2016-2019
- Co-Author/Speaker: *Estate Planning for Married Couples in a World with Portability and the Marital Deduction*, 44th Annual Midwest/Midsouth Estate Planning Institute, 2017; 38th, 39th Annual ALI CLE Planning Techniques for Large Estates, 2018, 2019
- Panelist: *Section 199A: Final Regulations, New Guidance, and Implications for Estate Planners*, ACTEC-ALI CLE Telephone Seminar/Audio Webcast, 2019
- Co-Author/Speaker: *Income Taxation of Trusts and Estates*, The Center for American and International Law 52nd Annual Short Course on Estate Planning, 2016-2019
- Co-Author/Panelist: *IRC 199A: Grafting a New Branch onto the Choice-of-Entity Decision Tree*, 53rd Annual Heckerling Institute on Estate Planning, 2019
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- Author/Speaker: *Income Tax Basics for Estate Planners*, American Bar Association Section of Real Property, Trust & Estate Law, Skills Training for Estate Planners – Fundamentals Course, 2015-2018
- Panelist: The Life Cycle of a Business Entity: Wind Down, Sale, or Transition of an Entity, ACTEC 2018 Summer Meeting
- Co-Author/Panelist: *Hot Tax Topics*, State Bar of Texas 24th Annual Advanced Estate Planning Strategies Course, 2018
- Co-Author/Speaker: *Knowing the Ropes and Binding the IRS: Income and Transfer Tax Issues of Settlements and Modifications Every Fiduciary Should Know*, 10th Annual Texas Tech Estate Planning & Community Property Law Journal CLE & Expo, 2018; 39th Annual Duke University Estate Planning Conference, 2017
- Co-Author/Co-Presenter: *Income Taxation of Trusts and Estates: Ten Things Estate Planners Should Know*, National Association of Estate Planning Councils, 54th Annual NAEPC Advanced Estate Planning Strategies Conference, 2017
- Panelist: *Estate Planning in Light of the New Administration: What Do We Tell Our Clients Now?*, State Bar of Texas 41st Annual Advanced Estate Planning and Probate Course, 2017
- Co-Author/Panelist: *It's 1:45 p.m. in the Garden of Good and Evil: Now How Do We Deal with Value in Estate and Business Planning and Estate and Trust Administration?*, State Bar of Texas 23rd Annual Advanced Estate Planning Strategies Course, 2017
- Co-Author/Co-Presenter: *Planning for Married Clients: Charting a Path with Portability and the Marital Deduction*, 42nd Notre Dame Tax and Estate Planning Institute, 2016; 36th and 37th Annual ALI CLE Planning Techniques for Large Estates, 2016, 2017

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I. INTRODUCTION

Estate planners often view Subchapter J (the portion of the Internal Revenue Code that deals with the income taxation of estates, trusts, beneficiaries and grantors), as the exclusive province of a select few accountants that prepare income tax returns for trusts and estates. In reality, all estate planners need to have a fundamental understanding of the income taxation of trusts and estates.

With the passage of the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013) ("ATRA 2012"), estate planners and their clients began to see a new focus on the role of income taxes as part of estate planning. ATRA 2012 reunified and made "permanent" the estate, gift, and generation-skipping transfer ("GST") tax laws. As part of these new laws, the highest tax bracket for estate, gift, and GST tax purposes went from 35% to 40%, making the spread between these transfer tax rates and the highest income tax rate closer than they had been in years. Combining the large (and inflation-adjusted) estate tax exclusions, together with portability, higher income tax rates, and a new income tax, estate planners had to change their conversations with clients during the estate planning and the estate administration process.

Now, with the enactment of the Tax Cut and Jobs Act of 2017, P.L. 115-97, 131 Stat. 2054 (2017) ("TCJA 2017") on December 22, 2017,[1] additional significant changes have been made to the income and transfer tax laws. TCJA 2017 essentially doubled the estate and gift tax exclusions and GST tax exemption for persons dying and transfers made between 2018 and 2025. As a result, we have unified estate, gift and GST tax laws with an exclusion (or exemption) temporarily set at $10,000,000, as adjusted annually for inflation after 2011 (scheduled to return to $5,000,000 after 2025, as adjusted for inflation after 2011), and a top transfer tax bracket of 40%.[2] For 2019, after applying the inflation adjustment, the exclusion is $11,400,000.[3] Changes to the income tax rates maintain a spread between the tax rates that is virtually nil.

Accordingly, it is essential for estate planners to have a fundamental understanding of the income tax issues that are important to their clients. These issues relate not only to income taxation of individuals, but also income taxation of trusts and estates. The income tax arena presents a multitude of planning opportunities that arise, both during lifetime, and during the administration of a trust or a decedent's estate. Language contained in (or omitted from) the governing instrument, as well as steps taken (or not taken) by the fiduciary in the course of administering a trust or estate, can have important income tax implications. This paper is intended as a resource to highlight essential income tax planning issues that arise (i) when drafting wills and trust agreements; and (iii) when administering a trust or the estate of a decedent. It assumes that the reader has a passing familiarity with the income tax rules applicable to individuals, and with non-tax issues associated with the administration of trusts and estates. While not a complete treatise on the subject, the paper is intended to highlight areas of income tax planning and reporting for grantors, executors, trustees, and beneficiaries.

II. INCOME TAXATION OF TRUSTS AND ESTATES

A. General Rules. Estate planning attorneys will tell you that trusts and estates are not "juridical" entities, by which they mean that unlike individuals, partnerships, corporations, and the like, they do not exist apart from the fiduciaries that control them. You cannot sue a trust or an estate, nor can a trust or an estate technically own property, earn income, or pay tax. Rather, the executor or trustee is the proper party to litigation. The executor or trustee holds legal title to assets, etc. In short, trusts and estates are not technically legal entities. Nevertheless, for purposes of applying the income tax rules, Congress and the IRS generally treat trusts and estates themselves as though they were entities. In this paper, we follow the same approach. When computing the taxable income of a

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[1] The technical name of the Act is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018", but "AAPRPTIIVCRBFY 2018" seems to be a remarkably unhelpful acronym. Some have suggested "the Act Formerly known as TCJA 2017," or perhaps its abbreviation, "AFKATCJA."

[2] Prior to TCJA 2017, inflation was measured by changes to the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics. TCJA 2017 modified the index to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"), which generally grows more slowly than CPI. Using CPI, the 2018 figure would have been $11.20 million instead of the $11.18 million that results from using C-CPI-U. Although many of the provisions related to individuals in TCJA 2017 are only effective for years 2018-2025, Chained CPI as the method of inflation adjustment is "permanent."

[3] 2019 inflation-adjusted figures were announced in Rev. Proc. 2018-57, 2018-49 IRB 827. For 2018, the exemption was $11,180,000. Rev. Proc. 2018-18, 2018-10 IRB 392.

trust or estate, then, we treat it as though it were a legal entity, and speak of the income, expenses, deductions and credits of trusts and estates as taxpayers. Section 641(b) of the Internal Revenue Code (the "Code")[4] lays out the general rule that the taxable income of an estate or trust is computed in the same manner as in the case of an individual, except as set forth in Part I of Subchapter J of the Code. Therefore, when applying general tax principles (e.g., that rents and dividends are taxable income, that municipal bond interest is not, that capital gains and qualified dividends are taxed at special rates, etc.) the same rules that apply to individuals apply to estates and trusts. The balance of the paper focuses on the special rules applicable to trusts and estates.

B. State vs. Federal Law Notions of "Income"

1. When An Estate or Trust Allocates "Income," That Means Fiduciary Accounting Income, Not Taxable Income. Estate planning attorneys that spend too much of their time studying tax rules sometimes forget that not every situation is governed by the Code. Nowhere is this failure more prevalent than in the area of allocating and distributing estate and trust "income." In general, when a trust (or the income tax rules applicable to estates and trusts) speaks of "income" without any modifier, it means fiduciary accounting income, and not taxable income. IRC § 643(b). The fiduciary accounting rules tell a fiduciary whether a receipt is principal or income, which in turn determines which beneficiary is entitled to it, i.e. an income or a principal beneficiary. In measuring fiduciary accounting income, the governing instrument and local law, not the Code, control. Therefore, estate planners should have a basic understanding of these state law rules. Allocations are generally made pursuant to directions set forth in the governing instrument, or in the absence of those directions, pursuant to the provisions of local law. As of this writing, forty-six states and the District of Columbia have adopted the Uniform Principal and Income Act ("UPIA").[5] Only Georgia, Illinois, Louisiana, and Rhode Island have not. Despite the benefits of "uniform" acts, many states have chosen to modify specific sections to their principal and income rules, including Texas. (For example, Section 116.174 of the Texas Trust Code effectively provides that income from mineral royalties for most trusts will be allocated 85% to income instead of the 10% specified in Section 411 of the Uniform Act.) Therefore, it is essential that the actual language of the applicable local law be reviewed.

a. Texas UPIA. In Texas, our version of UPIA can be found at Chapter 116 of the Texas Trust Code. Tex. Prop. Code, Ch. 116. Section 116.004 of the Texas Trust Code provides the outline for income and principal allocations, with detailed guidance on specific forms of property and activities being provided by Sections 116.151 through 116.206. Section 116.004 of the Texas Trust Code provides five rules for determining how allocations are to be made:

(1) Terms of the Instrument. Under the first rule, a fiduciary must administer the trust or estate in accordance with the terms of the trust instrument or Will, even if the statute provides some different provision.

(2) Grants of Discretionary Authority. If the trust instrument or Will grants the fiduciary the power to make discretionary allocations, the fiduciary may administer a trust or estate by the exercise of that discretionary power of administration, even if the exercise of the power produces results different from the results required or permitted under the Act.

(3) Application of the Act. If the governing instrument does not contain a contrary provision or grant discretion to the fiduciary, the provisions of the Act must be follow.

(4) When in Doubt, It's Principal. If no provision of the governing instrument or the Act controls, the receipt or disbursement must be allocated to principal.

(5) Fair and Reasonable Allocation. Finally, in exercising a "power to adjust" as outlined below, or a discretionary power of administration, whether granted under the governing instrument or the Act, the fiduciary "shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." A determination in accordance with the Act is presumed to be fair and reasonable to all of the beneficiaries. TEX. PROP. CODE § 116.004.

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[4] References herein to "Section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended.

[5] In 2018, the Uniform Law Commission issued its final version of the Uniform Fiduciary Income and Principal Act ("UFIPA") which updates UPIA. As of this writing, Utah is the only state to have enacted UFIPA, so technically, forty-five states are still using UPIA.

b. Allocation of Income.

(1) General Rules. UPIA provides that a trustee must make allocations of receipts between trust income and principal in accordance with the specific provisions of the governing instrument, notwithstanding contrary provisions of the Act. UNIF. PRIN. & INC. ACT § 103(a)(1) (2000). Provisions in the Will or trust agreement should therefore control allocations of estate and trust income and expenses, so long as the provisions are specific enough to show that the testator chose to define a specific method of apportionment. *See InterFirst Bank v. King*, 722 S.W.2d 18 (Tex. App.–Tyler 1986, no writ). In the absence of specific provisions in the instrument, the provisions of the Act (as provided in state law) control allocations of receipts between income and principal.

In Texas, for example, items accrued on the day before the date of death, such as rent, interest and annuities, are treated as principal under the Texas Trust Code, even if those items are considered income (presumably, income in respect of a decedent) under tax law. TEX. PROP. CODE § 116.102(a). However, if the income is derived from an asset that is specifically bequeathed, the income is distributable to the recipient of that asset. TEX. PROP. CODE § 116.051(l). Although income accrued before the date of death is principal, funds received by a trustee from an estate that constitute the estate's income under Section 310.004 of the Texas Estates Code is treated as trust income under Section 116.152 of the Texas Trust Code. TEX. ESTS. CODE § 310.004, TEX. PROP. CODE § 116.101(b)(2). Accordingly, this post-death income passing from the estate to the trust will not be "trapped."

(2) Allocations Under UPIA. UPIA applies a uniform approach in allocating receipts and disbursements between principal and income. In most cases, the cash basis is expressly used to characterize income and expenses.

(a) Distributions from "Entities". Section 401 of UPIA describes how to characterize distributions from "entities," which the Act defines to include corporations, partnerships, limited liability companies ("LLCs"), regulated investment companies (i.e., mutual funds), real estate investment trusts, and common trust funds. The general rule under UPIA is that all distributions received from these entities are income, subject to four exceptions. First, the Act treats long term capital gain distributions from mutual funds or real estate investment trusts as principal. Second, a distribution or series of related distributions received in exchange for the trust's interest in the entity are principal. Third, distributions in kind (as opposed to distributions of money) from entities are treated as principal. Fourth, distributions of money received as a total or partial liquidation are principal. In this regard, a distributions of money is treated as a partial liquidation if (i) it is designated by the entity as a liquidating distribution; or (ii) if the distribution or a series of distributions exceed 20% of the entity's gross assets prior to distribution (ignoring an amount that does not exceed the income tax that the trustee or beneficiary must pay on the entity's income). Of note, reinvested corporate dividends are treated as principal (but presumably only if they are reinvested pursuant to the trustee's power under the Act to adjust between income and principal to comply with the duty of impartiality between income and remainder beneficiaries). Texas has adopted this approach in Section 116.151 of the Texas Trust Code. TEX. PROP. CODE § 116.151.

(b) Mutual Fund Distributions. Section 401(c)(4) of UPIA provides that principal includes money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. The official comment to the Uniform Act states: "Under the Internal Revenue Code and the Income Tax Regulations, a 'capital gain dividend' from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act." *See* TEX. PROP. CODE § 116.151(c)(4).

(c) Business and Farming Operations. UPIA permits a trustee to aggregate assets used in a business or farming operation and to account separately for the business or activity (instead of accounting separately for its various components) if the trustee "determines that it is in the best interest of all of the beneficiaries" to do so. UNIF. PRIN. & INC. ACT § 403(a) (2000); TEX. PROP. CODE § 116.153(a). The trustee is permitted to maintain a reserve from its net cash receipts to the extent needed for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business. UNIF. PRIN. & INC. ACT § 403(b) (2000); TEX. PROP. CODE § 116.153(b).

c. Allocation of Expenses.

(1) General Rule. Like income, expenses may be allocated between fiduciary accounting income and principal based upon the terms of the governing instrument. If the instrument fails to specify how expenses are to be allocated, state law provides guidance.

(2) Allocations Under UPIA. Section 501 and 502 of UPIA describe allocations against income and principal. In Texas, Section 116.201 and 116.202 of the Texas Trust Code govern allocation of expenses. TEX. PROP. CODE §§ 116.201, .202.

(a) Charges Against Income. Under Section 501, charges against income include one-half of all regular trustee compensation (including investment advisory or custodial fees) and one-half of expenses for accountings and judicial proceedings that involve both the income and principal beneficiaries. All of the ordinary expenses of administration, management and preservation of property, and the distribution of income, including recurring taxes assessed against principal, insurance, interest and repairs are charged against income. Also charged to income are all court costs and attorney fees for other matters concerning income. UNIF. PRIN. & INC. ACT § 501 (2000); TEX. PROP. CODE § 116.201.

(b) Charges Against Principal. Charges against principal are all those expenses not charged to income, including one-half of trustee fees; accountings and judicial proceedings not charged to income; trustee compensation calculated on principal as a fee for acceptance, distribution, or termination of the trust, and disbursements made to prepare property for sale; and payments on the principal portion of debt. Also charged to principal are estate, inheritance, and other transfer taxes. UNIF. PRIN. & INC. ACT § 502 (2000); TEX. PROP. CODE § 116.202.

(c) Income Taxes. UPIA Section 505 generally charges taxes based upon income receipts to income, and charges taxes on principal receipts to principal, even if denominated as an "income" tax (such as capital gain taxes). The Section then goes on to allocate "tax required to be paid by a trustee on a trust's share of an entity's taxable income," which would presumably include income from partnerships, LLCs and S corporations. The Act requires that these taxes be paid proportionally from income, to the extent that receipts from the entity are allocated to income, and to principal to the extent (i) receipts are allocated to principal; or (2) the entity's taxable income exceeds the total receipts from the entity. UNIF. PRIN. & INC. ACT § 505(c) (2000). These allocations must be reduced by the amount distributed to a beneficiary for which a distribution deduction is allowed. UNIF. PRIN. & INC. ACT § 505(d) (2000). In 2008, the Uniform Law Commission made important changes to Section 505 of UPIA to deal with income tax issues associated with pass-through entities owned by trusts and estates. The revised statute deletes the requirement that taxes be charged to principal to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity. It then adds a provision requiring the trustee to adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary. The rewritten statute requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This treatment assures the trust is a source of cash to pay some or all of the taxes on its share of the entity's taxable income.[6] Only thirty-six states, including Texas, and the District of Columbia have enacted this amendment. *See, e.g.,* TEX. PROP. CODE § 116.205. These issues are discussed in greater detail beginning on page 34.

2. UPIA Power to Adjust. Separate from UPIA's directions as to the allocations of receipts and disbursements is UPIA's granting of the power to adjust to trustees of certain trusts. Once a trustee determines whether a receipt is allocated to principal or income, the trustee can shift the allocation somewhat by exercising the power to adjust in order to provide fairness among the beneficiaries.

a. Breadth of the Power. The framers and advocates of UPIA make much of its provision granting the trustee the power to adjust between principal and income "to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines . . . that the trustee is unable to comply with" the general requirement to administer the trust "impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." UNIF. PRIN. & INC. ACT §§ 103(b), 104 (2000).

[6] UFIPA essentially adopted the 2008 changes to UPIA.

The power to adjust includes the power to allocate all or part of a capital gain to trust income. This power is seen by many as a panacea to cure all of the ills of trust administration. Unfortunately, however, its application is limited.

b. Limitations on the Power to Adjust. The power to adjust is not available to all trustees. In particular, the power may not be used to make an adjustment: (1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment; (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion; (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside; (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (7) if the trustee is a beneficiary of the trust; or (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly. UNIF. PRIN. & INC. ACT § 104(c) (2000); TEX. PROP. CODE § 116.005. Many of the trusts with which estate planners struggle fall within category (1) (intended to qualify for the estate tax marital deduction) or (7) (the trustee is a beneficiary). As a result, the power to adjust is simply unavailable in many cases.

3. Equitable Adjustments. Separate from the power to adjust, UPIA Section 506 (and Texas Trust Code Section 116.206) permits a fiduciary to make adjustments between principal and income to offset the shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from (i) elections that the fiduciary makes from time to time regarding tax matters; (ii) an income tax imposed upon the fiduciary or a beneficiary as a result of a distribution; or (iii) the ownership by an estate or trust of an entity whose taxable income, whether or not distributable, is includible in the taxable income of the estate, trust or a beneficiary. This sort of adjustment, often referred to as an "equitable adjustment," has been the subject of common law decisions in a variety of jurisdictions.

> **Example 1:** In *Estate of Bixby*, 295 P.2d 68, 140 Cal. App. 2d 326 (1956), the executor elected under Code Section 642(g) to take deductions for income tax purposes, which reduced income taxes by $100,000, at the cost of $60,000 in estate tax savings. Based upon the terms of the Will, the income tax savings inured to the benefit of the income beneficiary, while the loss of estate tax savings came at the expense of the remainder beneficiaries. The net savings to the estate overall was $40,000, but as among its various beneficiaries, some gained at the expense of others. The court required the executor of the estate to allocate $60,000 to the remainder beneficiaries to compensate them for their damages as an "equitable adjustment." As a result, the remainder beneficiaries were unharmed, and the income beneficiaries received the net $40,000 tax savings.

4. Trapping Distributions. A "trapping distribution" may arise when one fiduciary (e.g., an estate) distributes property to a trust (e.g., a marital deduction trust), if the distribution carries with it taxable income in the form of the distributing entity's distributable net income. If the transferee fiduciary characterizes the receipt as corpus under principles of local law or the governing instrument, the recipient will not distribute that amount as "income" to the beneficiary. As a result, the DNI carried out by the distributing entity is "trapped" inside the transferee entity. This trapping of income presents an opportunity to use an otherwise simple trust as a taxpayer in the year it is funded. Naturally, since the trust's tax rates may be as high as 40.8% at only $12,750 in taxable income (applying 2019 rules), the tax savings generated by this technique are limited. A simple trust with $13,050 in income ($300 of which would be excluded by the trust's allowance in lieu of personal exemption) would pay a tax of $3,075.50 instead of $4,828.50 if the entire $13,050 were taxed to a beneficiary in the 37% bracket–a savings of only $1,753. If the beneficiary were subject to the 3.8% tax on net investment income, the savings would be $2,248.90. Under Section 302 of UPIA, income accrued at the date of death is principal, but funds received by a trustee from an estate that constitute the estate's income is treated as trust income. Accordingly, this post death income passing from the estate to the trust will not be "trapped."

C. The Conduit Principle of Taxation. The fundamental difference between estates and trusts on the one hand, and individuals and other types of taxpayers on the other, relates to what estate planning professionals refer to as the "conduit" principle of taxation that applies only to estates and trusts. In short, this principle imposes tax on estates and trusts only to the extent that they receive *and retain* taxable income in any year. If the estate or trust makes a distribution (or is required to make a distribution), then the Code generally (i) treats that distribution as coming first from the estate or trust's income for the year; (ii) permits the estate or trust a deduction for the amount of taxable income distributed; (iii) requires the recipient to report that same amount as income; and (iv) treats the character of the distribution (dividends, rent, interest, etc.) the same in the hands of the beneficiary as it was in the hands of the estate or trust. Thus, to the extent that distributions are required or actually made, the income "flows through" the estate or trust into the hands of the beneficiary.

D. Ten Things that Estate Planners Need to Know About Subchapter J. The conduit principle of taxation gives rise to numerous implications – enough in fact for a full semester law school course on the subject. The goal of this paper, however, is to arm its readers with some practical information on how these rules apply. With apologies to David Letterman, we present our list of the top ten income tax issues that every estate planner should know. We don't present them in the order that they appear in the Code, or even in order of importance. There are certainly other income tax issues that merit consideration. Mastery of these ten, however, should give an estate planner a good background in fundamental income tax issues that arise in the estate planning and administration context. Our "top ten list" starts with (1) understanding the distinction between simple trusts, complex trusts, and estates. We next turn to several important income tax issues that arise when estate or trust assets are distributed. These areas are: (2) the carry-out of "distributable net income" or "DNI"; (3) the charitable deduction; (4) the availability of an interest deduction; and (5) the treatment of trust and estate net losses. Estates, trusts and their beneficiaries can at times recognize gains (and sometimes losses) as a result of funding certain gifts. The paper thus points out (6) the possible recognition of gains by an estate or trust when appreciated assets are distributed; and (7) the impact upon beneficiaries of making unauthorized non-pro rata distributions of assets in kind. Next, we review the sometimes arcane rules that arise with regard to (8) assets which the Code characterizes as "income in respect of a decedent." The paper then discusses (9) the deductibility of certain administration expenses for income or estate tax purposes, and the need for the executor to make an election in that regard. The list finishes with (10) the notion that some trusts, known as "grantor trusts" are not taxpayers at all to the extent that the person who created the trust (or in some cases, the trust's beneficiary) may be treated for income tax purposes as the owner of all or a portion of the trust's property. There is a recurring theme throughout much of what follows: the income tax effects of trust and estate administration and distributions are often largely controlled by language included in (or omitted from) the governing instrument, and by specific steps taken and elections made by the executor or trustee in the administration of the estate or trust.

1. Trusts Can Be Simple or Complex (and Estates are Taxed Like Complex Trusts). Subchapter J of the Code deals with income taxation of trusts and estates, as well as beneficiaries and grantors, but with regard to trusts, it divides them into two broad categories, which are referred to (for no particularly good reason) as "simple" and "complex" trusts. The rules for estates are generally those applicable to complex trusts, with some minor differences. Therefore, in Subchapter J, one can really speak of three different kinds of entities: simple trusts, complex trusts, and estates.

a. Simple Trusts. The Code and Treasury regulations outline the tax treatment for "simple trusts" and their beneficiaries in Sections 651 and 652. In order to qualify as a simple trust: (a) the trust's governing instrument must provide that all of its income (measured under state law – not all of its taxable income) is required to be distributed currently; (b) the trust instrument must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes; and (c) the trustee must not make any distribution other than current income during the year in question. IRC § 651(a); Treas. Reg. § 1.651(a)-1. Note that this last requirement is applied on a year-by-year basis, which means that a trust may be a simple trust in one year, and a complex trust in another. If a trust requires that all of its income for the taxable year must be distributed to one or more non-charitable beneficiaries, the trust is a simple trust for that year, so long as no other distributions are made in that taxable year (even if they are permitted or required to be made in that year by the terms of the governing instrument).

The significance of being characterized as a simple trust is that these trusts are allowed a deduction in computing their taxable income for the amount of the income *required to be distributed currently* (limited to the trust's taxable distributable net income, discussed below), whether or not the income is actually distributed. IRC § 651. The amount allowed as a deduction to the trust is included in the income of the beneficiary (or beneficiaries), whether distributed or not. IRC § 652(a). The character of the amounts included in income are the same as the character in the hands of the trust. IRC § 652(b).

b. Estates and Complex Trusts. Any trust that is not a simple trust, is a "complex trust" (including an otherwise simple trust that distributes amounts in excess of its current fiduciary accounting income in any particular year). For trusts that are complex trusts (and for estates), a deduction is allowed from income for the taxable year for amounts required to be *or otherwise properly distributed to the beneficiaries*. IRC § 661(a). Thus, for complex trusts and estates, a deduction is permitted both as to amounts required to be distributed (referred to as "Tier I" distributions) *and* for amounts that an executor or trustee is permitted (but not required) to distribute but actually distributes (called "Tier II" distributions). As with simple trusts, the deduction may not exceed the total taxable distributable net income of the estate or trust for that year. IRC § 661(a). The character of the distributed income reported by the beneficiaries is the same as its character in the hands of the trust. IRC § 661(b) and § 662(b). The amount allowed as a deduction to the trust is included in the beneficiaries' income. IRC § 662(a). Estates and complex trusts may elect to treat distributions made during the first 65 days of their tax year as though they were made on the last day of the preceding tax year. This election enables executors and trustees to take a look at their taxable income after their books have been closed for the year, to decide whether to shift income out to beneficiaries. IRC § 663(b). Since simple trusts get a deduction regardless of whether the income has actually been paid out, the 65-day rule isn't necessary for them.

c. Other Differences. The characterization of trusts, or the status of a taxpayer as an estate, presents other differences as well. For example, in lieu of the personal exemption allowed to individual taxpayers under Section 151 of the Code,[7] trusts and estates receive a nominal deduction. IRC § 642(b)(3). For estates, the annual deduction is $600. IRC § 642(b)(1). The allowance for a trust that must distribute all of its income annually (regardless of whether it meets the other requirements to be treated as a simple trust) is $300. For all other trusts, the deduction is $100. IRC § 642(b)(2).

2. Estate and Trust Distributions Carry Out Distributable Net Income. Broadly speaking, income earned by a trust or estate in any year is taxed to the trust or estate to the extent that the income is retained, but is taxed to the beneficiaries to the extent that it is distributed to them. Executors and trustees must work with state law definitions of "income" that are different from the tax law concept of "taxable income." For example, capital gains are typically principal for state law purposes, even though they are taxable as income for federal income tax purposes. On the other hand, tax-exempt interest constitutes income under state law, even though it is not taxable income. The Code makes an effort to reconcile these differing definitions by using the concept of distributable net income ("DNI").

The Code sets forth a detailed method to determine which trust or estate distributions carry income out to the beneficiaries. Thus, the structure of the payments or distribution from a trust or estate may subject the beneficiary to income tax. For example, the payment of an amount from the residuary of an estate will typically carry out income that has been earned by the estate in the year of payment (i.e., distributable net income) while, as discussed below, the payment of a specific sum will not. *See* IRC § 663(a)(1). DNI is a basic concept of income taxation of trusts, estates and their beneficiaries. It is used as a "measuring rod" for allocating income among the trust or estate and the beneficiaries, and is a concept uniquely applicable to the taxation of trusts and estates. It is the fundamental tool used to implement the conduit principle, that is, a trust or estate is often nothing more than a conduit for property to pass to its beneficiaries. In computing DNI, the personal representative begins with the trust or estate's taxable income, which then must be modified in several respects in order to serve as an effective measure of the maximum allowable deduction to the estate or trust for distributions to beneficiaries (and which beneficiaries must then include in their gross income).

DNI is basically the amount of trust or estate income available for distribution in a particular tax reporting year. It can be classified as a trust's taxable income (before application of the distribution deduction), excluding net capital gains allocated to principal, but including net tax-exempt income, minus allowable deductions and losses. IRC § 643(a). DNI serves three functions. First, trust or estate DNI establishes the maximum amount that a trust or estate can deduct under Code Sections 651 and 661 as a distribution to its beneficiaries. Second, DNI determines the maximum amount that the trust or estate beneficiaries can be taxed upon under Code Sections 652 and 662.

[7] Although individual taxpayers are entitled to a personal exemption, Code Section 151(d)(5) provides that for tax years beginning after December 31, 2017 and before January 1, 2026, the personal exemption is zero.

Third, DNI determines the character of a distribution by a trust or estate. Specifically, it is used to characterize and divide distributions into different "classes" of income (such as qualified dividends, rent, passive income, tax-exempt income, etc.). The character of a distribution as taxable or tax-exempt may also affect the maximum deduction allowed to the trust or estate, and the maximum portion of the distribution included in gross income by the beneficiary, because trusts and estates may not deduct (and beneficiaries do not pay tax on) net tax-exempt income when distributed.

In summary, DNI in most cases is the taxable income of an estate or trust (before its distribution deduction), less its net capital gains[8], plus its net exempt income. The general rule is that any distribution from an estate or trust will carry with it a portion of the estate or trust's DNI.[9] Estate and trust distributions are generally treated as coming first from current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata.

> **Example 2:** Assume that A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. Unless the separate share rule discussed at page 9 below applies, the distributions are treated as coming first from estate income, and are treated as passing to the beneficiaries pro rata. Therefore, A will report income of $80,000 ($100,000 x ($200,000/$250,000)); B will report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate will be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, the estate would have received a $75,000 distribution deduction, and would have reported the remaining $25,000 as income on the estate's income tax return.

While most trusts must adopt a calendar year end, an estate may elect to use a fiscal year end based upon the decedent's date of death. The estate's fiscal year must end on the last day of a month, and its first year must not be longer than 12 months. IRC § 644. If the tax year of the estate and the beneficiary differ, the beneficiary reports taxable DNI not when actually received, but as though it had been distributed on the last day of the estate's tax year. IRC § 662(c). As noted earlier, Section 663(b) of the Code permits complex trusts to treat distributions made during the first 65 days of the trust's tax year as though they were made on the last day of the preceding tax year. This election enables trustees to take a second look at DNI after the trust's books have been closed for the year, to shift income out to beneficiaries. The Taxpayer Relief Act of 1997 extended the application of the 65-day rule to estates for tax years beginning after August 5, 1997. As a result, for example, the executor of an estate can make distributions during the first 65 days of Year 2, and elect to treat them as though they were made on the last day of the estate's fiscal Year 1. If the executor makes this election, the distributions carry out the estate's Year 1 DNI, and the beneficiaries include the distributions in income as though they were received on the last day of the estate's Year 1 fiscal year.

The general rule regarding DNI carry-out is subject to some important exceptions.

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[8] Capital gains are typically excluded from DNI, and as a result, they are often "trapped" in the trust or estate - if they are excluded from DNI, they simply cannot be carried out to beneficiaries when distributions are made, and so are taxed to the trust or estate. However, this rule is subject to three exceptions. Capital gains are included in DNI (and thus may be included in the amounts that carry out to beneficiaries) to the extent that they are, pursuant to the governing instrument or local law: (i) allocated to income; (ii) allocated to corpus but treated consistently by the trustee on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (iii) allocated to corpus, but actually distributed to a beneficiary or utilized by the trustee in determining the amount that is distributed or required to be distributed to a beneficiary. *See* IRC § 643(a)(3); Treas. Reg. § 1.643(a)-3(b).

[9] Although the proposed Treasury regulations related to Code Section 199A that were issued on August 8, 2018 provided that a trust or estate's taxable income for purposes of determining its threshold amount would be calculated before taking any distribution deduction, the final Treasury regulations corrected this unfair calculation. Accordingly, as corrected, to determine whether a trust or estate has reached or exceeded the threshold amount that could limit any potential 199A deduction, the distribution deduction is taken into account when calculating taxable income for Section 199A purposes. Treas. Reg. § 1.199A-6(d)(3)(iv). For any Section 199A deduction that applies, the deduction is apportioned among the trust or estate and their beneficiaries based on the relative portion of DNI to be distributed, and DNI is calculated with regard to the separate share rule but without regard to any 199A deduction. Treas. Reg. § 1.199A-6(d)(3)(ii).

a. Specific Sums of Money and Specific Property. Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If an executor or trustee pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate or trust. As a result, the estate or trust will not receive a distribution deduction for these distributions. By the same token, the estate or trust's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.

(1) Requirement of Ascertainability. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. In the case of the decedent's estate, the governing instrument is typically the decedent's Will or revocable trust agreement.

(2) Formula Bequests. Under the Treasury regulations, a marital deduction or credit shelter formula bequest *does not* usually qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, as discussed below, an executor may elect to deduct many estate administration expenses on the estate's income tax return, or on its federal estate tax return. If the executor elects the former, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction (or credit shelter bequest) cannot be resolved on the date of the decedent's death, the IRS takes the position that these types of bequests will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 CB 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death *does* carry out distributable net income from the estate.

(3) Payments from Current Income. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's DNI. Treas. Reg. § 1.663(a)-1(b)(2)(i).

(4) Distributions of Real Estate Where Title has Vested. The transfer of real estate does not carry out DNI when conveyed to the devisee thereof if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 CB 304. State law may provide for immediate vesting either by statute or by common law. *See, e.g.*, UNIF. PROB. CODE § 3-101. TEX. ESTS. CODE § 101.001; *Welder v. Hitchcock*, 617 S.W.2d 294, 297 (Tex. Civ. App. – Corpus Christi 1981, writ ref'd n.r.e.). Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate. Otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI. Rev. Rul. 68-49, 1968-1 CB 304. Note, however, that the IRS Office of the Chief Counsel released an IRS Service Center Advice Memorandum (SCA 1998-012) which purports to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).

b. The Tier Rules. As noted above, estates and complex trusts are entitled to deduct both amounts required to be distributed (referred to as "Tier I" distributions) and amounts that an executor or trustee is permitted (but not required) to distribute (called "Tier II" distributions). The significance of this distinction is that if an estate or trust makes both Tier I and Tier II distributions in a year, the pro rata rules that normally characterize distributions to beneficiaries do not apply. Instead, distributions are treated as carrying out DNI first only to Tier I (mandatory) distributees (carried out to them pro rata if more than one). IRC §§ 661(a)(1), 662(a)(1). If there is any DNI remaining after accounting for all Tier I distributions, then that DNI is carried out to Tier II distributees (again, pro rata if more than one). IRC §§ 661(a)(2), 662(a)(2). In addition, in determining the amount of DNI available to be carried out to Tier I distributees, any deduction for amounts paid to charitable organizations (discussed below), is ignored. IRC § 662(a)(1). In other words, DNI (computed without regard to the trust or estate's charitable deduction) is carried out to Tier I distributees. Then, the estate or trust is allowed its charitable deduction. Finally, any remaining DNI is carried out to Tier II distributees. As discussed below, no DNI gets carried out to charitable beneficiaries. Nevertheless, the effect of these ordering rules is to treat charities somewhat like an "intermediate" tier when allocating a trust or estate's income among its distributees.

c. The Separate Share Rule. When the tier rules don't apply (or within each tier when they do apply), estate or trust distributions made to multiple beneficiaries generally carry DNI out to them pro rata.

Example 3: In a year in which an estate has $10,000 of DNI, the executor distributes $15,000 to A and $5,000 to B. Unless the tier or separate share rules apply, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. If the $10,000 of DNI was comprised of $5,000 of interest, $2,000 of dividends, and $3,000 of rental income, A will include 75% of each category of income, and B will include 25% of each category. Note also that if A was a Tier I beneficiary, the result would be different and A would include $10,000 of DNI in his income.

However, 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, then solely for purposes of allocating DNI, the "separate share rule" applies. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's or trust's DNI. IRC § 663(c). As a result, executors and trustees have to determine whether the trust agreement, Will or state intestate succession laws create separate economic interests in one beneficiary or class of beneficiaries.

Example 4: A Will bequeaths all of the decedent's IBM stock to X and the balance of the estate to Y. During the year, the IBM stock pays $20,000 of post-death dividends to which X is entitled under local law. No other income is earned. The executor distributes $20,000 to X and $20,000 to Y. Prior to the adoption of the separate share rule, the total distributions to X and Y would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata (i.e., $10,000 to X and $10,000 to Y). But X has an economic interest in all of the dividends and Y is not entitled to them. Therefore, the distribution to Y must be from corpus. Under the separate share rule, the distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y. Thus, application of the separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions.

Distributions to beneficiaries who don't have "separate shares" continue to be subject to the pro-rata rules. Application of the separate share rule is mandatory. The executor or trustee cannot elect separate share treatment, nor may the executor or trustee elect out of it. The separate share rule has long applied to trusts, but was not applied to estates until 1997. The IRS has issued final regulations applying the separate share rule to estates. Treas. Reg. § 1.663(c)-4. In practice, application of the separate share rule to estates is often quite complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. Under the final Regulations, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share. Treas. Reg. § 1.663(c)-5, Exs. 3-11. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share. Treas. Reg. § 1.663(c)-4(c). A bequest of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Section 663(a)(1) of the Code) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares. *Id.* A revocable trust that elects to be treated as part of the decedent's estate is always a separate share, and may itself contain two or more separate shares. Treas. Reg. § 1.663(c)-4(a). For a good discussion of some of the complexities associated with the application of the separate share rule to estates, see Newlin, *Coping with the Complexity of the Separate Shares under the Final Regs.*, 27 EST. PLAN. J. 243 (July 2000).

d. Income From Property Specifically Bequeathed. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate. *See, e.g.,* UNIF. PRIN. & INC. ACT § 201(1); TEX. ESTS. CODE § 310.004(b). Until the adoption of the separate share rule, DNI was reported on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to the beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest," the separate share rule should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income. In addition, the later distribution should not carry out DNI under the separate share rule, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rule, while complex to administer, has the advantage of making the income tax treatment of estate distributions more closely follow economic reality.

e. Interest on Pecuniary Bequests. State law or the governing instrument may provide that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, typically beginning one year after the date of death. *See, e.g.*, TEX. ESTS. CODE § 310.004, TEX. PROP. CODE § 116.051(3). The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under the Uniform Principal and Income Act ("UPIA"), the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. UNIF. PRIN. & INC. ACT § 201(3) (1997); TEX. PROP. CODE § 116.051. Interest payments are not treated as distributions from the estate for DNI purposes. Instead, they are treated as an interest expense to the estate. As a result, they do not carry out estate income. Rev. Rul. 73-322, 1973-2 CB 44. For a discussion of the income tax issues associated with the payment of this interest payment by the estate, see page 11 below.

3. Trusts and Estates Get Unlimited Income Tax Deductions for Charitable Distributions. Distributions made to charities are not treated as distributions to "beneficiaries" for purposes of the DNI carry-out rules. IRC § 663(a)(3). Instead, amounts of gross income paid to (or in the case of estates, permanently set aside for) charities are eligible for an income tax charitable deduction. IRC § 642(c). If the distribution generated both a charitable deduction and a deduction for carrying out DNI, the trust or estate would obtain a double benefit for such distributions. Unlike individuals, trusts and estates are not limited in their charitable deductions to a percentage of their adjusted gross income. Trusts and estates can take a deduction for all income so paid. On the other hand, unlike individuals, trusts and estates may not carry forward any unused deductions into a succeeding taxable year. A special rule impacts the timing of charitable deductions. Specifically, if a charitable contribution is paid after the close of a taxable year and on or before the last day of the following year, then the trustee or executor may elect to treat the contribution as paid during the prior taxable year. IRC § 642(c)(1). Again, this one-year look-back has no counterpart for individuals. The character of income distributed to charity is generally a pro rata portion of each component of the trust or estate's income for the year. To the extent that the trust or estate has tax exempt income during the year, the proportion of that income deemed distributed to charity does not qualify for an income tax deduction. *See* Treas. Reg. § 1.662(c)-4. The regulations further provide that if a distribution to charity does not qualify for a charitable deduction by reason of Code Section 642(c), it is not carried out as part of DNI and therefore is not eligible to be treated as a distribution deduction under Section 661. Treas. Reg. § 1.663(a)-2.

4. Interest Paid on Pecuniary Bequests May Be Deductible. As noted above, state law or the governing instrument may provide that at some point in time, the devisee of a pecuniary bequest is entitled to interest on the bequest. Many jurisdictions provide that interest begins to accrue one year after the date of death. *See, e.g.,* TEX. PROP. CODE § 116.051(3). UPIA provides that this interest is charged against income to the extent that it is sufficient, and thereafter against principal. UNIF. PRIN. & INC. ACT § 201(3) (2000); TEX. PROP. CODE § 116.051(3). For income tax purposes, however, payment of this interest is treated not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary. Rev. Rul. 73-322, 1973-2 CB 44. Under Section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. Some practitioners have sought to characterize this interest as deductible "investment interest." Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment, and capital gains attributable to that property. Property held for investment is described by reference to Section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. IRS Notice 89-35, 1989-13 IRB 4, provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under the Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods

of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by an estate in funding a bequest, perhaps these principles can be applied by analogy to estates. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" to the beneficiary was incurred because the estate failed to distribute its assets to fund the pecuniary bequest promptly. The estate was thus able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the governing instrument or local law. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest." It should be noted, however, that in an example contained in the Treasury regulations relating to the separate share rule, the IRS states (without explanation) that interest paid on a spouse's elective share that is entitled to no estate income, but only statutory interest, is income to the spouse under Section 61 of the Code, but non-deductible to the estate under Section 163(h). Treas. Reg. § 1.663(c)-5, Ex. 7. The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under Section 163(h) is gratuitous, and in our view, erroneous. It appears that the only case to consider this matter is *Schwan v. United States*, 264 F. Supp. 2d 887 (D. S.D. 2003). In *Schwan*, the court rejected the executors' argument that the interest was incurred to prevent the forced liquidation of stock held by the estate, noting that the stock had already been transferred to the estate's beneficiary when the interest obligation began to run. The estate, therefore, did not even own the stock when the interest was imposed, and had no interest in preventing its forced liquidation. On these facts, the investment interest question was not squarely before the court.

5. <u>Net Losses and Excess Deductions of Trusts and Estates are Wasted, Except in Their Final Year</u>. Distributions from trusts and estates carry out DNI, but what if the trust or estate has a net loss for the year? Despite the conduit approach to trust and estate taxation, their deductions do not pass directly through to beneficiaries. By reducing DNI, deductions reduce the maximum amounts taxable to beneficiaries, but once DNI is reduced to zero, any excess deductions are generally useless to the beneficiaries. In general, these losses must simply go unused, unless some provision of the Code allows them to be carried forward for use by the trust or estate in a later year. Rev. Rul. 57-31, 1957-1 CB 201. Thus, a trust or an estate may carry forward a net capital loss under Code Section 1212(b)[10], or carry forward a net operating loss incurred in a trade or business under Code Section 172[11], but except in the termination year of the trust or estate (as further discussed below), there is generally no way to pass these net losses out to beneficiaries, or to otherwise use losses for which no carryforward is provided.

a. <u>Losses and Carryforwards</u>. Code Section 642(h) mitigates the waste of excess deductions and unused carryovers for the taxable year in which a trust or estate terminates. This provision has the effect of transferring unused net operating and capital loss carryovers from the terminating trust or estate to its beneficiaries, along with any excess of deductions over gross income for that year. When a beneficiary inherits an unused carryover under Code Section 642(h), he or she may find it somewhat the worse for wear. An inherited carryover cannot be carried back to earlier taxable years of the beneficiary, and in determining a carryover's remaining statutory life, the last taxable year of the trust or estate counts as a full year regardless of how short it may be, as does the beneficiary's tax year that includes the end of the entity's last year. Treas. Reg. § 1.642(h)-1(b). *But see Dorfman v. Comm'r*, 394 F.2d 651 (2d Cir. 1968) (holding this portion of the regulation invalid).

b. <u>Excess Deductions</u>. In addition to carryovers, Code Section 642(h)(2) allows beneficiaries to deduct any excess of the entity's deductions over gross income for its final taxable year. In computing this excess, the deductions allowed by Section 642(b) (the deduction in lieu of personal exemption) and Section 642(c) (the

[10] IRC § 1212(b) generally permits non-corporate taxpayers with capital losses exceeding those that can be used to reduce capital gains or ordinary income in the taxable year in which sustained to be carried forward to succeeding years indefinitely.

[11] Prior to 2018, under Code Section 172, net operating losses could ordinarily be carried back to the two taxable years before the loss year and could be carried forward to the 20 succeeding years, allowing the expenses of earning income to be taken into account over a 23-year cycle. TCJA 2017 revised this rule for losses arising after 2017 in most circumstances to eliminate the two-year carryback and limit the carryforward in any year to 80% of taxable income computed before the carryback, but to permit the carryforward indefinitely.

charitable deduction) are disregarded. Net operating loss and capital loss carryovers are also disregarded, since they pass independently to beneficiaries under Code Section 642(h)(1), (except that a net operating loss carryover expiring in the terminating year of the trust or estate is taken into account, to the extent not used by the trust or estate, and hence passes through to beneficiaries under Section 642(h)(2) rather than as a carryover under Section 642(h)(1).) Treas. Reg. § 1.642(h)-2(b). Unlike carryovers passing to beneficiaries, excess deductions can be used only in a beneficiary's taxable year in which the trust or estate terminates, and then only as an itemized deduction, not in computing the beneficiary's adjusted gross income. Treas. Reg. § 1.642(h)-2(a). Because TCJA 2017 eliminated miscellaneous itemized deductions, i.e., those deductions subject to a 2% AGI floor, for individuals for years 2018 through 2025, beneficiaries will not be able to use most of these excess deductions. IRC § 642(a), (b), (g). Therefore, before terminating an estate or trust during these years, thought should be given as to whether termination should be held off if a possibility exists for the estate or trust to recognize income in order to use the deductions.

c. Apportionment Among Beneficiaries. Under Section 642(h), carryovers and excess deductions pass only to "the beneficiaries succeeding to the property of the estate or trust," who are "those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income . . . ." Treas. Reg. § 1.642(h)-3(a). The succeeding beneficiaries of testate estates are normally the residuary beneficiaries, rather than persons to whom specific property and sums of money are bequeathed. The opposite might be true if an estate is exhausted by specific bequests and legacies, leaving no residue, but there is no authority on point. If two or more persons succeed to property of the estate or trust, the passed items are allocated among them, "proportionately according to the share of each in the burden of the loss or deductions." Treas. Reg. § 1.642(h)-4.

6. An Estate or Trust May Recognize Gains and Losses When It Makes Distributions In Kind. Unless a specific exception applies, all estate or trust distributions, whether in cash or in kind, carry out the estate's or trust's DNI. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the *lesser* of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate or trust does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is subject to some important exceptions.

a. Distributions Satisfying the Estate's or Trust's Obligations. Distributions that satisfy a pecuniary obligation of the estate or trust are recognition events for the estate or trust. The fair market value of the property is treated as being received by the estate or trust as a result of the distribution; therefore, the estate or trust will recognize any gain or loss if the estate's or trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

b. Distributions of Assets to Fund Pecuniary Gifts. A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount." Payment of a bequest described as a fixed dollar amount (e.g., "I give $100,000 to Phil, if he survives me.") may give rise to gain recognition if funded with property in kind, as opposed to cash. In addition, a formula pecuniary (dollar-amount) bequest is typically treated as a "specific dollar amount" for this purpose.

> **Example 5.** A formula gift requires an executor to distribute $400,000 worth of property. If the executor properly funds this bequest with assets worth $400,000 at the time of distribution, but with an adjusted cost basis of only $380,000 at the date of death, the estate will recognize a $20,000 gain.

The rules that apply this concept to formula bequests should not be confused with the "specific sum of money" rules that govern DNI carry outs. As noted above, unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). Such gifts are nevertheless treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a result, gains or losses could be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate. *Compare*

Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f) (gain or loss is recognized if distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). *See also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 CB 286; *Kenan v. Comm'r*, 114 F2d 217 (2d Cir. 1940). For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997 repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has a basis in excess of its fair market value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates by application of the related party rules of Section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under Section 645 of the Code.[12]

c. Pension and IRA Accounts Used to Fund Pecuniary Bequests. Some commentators have argued that if a pension asset or IRA is used to satisfy a pecuniary legacy, the use of that asset will be treated as a taxable sale or exchange, and this treatment will accelerate the income tax due. This analysis is based upon Treasury Regulation Section 1.661(a)-2(f), which requires an estate to recognize gain when funding a pecuniary bequest with an asset whose fair market value exceeds its basis, as though the asset is sold for its fair market value at the date of funding. *See* Rev. Rul. 60-87, 1960-1 CB 286. If an estate uses an asset constituting income in respect of a decedent to satisfy a pecuniary bequest, application of this principle would cause the gain to be accelerated. In our opinion, however, it can be persuasively argued that this acceleration will not occur if the beneficiary is not the estate, but the trustee named in the participant's will. Three lines of analysis confirm this result:

(1) No Receipt By Estate. The recognition rules under Treasury Regulation Section 1.661(a)-2(f) apply only in the context of a distribution *by the estate* in satisfaction of a right to receive a specific dollar amount. When a "testamentary trustee" is named as the beneficiary of a pension plan or IRA, there is clearly no distribution by the estate, and no acceleration event should occur to the estate. The estate, after all, is subjected to taxation only on income *received by the estate* during the period of administration or settlement of the estate. IRC § 641(a)(3). Pension benefits payable directly to the trustee of the trust established under the Will of the plan participant are never "received by the estate." This fact remains true even if the Will contains instructions directing the testamentary trustee to use these funds in whole or in part to compute the amount of a pecuniary bequest. The fact that the executor takes these non-testamentary transfers into account in measuring the amount of *other* assets needed to fund the pecuniary bequest should not change this result. Since the non-probate pension assets are not subject to administration, the estate cannot properly be said to be the taxpayer with respect to any transaction involving these benefits.

(2) No IRD Transfer by Estate. Separate and apart from the gain recognition rules of Treasury Regulation Section 1.661(a)-2(f) is the recognition rule of Section 691 of the Code that governs so-called "income in respect of a decedent" or "IRD" (discussed below beginning at page 15). However, the recognition rules of Section 691(a)(2) of the Code, by their terms, apply only if the right to receive income in respect of a decedent is transferred "*by the estate of the decedent* or a person who receives such right by reason of the death of the decedent . . ." (emphasis added). If the testamentary trustee is the beneficiary, there is simply no transfer *by* the estate. Moreover, there is no transfer *by* any "person" who receives such right by reason of the decedent's death. The Code expressly excludes from the definition of "transfer" requiring IRD acceleration any "transmission at death . . . *to* a person pursuant to the right of such person to receive such amount by reason of the death of the decedent. . ." IRC § 691(a)(2) (emphasis added). In that event, the recipient (here, the trust) includes these amounts in gross income not when the right to the payment is received, but only when the payments themselves (i.e., the distributions from the retirement plan) are actually received. IRC § 691(a)(1)(B).

(3) Constructive Receipt Rules. The general rules which describe the timing of recognition for income attributable to an IRD asset are reinforced by the statutes expressly governing pension distributions. Amounts held in qualified plans and IRAs are taxable to the recipient only when actually distributed. IRC §§ 72, 402(a). The

[12] For decedents dying in 2010 whose executors elected out of the federal estate tax and into the modified carry-over basis rules of Section 1022, recognition of gain on the funding of a pecuniary bequest was limited to post-death appreciation. IRC § 1040. Note, however, that if the modified carryover basis rules were applicable, any transfer of property by a United States person (including a trust or estate) to a non-resident alien resulted in the recognition of all built-in gains. IRC § 684(a).

mere fact that benefits under the plan or IRA are made available, or that the participant or beneficiary has access to them, is not determinative, since the constructive receipt rules do not apply to these assets. IRC §§ 402(a), 408.

(4) Proper Tax Treatment. Therefore, if the testamentary trustee receives, whether by a spouse's disclaimer or by direct designation by the participant, the right to receive plan distributions, no income tax should be payable until such time as distributions are actually made from the plan or IRA to the trust, even if the assignment of the right to receive plan assets otherwise reduces (or eliminates) the amount that the estate needs to distribute in satisfaction of a pecuniary bequest. Instead, the testamentary trust should be able to defer taxation on pension and IRA proceeds until such time as those accounts are distributed (which may be until they are required to be distributed in accordance with the minimum required distribution rules). *See* PLR 9630034 (pecuniary disclaimer by spouse of one-half interest in decedent's IRA does not cause recognition to spouse or estate).

d. Section 643(e)(3) Election. The executor may elect under Section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The Section 643(e) election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain or loss on only those assets. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets. Note that if an executor makes a Section 643(e)(3) gain-recognition election in a year that an IRD asset is distributed by the estate, gain would be accelerated, even if the distribution is otherwise subject to a Section 691(a)(2) exception, since the asset representing the IRD will be treated as having been sold by the estate in that year. For fiscal years beginning after August 1, 1997, the Section 643(e)(3) election (or an actual sale to a beneficiary) can cause the estate to recognize gains, but not losses, since under the principles of Section 267 of the Code, the estate and its beneficiary are now treated as related taxpayers. IRC § 267(b)(13).

7. Estate Beneficiaries May Recognize Gains and Losses if the Estate Makes Unauthorized Non Pro Rata Distributions in Kind. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries (meaning unauthorized under the terms of the governing instrument or local law), the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 CB 159. See Texas Estates Code Section 405.0015 for local law giving an independent executor the authority to make such distributions in certain instances.

> **Example 6:** A decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm was worth $110,000. At the date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if local law or the Will or revocable trust fails to authorize non-pro rata distributions*, the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" her interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. *See* PLR 9429012. To avoid this result, local law or the governing instrument should expressly authorize non-pro rata distributions. *See* PLRs 9422052, 9523029 (no gain recognized).

8. Income in Respect of a Decedent is Taxed to the Recipient. A major exception to the rule that an inheritance is income-tax free applies to beneficiaries who receive payments that constitute income in respect of a decedent ("IRD"). IRC §§ 102(a), 691; Treas. Reg. § 1.691(a)-1(b). Keep in mind that not only is the receipt of IRD income taxable to the recipient of the income, the IRD asset is includible in the decedent's estate for estate tax purposes. IRC § 2033.

a. IRD Defined. IRD is not defined by statute, and the definition in the Treasury regulations is not particularly helpful. Generally, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return. *See* Treas. Reg. § 1.691(a)-1(b). IRD may be included in the gross income of the decedent's estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the item of income. Because a beneficiary may include IRD in his or her income for income tax purposes, which means the beneficiary may pay income tax on that receipt, IRD is an exception to the rule of Code Section 102(a) that inheritances are income-tax free. Examples of IRD include (1) accrued interest, (2) dividends declared but not payable, (3) unrecognized gain on installment obligations, (4) bonuses and other compensation or commissions paid or payable following the decedent's death, (5) interests in partnerships that hold unrealized receivables or inventory items, and notably, (6) amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed (which would not include Roth IRAs and nonqualified retirement plan contributions, but pursuant to Revenue Ruling 75-125, 1975-1 CB 254 would include net unrealized appreciation in employer securities distributed from a qualified retirement plan and for which no election was made to include the appreciation in income). Therefore, assets such as Roth IRAs and a decedent's after-tax investment in retirement plans are not IRD. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981): (i) the decedent must have entered into a "legally significant transaction" – not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived. The basis in an IRD asset is equal to its basis in the hands of the decedent; no basis adjustment occurs at death. IRC § 1014(c). This rule is necessary to prevent recipients of IRD from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis).

b. Recognizing IRD. If the executor distributes an IRD asset in a manner that will cause the estate to recognize gain on the distribution, or if a Section 643(e)(3) election is made and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to receive IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received. Treas. Reg. § 1.691(a)-4(b)(2). If IRD is to be recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result. *See* PLR 9507008.

> **Example 7:** In 2019, X dies with a $14.4 million estate. The Will makes a formula marital gift of $3,000,000 to the spouse, leaving the rest of the estate (equal to the decedent's $11.4 million federal estate tax exclusion) to a bypass trust. If an IRD asset worth $3,000,000 but with a basis of $0 is used to fund the marital gift, the estate will report $3,000,000 of income. The spouse will receive the $3,000,000 worth of property, but the estate will owe income tax of some $1,108,000, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $10,292,000 to fund the bypass trust.

Under these circumstances, the testator may wish to consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

c. Deductions in Respect of a Decedent. A concept analogous to IRD is applied to certain deductible expenses accrued at the date of the decedent's death but paid after death. These "deductions in respect of a decedent" ("DRD") are allowable under Code Section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowed as deductions in respect of a decedent for income tax purposes to the person or entity paying those expenses. IRC § 691(b). The general rule disallowing both income and estate tax deductions for administration expenses, discussed below, does not apply to DRD. The theory behind allowing this "double" deduction is that had the decedent actually paid the accrued expense prior to death, he could have claimed an income tax deduction, and the cash on hand in his estate would be reduced, thereby effecting an estate tax savings as well. Of course, interest, administration expenses, and other items not accrued at the date of the decedent's death are subject to the normal election rules of Section 642(g) of the Code discussed below.

9. The Executor Can Elect to Deduct Many Expenses for Either Income or Estate Tax Purposes (but Not Both). An executor is often confronted with a choice of deducting estate administration expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed. IRC § 642(g). Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the

estate tax return. Between 1993 and 2001, the analysis was more difficult since income tax rates might or might not exceed effective estate tax rates in those years. For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%). Beginning in 2013, with a top income tax rate of 39.6% and a possible net investment income tax of 3.8%, executors were once again faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 43.4%) would be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%. For tax years beginning after 2017 and before 2026, the combined top income tax rate of 40.8% and the top estate tax rate of 40% are virtually the same. Nevertheless, not all beneficiaries are in the top income tax bracket and ultimately, one must "run the numbers" on both returns to determine which offers the most tax savings.

a. <u>Section 642(g) Expenses</u>. The executor must make an election to take administration expenses as a deduction for income tax purposes by virtue of Section 212 of the Code, or to deduct those same expenses as an estate tax deduction under Section 2053 of the Code. No double deduction is permitted. Expenses to which this election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income. Treas. Reg. § 1.212-1(i). Note, however, that expenses attributable to the production of tax-exempt income are denied as an income-tax deduction to estates, just as they are to individuals, under Section 265(a)(1) of the Code. Interest on estate taxes deferred under Section 6166 of the Code, which now accrues at only 45% of the regular rate for interest on underpayments, is no longer allowed as an estate tax <u>or</u> an income tax deduction. IRC §§ 163(k), 2053(c)(1)(D), 6601(j).

b. <u>Method of Election</u>. There appears to be some confusion among tax return preparers about how the Code Section 642(g) election is made. Technically, the Code and Treasury regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors protectively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter (or other confirmation that the estate tax has been finally determined) and deductions on the estate tax return have proven unnecessary. The election is not treated as made and final until a "fee waiver" (a sworn declaration) making the election is filed with a fiduciary income tax return. Therefore, the election need not be made until filing a final, amended fiduciary return for the year in which the expenses are paid. The only declaration regarding the election in the estate tax proceeding occurs when an agreed deficiency assessment is obtained in the estate tax audit process with the request by an agent for the fiduciary to sign an IRS Form 890, "Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment–Estate, Gift, and Generation-Skipping Transfer Tax." Pursuant to Form 890, the fiduciary waives notice and formal process on a deficiency assessment. The form contains a declaration regarding the fee waiver that binds the representative to the decision on where to claim these expenses. One might argue, however, that protective elections on both the income and estate tax return might be dangerous if the estate receives a closing letter (or other confirmation that the estate tax has been finally determined) without examination of or adjustment to the return. Under these circumstances, even though no IRS Form 890 would have been filed, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

c. <u>Payments from Income</u>. Increased attention has been focused on the interaction of state law and tax rules in determining whether estate administration expenses are chargeable to principal or income, particularly in estates seeking an estate tax marital or charitable deduction. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124 (1997) where the executor charged administration expenses to estate income for both state law and tax law purposes. The IRS held that such an allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. The Supreme Court disagreed, holding that the Treasury regulations in place at the time justified the tax court's finding that the marital deduction was not jeopardized.

(1) <u>Regulatory Guidance</u>. In response to the *Hubert* decision, the IRS announced new regulations providing guidance on this issue, which apply to estates of decedents dying after December 3, 1999. Treas. Reg. §§ 20.2013-

4(b)(3), 20.2055-3, 20.2056(b)-4(d). Unlike the "material limitation" rules under the prior regulations, the new regulations permit deductions depending upon the nature of the expenses in question. The regulations provide that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" require a dollar for dollar reduction in the amount of any marital or charitable deduction, regardless of whether the expenses are deducted on the estate's income tax return or on the estate tax return. *Id.* If an estate tax return is required and these expenses are taken on the estate's income tax return, the expenses are deemed to reduce any marital and charitable deduction taken on the estate tax return, thus causing an estate tax that might not otherwise be due.

(2) <u>Estate Management Expenses</u>. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i), 20.2056(b)-4(d)(1)(i).

(3) <u>Estate Transmission Expenses</u>. Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses are deemed to reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii), 20.2056(b)-4(d)(1)(ii). *See also Brown v. United States*, 329 F.3d 664 (9th Cir. 2003) (discussing *Hubert* and the procedures for properly determining the deduction for administration expenses).

(4) <u>Reduction for Unrelated Estate Management Expenses</u>. In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property interest not included in the marital share." Treas. Reg. § 20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4).

(5) <u>Special Rule for Estate Management Expenses Deducted on Estate Tax Return</u>. If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under Section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3), 20.2056(b)-4(d)(3). The justification for this position is the language in Section 2056(b)(9) of the Code, which provides that nothing in Section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent.

> **Example 8:** $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse. The decedent's applicable credit amount had been fully utilized prior to death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child. Treas. Reg. § 20.2056(b)-4(d)(5), Ex. 4.

d. <u>Summary of Deductible Expenses</u>.

(1) <u>Items Deductible ONLY on the Decedent's Final Income Tax Return</u>:

(a) Itemized deductions paid prior to date of death (other than miscellaneous itemized deductions for years 2018-2025). IRC §§ 67(g), 161-223.

(b) Capital loss carryforward of the decedent. IRC § 1212(b).

(c) Charitable contributions carryforward of the decedent. IRC § 170(d)(1).

(d) Net operating loss carryforward of the decedent. IRC § 172(b).

(e) Disallowed investment interest carryforward of the decedent. IRC § 163(d)(2).

(f) Disallowed S corporation carryforward of the decedent. IRC § 1366(d)(2).

(g) Investment tax credit carryforward of the decedent. IRC § 46.

(2) Items Deductible on EITHER the Decedent's Final Income Tax Return or the Estate Tax Return:

(a) Medical expenses of the decedent paid out of his estate within one year after date of death. IRC § 213(c).

(3) Items Deductible ONLY on the Estate Tax Return:

(a) Funeral expenses. IRC § 2053(a)(1); Treas. Reg. § 20.2053-2.

(b) Claims against the estate of a personal non-deductible nature (e.g., federal income and gift taxes unpaid at date of death). IRC § 2053(a)(3).

(c) Administration expenses attributable to tax-exempt income. Rev. Rul. 59-32, 1959-1 CB 245.

(4) Items Deductible ONLY on the Estate's Income Tax Return:

(a) State and local taxes on estate income (subject to a $10,000 aggregate limit for state and local taxes for years 2018-2025). IRC §§ 164(a), (b)(6), 2053(c)(1)(B).

(b) Real estate taxes not accrued prior to death (subject to the $10,000 aggregate limit described above). IRC §§ 164(a), (b)(6), 2053(c)(1)(B).

(c) Interest accruing after date of death on indebtedness incurred by the decedent or the estate that are not allowable as expenses of administration under local law. IRC §§ 163(a), 2053(c)(1)(B).

(5) Items Deductible on EITHER the Estate's Income Tax Return or the Estate Tax Return:

(a) Administration expenses, except administration expenses attributable to tax-exempt income, may be taken on the Form 1041 (U.S. Income Tax Return for Estates and Trusts) or the Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return). Any administration expenses, including those attributable to tax-exempt income, not claimed on the Form 1041 can be claimed on the Form 706. IRC §§ 212, 642(g), 2053(a). *See* Rev. Rul. 59-32, 1959-1 CB 245.

(b) Casualty and theft losses. IRC §§ 165, 642(g), 2054.

(6) Items (called "Deductions in Respect of a Decedent") Deductible BOTH on the Estate's Income Tax Return and on the Estate's Estate Tax Return:

(a) Business expenses accrued prior to death. IRC §§ 163, 2053(a).

(b) Interest expenses accrued prior to death (subject to various limits). IRC §§ 163, 2053(a).

(c) Taxes accrued prior to death (subject to various limits). IRC §§ 164, 2053(a), 2053(c)(1)(B).

(d) Expenses incurred for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax accrued prior to death. IRC §§ 212, 2053(a).

(e) For divorce or separation instrument entered into prior to January 1, 2019, alimony or separate maintenance payments accrued prior to death. IRC §§ 215, 2053(a). *See* Rev. Rul. 67-304, 1967-2 CB 224.

10. Understanding the Grantor Trust Rules. Part E of Subchapter J of the Code provides a set of rules that override the general trust taxation rules and cause the income of certain trusts to be taxed to the grantor (or someone treated as the grantor) to the extent that he or she has retained prohibited enjoyment or control of trust income and/or principal. The key to the inquiry is whether the grantor enjoys trust benefits, has retained so much control, or has left so many "strings" attached to the trust as to be fairly treated as the true owner of the trust property for income tax purposes. The powers listed in the grantor trust rules are exclusive – no amount of control by the grantor will cause the grantor to be taxed if the power in question is not set forth in the Code. IRC § 671.

a. Implications of the Grantor Trust Rules. The grantor trust rules generally treat the grantor as the owner of any portion of the trust property over which a grantor trust power applies. As a result, all items of income, deduction, expenses, and credits associated with that portion of the trust are reported directly by the grantor on his or her income tax return.[13] IRC § 671. In addition, if the assets included in that portion are sold by the grantor to a grantor trust (or vice versa), no gain is recognized on the sale. *See* Rev. Rul. 85-13, 1985-1 CB 184. Keep in mind that for all transfers in trust after March 1, 1986, for purposes of the grantor trust rules, when reading the term "grantor" throughout the rules, you need to read "or the grantor's spouse" afterwards, whether or not those words literally appear in the Code. IRC § 672(e). This is the spousal attribution or spousal unity rule. Another set of rules are important to keep in mind when reading the grantor trust rules: the portion rules. Each grantor trust rule states that it applies only to the portion of the trust over which the described power or interest is retained. For example, based upon the specific case at issue, the grantor trust rules may apply to only the income portion, only the principal portion, or both; they may apply to specific assets or fractions of a trust; or they may apply for some periods but not others. The portion described is then the portion (which may be all) of the trust that will be treated as being owned by the grantor.

b. Right of Reversion. If a grantor creates a trust that lasts until a future date, but retains the right to have the trust property returned to the grantor when the trust terminates, the trust is a grantor trust to the extent of the reversion unless the grantor may receive the property only after a specific period authorized in the statute. IRC § 673. For trusts created on or before March 1, 1986, the set period was ten years. As a result, it was not at all unusual to find trusts that were structured to last for eleven years (or ten years and one month, or ten years and one day). Such a trust would thus pay tax on its income during that period (or shift its taxable income out to a trust beneficiary), after which the property would pass back to the grantor, perhaps to be contributed to a new or different trust. In 1986, the Section 673 "safe" period was modified so that the grantor is treated as the owner of any portion of a trust in which he or she has a reversionary interest in either the corpus or the income of the trust, if, as of the inception of the trust, the actuarial value of the grantor's reversion exceeds five percent of the value of the trust. IRC § 673(a). In addition, the Code provides that a grantor may retain a reversion without running afoul of the grantor trust rule if it arises in the event that a beneficiary who is a lineal descendant of the grantor dies before attaining age 21. IRC § 673(b). With interest rates near historic all-time lows, the latter exception is subsumed within the first (i.e., the actuarial value of such a reversion would virtually always be less than five percent). However, no practical reversion can be held by the grantor in a term-of-years trust without triggering the grantor trust rules.[14] Note, however, that regardless of the time of the reversion, if the trust had taxable income allocated to corpus (such as capital gains), since the corpus would ultimately revert to the grantor, that income would be taxed to the grantor, even if earned during the "safe" period. *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973).

c. Power to Revoke. Section 676 of the Code treats a trust as a grantor trust if the grantor retains a revocation power, unless the power to revoke does not arise until after the "safe" Section 673 period. Under the law of most states, a trust, by default is irrevocable, but that is not universally the case. For example, under Texas law, a grantor may revoke the trust unless it is made irrevocable by the express terms of the instrument creating it. TEX. PROP. CODE § 112.051(a). Therefore, it is prudent to expressly state in the governing instrument whether the grantor retains the right to revoke the trust. Note that Section 676 of the Code applies also to a power of revocation held by a "non-adverse party," i.e., a party who has no substantial adverse economic interest in the trust. Accordingly, inter vivos trusts that grant a power of appointment should perhaps include a provision precluding the power holder from exercising the power in favor of the grantor or the grantor's spouse, since exercising the power of appointment in their favor would be the functional equivalent of a third party having the right to revoke the trust.

d. Retention of Income. Section 677 of the Code is the most commonly invoked grantor trust provision, and is often invoked intentionally, as in the context of revocable inter vivos trusts used as will substitutes (to which Section 676 applies as well). Code Section 677 applies grantor trust treatment to trusts the income of which, without the consent of an adverse party, either must be paid to the grantor or the grantor's spouse, or may, in the discretion of the grantor or a non-adverse party, be paid currently to the grantor or the grantor's spouse. Section 677 will also be invoked if trust income may be accumulated for future distribution to the grantor or the grantor's spouse. Income

[13] Note that the provisions of Code Section 199A do not apply to grantor trusts, and the grantor or other person treated as the grantor calculates the deduction as if he or she conducted the portion of the activities attributed to the trust. Treas. Reg. §§ 1.199A-1(a)(2), -6(d)(2).

[14] For example, with an interest rate of 2.2%, a reversion is worth less than 5% only after 138 years!

must be available for the direct or indirect benefit of the grantor, but even a relatively insubstantial "benefit" may give rise to grantor trust treatment. Section 677 is raised, for example, merely by the use of trust income to pay premiums of life insurance on the life of the grantor or the grantor's spouse, regardless of the ownership or beneficiary of the policy. IRC § 677(a)(3). In addition, payments that discharge a legal or contractual obligation of the grantor (or the grantor's spouse) are treated as indirect payments to the grantor. Section 677(b) provides an exception to this latter rule by limiting taxability only to amounts actually distributed in the proscribed manner. The exception applies to discretionary distributions of income for the support or maintenance of someone that the grantor is obligated to support. Note that the distributions needn't "discharge" the grantor's legal obligations of support. Rather, Section 677(b) applies to all actual distributions for support of someone whom the grantor is legally obligated to support.

e. Right to Control Beneficial Enjoyment. Section 674 of the Code is probably the most complex of the grantor trust provisions, but most practitioners understand its direct application relatively well. Unfortunately, many draftsmen fear its more subtle applications. Section 674 begins with the broad proposition that grantor trust treatment applies if the grantor (or a non-adverse party) retains the right to control the beneficial enjoyment of the trust property without the approval or consent of an adverse party. Virtually all trusts permit trustees to control beneficial enjoyment of trust property without the consent of the beneficiaries, so Section 674 outlines broad exceptions to the general rule that largely prevent grantor trust treatment. A Section 674 problem usually arises when a grantor demands the broadest powers, with even broader powers granted to "independent" trustees. Too often, practitioners fear that the powers granted are a bit too broad, or that the "independent" trustee's powers will somehow be attributed back to the grantor. (*But see* Rev. Rul. 95-58, 1995-36 IRB 16, revoking Rev. Rul. 79-353, 1979-2 CB 325, as modified by Rev. Rul. 81-51, 1981-1 CB 458 – these revoked rulings held that for transfer tax purposes, a grantor's right to remove and replace a corporate trustee conferred upon the grantor the powers of the trustee). As a result, many practitioners fail to take advantage of the considerable flexibility permitted under Code Section 674. The exceptions to Section 674 are numerous. In summary, anyone can have the powers described in Section 674(b). If the grantor wants to serve as trustee without causing grantor trust treatment, most drafters get the flexibility and control a grantor desires by giving the grantor the powers set out in Section 674(b)(5)(A) (discretionary distributions of corpus pursuant to an ascertainable standard) and (B) (advancement treatment) yielding adequate control over corpus; and Section 674(b)(6) (withholding income during minority) and (7) (withholding income during disability) for fiduciary accounting income. In addition, Section 674(d) of the Code provides an exception for trustees other than the grantor and the grantor's spouse. These trustees can have the power to make distributions of income or principal limited by an ascertainable standard without triggering grantor trust treatment. Finally, if no more than half of the trustees are related or subordinate to the grantor, anyone (other than the grantor and the grantor's spouse) can have unlimited discretion under Section 674(c). Note that the exceptions contained in Section 674 do not generally apply if the grantor or a non-adverse party retains the right to add beneficiaries to the trust (other than after-born descendants). As a result, persons drafting trusts designed to *intentionally* invoke grantor trust treatment frequently add a power in someone other than the grantor or a beneficiary to add a beneficiary (often a charity) to the trust. This power causes the trust to be a grantor trust for income tax purposes, but does not cause the property to be included in the estate of the grantor for federal estate tax purposes. In addition, if the person holding the power cannot add himself or herself as a beneficiary, the power does not cause income or estate tax inclusion to the power holder.

f. Certain Administrative Powers. Generally speaking, Section 675 powers are either non-fiduciary powers over closely held business stock, or powers in the grantor or a non-adverse party to self-deal with the trust. More specifically, the prohibited powers are a power in the grantor, the grantor's spouse, or a non-adverse party (without the consent of an adverse party) to deal with, dispose of, or exchange either income or principal for less than full and adequate consideration, even if the grantor cannot benefit thereby; a power in the grantor or the grantor's spouse to borrow, or a power in a non-adverse party to lend to the grantor or the grantor's spouse, on less than adequate interest and security (*see, e.g.,* PLR 9446008) (but the power to lend is permitted if it includes the broad power to lend without regard to interest or security); the actual borrowing of any portion of the trust by the grantor or the grantor's spouse, except loans made but repaid in prior years, and loans made for adequate security and interest if made by an independent trustee; a power in the grantor, the grantor's spouse, or a non-adverse party (without the consent of the trustee) to act in a non-fiduciary capacity, to vote or direct voting in a corporation in which the aggregate holdings of voting stock by the grantor, the grantor's spouse, and the trust are "significant," or to invest or veto investment, or to direct either, to the extent that the trust holds securities in a corporation in which the aggregate holdings of voting stock by the grantor, the spouse, and the trust are "significant;" and a power to reacquire the trust corpus by substituting property of equivalent value. This last power is one which is frequently used to obtain grantor trust treatment. Specifically, in the context of trusts drafted to *intentionally* invoke the grantor trust rules, a power may be added permitting the grantor (or a non-adverse party), acting in a non-fiduciary capacity, to reacquire trust property by substituting property of equivalent value. Since any such substitution requires the payment by the grantor of full and adequate consideration, this power causes the trust to be a grantor trust for income tax purposes, but does not cause the trust's property to be included in the estate of the grantor for federal estate tax purposes.

g. Section 678. Code Section 678 may apply rules similar to the grantor trust rules to persons other than grantors. This Code section is applied in two parts, the first relating to the existence of a power, and the second relating to the release or modification of a power.

(1) Power to Vest Trust Property in One's Self. Section 678(a)(1) describes a power to vest income or corpus in one's self. This power held in conjunction with another person, even if that person is not an adverse party, does not invoke grantor trust treatment. The statute singles out for grantor trust treatment only those powers exercisable solely by the power holder. Section 678 issues typically arise in the context of a trust when a beneficiary is the sole trustee of a complex trust as, for example, when the surviving spouse is the sole trustee of the trust, and has the authority to make discretionary distributions to him- or herself. Unlike the transfer tax rules, Section 678 of the Code does not contain an express exception for powers limited by an ascertainable standard. A number of cases decided prior to the adoption of Section 678 suggest that such an exception should be read into the statute. *See Smither v. United States*, 108 F. Supp. 772 (S.D. Tex. 1952), aff'd, 205 F.2d 518 (5th Cir. 1953); *Funk v. Comm'r*, 185 F.2d 127 (3d Cir. 1950); *see also*, *United States v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960) (holding that an ascertainable standard caused capital gains to be taxed to an implied trust and not to the life tenant holding the power). As a result, if a beneficiary is serving as sole trustee but may make distributions to him- or herself only for health, support, maintenance, and education (a common situation when, for example, a surviving spouse is serving as sole trustee of a bypass trust), Section 678 probably does not apply. In the context of inter vivos trusts, a common source for Section 678 exposure is a *Crummey* withdrawal right, granted to ensure that a trust beneficiary has a present interest qualifying gifts to the trust for a federal gift tax annual exclusion under Section 2503(b) of the Code. *See* PLR 9535047. Treasury Regulation Section 1.678(a)-(1)(b) expands Section 678(a)(1) of the Code to include any power, directly or indirectly, to apply income or principal to the person's individual benefit. This rule is analogous to the grantor trust rule regarding retained income in Section 677 of the Code, and is subject to similar exceptions. Thus, under Section 678(c) of the Code (the sibling to Code Section 677(b)), a power to apply income to the support or maintenance of a person the power holder is obligated to support or maintain will not cause all trust income to be taxed to the holder of the power. Rather, only amounts actually applied for the support or maintenance of someone that the power holder is obligated to support will be taxed to the power holder.

(2) Released or Lapsed Powers. The second component of Section 678(a) of the Code relates to releases or modifications of powers described in Code Section 678(a)(1). Generally, Section 678(a)(2) of the Code imposes grantor trust treatment on the power holder for any power released or modified in a fashion that would give rise to the application of the grantor trust rules were the release a transfer by the grantor. For example, if a beneficiary has a power to withdraw income from a trust, but allows that power to lapse, so that the unwithdrawn income is added to principal, the beneficiary will be treated as the "owner" of the lapsed income. If the unwithdrawn income had been property transferred to the trust by the grantor, the right to the income therefrom would generate grantor trust treatment pursuant to Code Section 677(a)(1). Therefore, the continuing right to income from the property formerly subject to the withdrawal right will cause the person to be treated as the owner of property over which the withdrawal right lapsed, and continued lapses may cause the person to be treated as the owner of an increasing portion of the trust each year. *See, e.g.*, *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945); s*ee also* PLR 200104005 (cumulative lapse of withdrawal right permitted beneficiary to exclude portion of gain on sale of primary residence under IRC § 121).

(3) Renunciations of Powers. Section 678(d) of the Code provides an exception to both inclusion rules of Code Section 678(a) by permitting the power holder to renounce or disclaim the tainted power within a "reasonable time" after the power holder becomes aware of its existence. Neither the statute nor the regulations define "reasonable time." Presumably, the disclaimer rules in force prior to the adoption of Code Section 2518, or perhaps

the more objective (nine-month) rules adopted thereby, would be helpful as an analogy. Does the renunciation rule permit a beneficiary holding a "5 or 5" power to avoid application of Section 678 of the Code by notifying the trustee of his declination to withdraw funds each year within a "reasonable time" after the trustee advises him of a contribution? Revenue Ruling 81-6, 1981 CB 385, which holds that a holder of a withdrawal right is taxed on the income associated therewith under Code Section 678(a), does not address the disclaimer rules associated with a renunciation of the right.

III. STATE INCOME TAXATION OF TRUSTS

In considering income tax consequences of trust administration, it is important to consider not only federal income tax issues, but also issues relating to state income taxes. Trusts can present unique multi-jurisdictional problems when the trust is established by a grantor in one state, administered by a trustee residing in another state, for the benefit of beneficiaries in one or more other states. Moreover, the trust may hold income-producing property situated in yet another state. Although many states have statutes designed to limit the taxation of trust income in multiple states, no state imposing an income tax wishes to lose tax revenue to another state. Therefore, these double-tax prevention measures are imperfect at best. A detailed, if somewhat dated, discussion of the state tax regime attributable to trusts, together with a helpful summary of state tax rules and rates in each state, is set forth in Gutierrez and Keydel, *Study 6: State Taxation on Income of Trusts with Multi-State Contacts*, ACTEC STUDIES (2001). An updated table is found in the current ACTEC State Survey, Nenno, *Bases of State Income Taxation of Nongrantor Trusts* (updated through Aug. 14, 2019).

A. Constitutional Issues. In order to pass constitutional muster, a state seeking to impose tax on a trust's income must establish some nexus to the trust. In the words of the U.S. Supreme Court, "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 US 340, 344-45 (1954). In general, states may impose a tax on nonresidents with respect to income derived within the state, so long as the tax is no more onerous than the tax imposed under like circumstances on residents of the taxing state. *Shaffer v. Carter*, 252 US 37, 50 (1920).

1. The Nexus Requirement. For most states, "contacts" with the state are described in terms of "residency." A state may constitutionally tax all of the income of its residents, regardless of the source of that income. *Oklahoma Tax Comm'n v. Chickasaw Nation*, 515 US 450, 462-63 (1995). If a trust is determined to be a resident of a state, the state may tax the trust's undistributed income. *New York ex rel. Cohn v. Graves*, 300 US 308 (1937). The Due Process Clause of the U.S. Constitution, however, requires that residency be based upon a sufficient nexus between the trust and the taxing state.

2. Contacts Supporting State Taxation. The seminal case in the area of establishing a trust's "residency" for income tax purposes points to six factors to consider in fixing this nexus. *In re Swift Trust v. Dir. of Revenue, State of Missouri*, 727 S.W.2d 880 (Mo. 1987). These factors are (1) the domicile of the grantor; (2) the state in which the trust is created; (3) the location of the trust property; (4) the domicile of the beneficiaries; (5) the domicile of the trustee; and (6) the location of the administration of the trust. Moreover, the nexus must be tested not at the inception of the trust, but at the time that the tax is being imposed. The *Swift Trust* court held that of these six factors, the first two are irrelevant for years following the inception of the trust, and the domicile of the beneficiaries was not a sufficiently important nexus. Therefore, the other three factors (location of trust property, domicile of the trustee and location of administration) were determinative.

3. Broader Views of Contacts. Some states take a much broader view of which contacts support taxation than did the *Swift Trust* court. For example, the Connecticut Supreme Court found that the domicile of the grantor at the time of death is sufficient to establish the residence of the trust for state income tax purposes. *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999). The court in *Chase* distinguished the much earlier U.S. Supreme Court case of *Safe Deposit & Trust Company v. Virginia*, 280 US 83 (1929) on the somewhat dubious basis that the court there applied the Due Process Clause to avoid the taxation of intangibles in multiple jurisdictions, noting that this tax issue was not now a part of the due process jurisprudence. In general, while courts examining state income taxation of trusts have focused on the "due process" issues associated with the U.S. Constitution, the U.S. Supreme Court has held that in order to pass constitutional muster, state income tax regimes must satisfy the "interstate commerce" clause as well. Notable in its analysis of the Interstate Commerce Clause is the non-trust case of *Quill Corporation v. North Dakota*, 504 US 298, 307-08 (1992), in which the U. S. Supreme Court extended the nexus test to cases in which an entity has an "economic presence" in a state, even though it does not have a physical presence there.

4. Interstate Commerce Issues. While the *Quill* decision extended the notion of nexus for due process purposes, it added new requirements for state taxation to pass muster under the Constitution's Interstate Commerce Clause. First, the tax must be fairly apportioned among all jurisdictions with which the entity has a nexus. Second, the tax must not discriminate against interstate commerce. Finally, the tax must be fair relative to the benefits provided to the entity by the state. *Id*. at 311. The Court in *Quill* pointed to a physical presence of the taxpayer in the state as a requirement to justify state income taxation. Twenty-six years later, in light of the expansion of e-commerce, the Supreme Court re-examined the *Quill* test in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018). Overturning *Quill*, the Supreme Court held that physical presence is not required. Instead, the Court required only that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Id.* at 2085. Some cases dealing with state income taxation of trusts have addressed both the Interstate Commerce Clause and the Due Process Clause. However most cases discuss only the Due Process Clause. Nevertheless, many of those cases have cited *Quill* for and its discussion of "substantial nexus." Although *Wayfair* overruled *Quill*, it nevertheless held that an essential element of the Interstate Commerce Clause is that an activity exist "with substantial nexus with the taxing State." *Id.*at 2093. Instead of physical presence, however, the *Wayfair* court held that the required nexus can be established when the taxpayer "avails itself of the substantial privilege of carrying on business in that jurisdiction." *Id.*at 2099. Application of these principles to the multi-state income taxation of trusts awaits further analysis by the courts. *See also McNeil v. Pennsylvania*, 67 A.3d 185 (Pa. Commw. Ct. 2013) where the Pennsylvania court held that the presence of only the trust's grantor and discretionary beneficiaries in Pennsylvania was insufficient to create nexus to satisfy the Interstate Commerce Clause.

B. State Tax Regimes.

1. Resident vs. Non-Resident Trusts. Most states implement their tax regimes by differentiating between "resident" and "nonresident" trusts. Therefore, a preliminary matter in determining state income tax issues is to identify the "residence" of the trust. States do not, however, apply a uniform test in determining which trust is classified as a "resident" trust. *See* Nenno, *Reprise! The State Taxation of Trust Income Five Years Later*, 51 U. MIAMI HECKERLING INST ON EST. PL. ¶1500 (2017); Nenno, *Planning to Minimize or Avoid State Income Tax on Trusts*, 34 ACTEC L.J. 131 (Winter 2008); Gutierrez, *The State Income Taxation of Multi-Jurisdictional Trusts, The New Playing Field*, 36 U. MIAMI HECKERLING INST ON EST. PL. 12 (2002). States typically impose an income tax on all income of resident trusts, regardless of where it is earned. On the other hand, for nonresident trusts, states generally impose tax only on income derived from sources located within the taxing state. For most states, in-state revenue sources are limited to income derived from real estate located within the state, or from closely held businesses situated within the state.

2. Determining Trust Residency.

a. Residence of the Grantor. Most states use the residency of the grantor as the starting point for fixing the residency of the trust. For example, Illinois, Minnesota, Missouri, New York, Virginia, and the District of Columbia impose an income tax on the trust where the only contact with the state is the residency of the grantor at the time the trust is created (or in the case of a revocable trust, the time that the trust becomes irrevocable). It appears that courts are reluctant to find this factor alone is sufficient to pass constitution due process muster. For example, in *Linn v. Department of Revenue*, 2 N.E. 3d 1203 (Ill. App. Ct. 2013), the Illinois court declared this provision an unconstitutional violation of the Due Process Clause of the U.S. Constitution where the trust was administered in Texas and governed by Texas law. The court cites the U.S. Supreme Court in *Quill*, cited above. Finding no Illinois precedent, the court cites cases from other jurisdictions, including *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999); *McCulloch v. Franchise Tax Board*, 390 P.2d 412 (Cal. 1964); *Blue v. Department of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990); and *Mercantile-Safe Deposit & Trust Company v. Murphy*, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963). *Gavin*, which upheld the application of the Connecticut income tax on the undistributed income of a lifetime trust created by a Connecticut grantor, was cited at length by the court. A critical fact in that case was that the beneficiary resided within the state for the year in question and the court assumed that the beneficiary would receive all trust property shortly. In *Linn*, the court noted, there were no Illinois beneficiaries. Relying on *Blue* and *Mercantile*, the court found that a grantor's residence within a state wasn't itself enough to satisfy due process. Reaching a contrary result, the Court of Appeals in *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997) held, following *Quill*, that physical presence of the trustee or a trust beneficiary was not necessary to establish a sufficient nexus for taxation. The fact that the trust was created by a District of Columbia decedent, and that the District's courts received accountings and handled litigation regarding the trust on several occasions, was enough to satisfy due process criteria. Some states (e.g., Idaho, New Jersey and New York) appear to be on more solid ground by adding a requirement that some other nexus (at least some trust property in the state, a beneficiary be in the state, etc.) be present as well.

In *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018), aff'g 2017 WL 2484593 (Minn. T.C. 2017), the Minnesota Supreme Court held that a state statute that imposes state income tax on trust income solely because the grantor was a resident of Minnesota at the time the trust became irrevocable violates the due process clauses of both the state and the United States. In this case, all but one of the beneficiaries resided in states outside of Minnesota, and the trustee resided and the trust was administered outside of Minnesota. The court found that the grantor being a resident of the state at the time that the trust was irrevocable was irrelevant and not enough to connect the trust to the state for income tax purposes; rather, it is the connection between the trustee and the state in the tax year at issue that are important. In addition, the court found that because the trust did not own any tangible, physical property in Minnesota, no basis existed in that regard to support taxation. The state needs some connection between the trust income and the protections and benefits provided by the state to the trust in order to justify state taxation of its income.[15]

b. Residence of the Trustee. The trustee is the legal owner of the assets of the trust. As a result, many states (e.g., Arizona, California, and Kentucky) use the residency of the trustee as the main criterion for fixing the trust's residence. Some states take other factors into consideration. For example, some jurisdictions (e.g., Delaware and Hawaii) look to the residence of the trustee only if the trust has at least one resident beneficiary.

c. Place of Administration. Some states, such as Colorado, Indiana, Kansas, Mississippi, South Carolina, and Utah, look primarily or exclusively to the place of administration as the basis for determining a trust's residence. Other states have found that the place of administration alone is not a sufficient nexus to a state to support state income taxation. *See Bayfield County v. Pishon*, 162 Wis. 466, 156 N.W. 463 (1916).

d. Residence of the Beneficiary. Most states do not look to the residency of the beneficiary alone to determine trust residence. A beneficiary resident in the state may be taxed on income distributed to that beneficiary, but the trust is generally not taxed by virtue of the beneficiary's residence alone. *Maguire v. Trefry*, 253 US 12 (1920); *Guaranty Trust Co. v. Virginia*, 305 US 19 (1938). Six states (California, Georgia, Montana, North Carolina, North Dakota, and Tennessee), however, do look to the residency of the beneficiary. For example, Georgia imposes a tax on trusts with beneficiaries residing in Georgia, or more precisely, a resident trustee may avoid taxation on income that is distributed to, or accumulated for later distribution to, a non-resident of Georgia, if the income is received from business done outside of Georgia or from property outside of Georgia. O.C.G.A. § 48-7-22(a)(3)(A).

Recent cases have picked apart the nexus rules and in some cases invalidated state income tax regimes where nexus was found to be too tenuous. For example, in *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013), the Illinois court favorably cited Connecticut's *Gavin* decision and held that the critical link between a state and a trust for income tax purposes is the residency of the beneficiary, rather than the residency of the grantor. As mentioned above, the court ultimately held that the state could not tax a trust merely because the trust's grantor had been an Illinois resident at the time that the trust was created. *Id.* at 1210. In *McNeil v. Commonwealth of Pennsylvania*, 67 A.3d 185 (Pa. Commw. Ct. 2013), the Pennsylvania Commissioner's Court ruled that imposing tax on a trust violated the U.S. Commerce Clause on the grounds that the trust did not have substantial nexus with the state and did not benefit from the state's economic markets, courts, or laws. With regard to the substantial nexus requirement, the court concluded that neither the grantor's status as a resident when the trust was created nor the beneficiaries' status as residents established sufficient physical presence for the trust's income to be taxed in Pennsylvania. Most recently, the United States Supreme Court chimed in in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. ___, 139 S. Ct. 2213 (2019). In an extremely narrow ruling, a unanimous Court held that a trust beneficiary's North Carolina residency alone was an insufficient connection for the state to tax the trust's income, noting that the Due Process Clause of the U.S. Constitution requires some particular relationship between the state resident and the trust assets that the state seeks to tax. Under the *Kaestner* facts, and limited to those facts, the court found an insufficient relationship between a purely discretionary beneficiary and the trust assets for the state to tax the trust's income. Unfortunately, the Court specifically stated that it was not deciding what degree of possession, control, or enjoyment would be sufficient to support taxation by

[15] The state of Minnesota petitioned the U. S. Supreme Court for certiorari in this case, but the Supreme Court denied certiorari on June 28, 2019.

North Carolina based on the residence of a trust's beneficiary, and it gave no bright line rule regarding what particular relationship would suffice. The Court, however, indicated that the result might have been different if a grantor or a trustee was a resident of the state.

3. Income Derived from Within the State. Almost all states imposing an income tax do so on income derived from sources derived within the state, regardless of the residency of the trust. The benefit that the state provides to enable the production of income generally provides a sufficient nexus to permit the state to tax locally derived income of nonresident trusts. *Shaffer v. Carter*, 252 US 37 (1920). Domestic income typically includes income from real or tangible property located within the state, the conduct of a business located within the state, or to intangible property that has acquired a business situs within the state.

C. Selecting a Trust Situs to Avoid State Tax. State income taxation is one of several factors that a grantor may consider in selecting the situs to establish a trust. Moreover, if permitted, a trustee may seek to move the situs of a trust to a state that offers a favorable state income tax environment. For a discussion of these issues, see Nenno, *Reprise! The State Taxation of Trust Income Five Years Later*, 51 U. MIAMI HECKERLING INST ON EST. PL. ¶1500 (2017); Warnick and Pareja, *Selecting a Trust Situs in the 21st Century*, 16 PROB. & PROP. 53 (Mar./Apr. 2002); and Sligar, *Changing Trust Situs: The Legal Considerations of "Forum Shopping"*, TR. & EST., July 1996 at 40.

IV. ISSUES WITH FLOW-THROUGH ENTITIES

A. Partnerships

1. Entity Not Taxed. Partnerships are subject to a unique set of rules under the Internal Revenue Code. On the one hand, the law sometimes views a partnership as a legal entity. In other contexts, a partnership is viewed as an aggregate of individual partners. Congress chose the latter approach in taxing income derived through a partnership. In other words, unlike an individual, trust, or corporation, a partnership itself is not subject to income tax. Instead, the partnership serves only as a reporting vehicle for the partners. The partners themselves must pay tax on the income generated by partnership operations. This pass-through theory of taxation is sometimes difficult to apply. Most taxpayers operate on a cash basis, and pay tax based upon their own realization events (and cash flow). Unlike the conduit theory of trust and estate taxation, the flow-through of partnership-level items is not based upon distributions from the partnership. The partnership itself never pays tax. It simply records realization events at the partnership level and reports them to the partners (and the IRS); all tax attributes are reported by the partners themselves on their own tax returns, irrespective of partnership distributions.

2. Taxation of Partners. The partners in a partnership are the taxpayers with respect to partnership income, losses, deductions, and credits. These items, as they arise at the partnership level, are treated as having occurred at the partner level, and are allocated among the partners in accordance with the terms of the partnership agreement. Partners are taxed on partnership activities regardless of whether the partnership makes distributions to the partners. In that regard, a partner in a partnership is not taxed based upon the cash flow rules which most individual taxpayers are otherwise accustomed. Partners need not apportion individual items of income, loss, deduction, or credit among them equally or in the ratio of their contributions. They may agree to any form of allocation. In order to ensure that the allocation of these items is not manipulated by the partners to artificially minimize taxation, the allocations are given effect only if they have a substantial basis in economic reality as among the partners themselves. IRC § 704.

3. Basis Issues. As with other taxpayers, basis plays a key role in measuring partnership gains and losses. Partnerships present an unusual layering of these rules, however, since a partner may sell not only his or her interest in the partnership's assets, but also his or her partnership interest itself. Thus, separate measures must be made of the partnership's basis in its assets, and the partners' respective bases in their partnership interests.

a. Inside Basis. The partnership's basis in the assets held by the partnership (referred to as "inside basis") is figured much like a corporation's basis in its assets. Thus, for example, assets contributed by the partners to the partnership generally have a carryover of the contributing partner's basis (increased by any gain recognized on the transfer), and the holding period of the contributing partner in the assets carries over to the partnership as well. IRC §§ 723, 1223(1). Assets acquired by the partnership have a basis equal to cost. Depreciation may be taken at the partnership level (and passed through to the partners), thereby decreasing the partnership's basis in the depreciated assets.

b. Outside Basis. For most tax purposes, the partners are not treated as the owners of those assets; they instead own partnership interests (or LLC membership interests). Each partner separately maintains a basis in that interest (referred to as "outside basis"). Partners who enter the partnership by contributing assets generally begin with a basis in their partnership interest equal to the basis of the assets contributed, and their holding period in the contributed assets becomes their holding period in the partnership interest. IRC §§ 722, 1223(1). Partners who acquire their interest by purchase from another partner begin with a basis equal to the purchase price. IRC § 1012(a). Partners who acquire their interest by gift receive a carryover of the donor's basis in the interest, while partners who acquire their interest by inheritance receive a new basis in the partnership interest equal to the fair market value of that interest at the time of the deceased partner's death. IRC §§ 1014(a), 1015(a). Regardless of how basis is initially set, each partner's basis in their partnership interest constantly goes up and down like an old-fashioned thermometer. It goes up by his or her share of partnership income and the basis of assets later contributed to the partnership, and goes down by his or her share of partnership losses and the basis of property distributed to him or her by the partnership. IRC §§ 705(a), 723, 733. If a partnership makes distributions of money (which includes cash and marketable securities) to its partners in excess of their unrecovered basis in the partnership, those distributions are generally taxed to the partners. IRC § 731(a)(1). If the partnership makes a distribution of property other than money, no gain recognition occurs and the partner's basis in the distributed property is the lesser of the partnership's basis in the property or the partner's outside basis. IRC §§ 731(a)(1), (b), 732(a).

4. Limited Partnership Planning Opportunities

a. Eliminating Partnership Discounts. One hoped-for feature of many partnerships established among family members has been the reduction in value of interests held by senior family members. Value reductions arise from discounts associated with lack of control and lack of marketability associated with typical limited partnership interests. These discounts have enabled taxpayers to transfer interests by gift or at death at a fair market value less than the liquidation value of the partnership interests transferred. By holding these partnership interests at death, the goal was to reduce estate taxes payable, albeit at the cost of a lower outside basis in the partnership interest. For clients with taxable estates, any discounts available to save estate taxes may be welcome. With many clients now no longer subject to estate tax, however, the costs associated with basis reduction may no longer be offset by estate tax savings. For these clients who nevertheless wish to maintain their partnerships in place for the many non-tax advantages they offer, consideration should be given to whether the partnership agreement can be modified to eliminate the discounts associated with the limited partnership structure. One approach might be to provide in the partnership agreement that senior family members (or the personal representative of their estates) have the right to sell their limited partnership interests to the partnership at any time at their full liquidation value. This "put" right should have the effect of eliminating usual discounts if a willing buyer could succeed to those rights.

b. Other Partnership Issues. There are a number of basis management tools for practitioners who are willing to master the complex tax rules relating to basis for partners and partnerships. As noted above, the difference between a partner's outside basis in a partnership interest and the partnership's inside basis in its assets can give rise to opportunities to obtain favorable basis adjustments upon the death of a partner. Other basis planning opportunities can be used by taking advantage of the rule that, in most cases, allows partnerships to distribute non-cash assets to partners without either the partnership or the partner recognizing any gain. Generally, a partner that receives a distribution in kind from a partnership receives a carryover basis in any distributed asset, and reduces his or her outside basis in the partnership by the basis of the asset received. If the partnership's inside basis in the distributed asset exceeds the partner's outside basis in his or her partnership interest, however, the basis in the partner's outside basis in the partnership interest becomes the partner's basis in the property received, and the partner's basis in his or her partnership interest goes to zero. *See* IRC §§ 732(a)(1), 733. Thus, for example, if a partner with a $50,000 outside basis receives a partnership asset worth $100,000, but with an inside basis of only $10,000, the distributee partner recognizes no gain, but instead takes a $10,000 basis in the distributed property and reduces his or her outside basis in the partnership interest by a corresponding amount. If instead the partnership's basis in the distributed asset was $60,000, then the partner's basis in the asset would be $50,000 and the outside basis in his or her partnership interest would be reduced to zero. In either event, if the distributed asset and/or the partnership interest are held at the time of the partner's death, they would receive a new cost basis equal to their fair market value at that time, and if the partner's estate or heirs ultimately sell the asset, the substantial built-in gain would not be recognized. These rules can be complex, especially if the partnership property is encumbered by debt. *See* IRC § 752. In addition, special rules may apply if the partnership holds so-called "hot assets" (generally, ordinary income assets such as unrealized receivables or substantially appreciated inventory), which might cause the partner to recognize income upon distribution of assets, even if the only assets distributed are capital assets. *See* IRC § 751.[16]

B. S Corporations

Most corporations are taxed upon the income earned by the corporation. If income is later distributed to the corporation's shareholders, that income is again taxed at the shareholder level as a dividend. This regime of double taxation can make operation as a corporation unattractive for many businesses. At the same time, however, the limited liability afforded to corporate operations under state law makes operating as a corporation extremely attractive for businesses. To address this dilemma, Congress permits certain qualified corporations and their shareholders to opt out of the usual tax system for corporations (described in Subchapter C of the Internal Revenue Code) and instead elect to be taxed much as a partnership (under Subchapter S of the Code).

1. Qualification. Only eligible small business corporations may elect to avoid the double tax regime applied to most corporate taxpayers. IRC § 1362. An eligible small business is one which does not have more than 100 shareholders, all of whom are individuals (or estates or certain eligible trusts), and none of whom are nonresident aliens.[17] IRC § 1361(b). In addition, the corporation must not have more than one class of stock (except that voting and non-voting common stock is permitted). *Id.* If the corporation meets these threshold requirements, and if the corporation and each shareholder makes an election to be taxed as an "S Corporation," then the corporation itself is generally not taxed.

2. Entity Not Taxed. An S corporation is not itself subject to tax (except in rare instances which are beyond the scope of this overview). IRC § 1363. Instead, the entity is treated for most purposes like a partnership. The shareholders are subjected to tax on the S corporation's items of income, losses, deductions, and credits (regardless of whether the corporation pays any dividends to its shareholders), much like the partners of a partnership. IRC § 1366. Since S corporations must have only one class of stock, these items cannot be specially allocated among the shareholders. Instead, they are generally passed out to the shareholders pro rata, based upon their respective shareholdings.

3. Basis Issues. S corporation basis issues are similar to those arising with partnerships. The corporation must keep track of its basis in the assets owned by the corporation. At the same time, the shareholders themselves must keep track of their outside basis in their stock, which is adjusted to reflect income and losses of the corporation, as well as contributions by and distributions to shareholders. IRC § 1367.

4. Ownership by Trusts and Estates. In adopting the S corporation rules, Congress sought to limit their application to those entities whose owners are identifiable U.S. individuals. Since an individual is mortal, the rule was extended to permit estates of decedents to remain as shareholders of S corporations during a reasonable period of administration. Congress apparently viewed trusts with somewhat more suspicion, as potential vehicles to shift income away from domestic individuals, or at least to complicate identification of the appropriate taxpayers. As a result, only a limited class of trusts are permitted to be S corporation shareholders. Ownership of S corporation stock by prohibited trusts terminates the S corporation election. Code Section 1361(c)(2)(A) limits trust ownership of S corporation stock to:

- Trusts that qualify as grantor trusts (the grantor is treated as the taxpayer);
- Trusts receiving stock pursuant to the terms of a Will, for a period of two years, beginning on the date that the stock is transferred to the trust, not the date of death (the trust is treated as the taxpayer);
- A Qualified Subchapter S Trust ("QSST"), which is a trust with a single income beneficiary who is entitled to receive all income annually, and that requires any principal distributions during the beneficiary's lifetime be made only to that beneficiary (the beneficiary makes the QSST election and is treated as the taxpayer); and
- An Electing Small Business Trust ("ESBT"), which is a trust that has only eligible individuals, estates, or certain charities as beneficiaries, and for which the trustee makes an election to have the S stock treated as

[16] For a more thorough discussion, see Yuhas and Radom, *The New Estate Planning Frontier: Increasing Basis*, 122 J. OF TAX'N 4, 13-23 (2015).

[17] TCJA 2017 revised the rules regarding nonresident aliens and ESBTs, discussed below. As of January 1, 2018, if a nonresident alien is a potential current beneficiary of an ESBT, the S election is not automatically terminated. IRC § 1361(c)(2)(B)(v).

a separate trust, (the trust is treated as the taxpayer, taxed at the highest marginal federal income tax rate, regardless of whether its income is distributed).

IRC §§ 1361(c)(2)(A), (d), (e).

C. Limited Liability Companies

A limited liability company is in large measure a hybrid entity under state law. It typically operates much as partnership under applicable state statutes, but has the uniquely corporate characteristic of limited liability. That is, unlike a general partnership (or the general partner(s) of a limited partnership), the owners of a limited liability company have no personal liability to the creditors of the entity. Members of an LLC are in that respect very much like the shareholders of a corporation. The Code does not set forth separate treatment for limited liability companies. Instead, unless the entity elects otherwise, it is taxed as a partnership for federal income tax purposes. Theoretically, the LLC could elect to be taxed as a corporation, and then if it met the eligibility requirements, it could make an S election. Most LLCs, however, simply accept partnership tax treatment. In that regard, they may adopt special allocation rules to apportion profits and losses among members and obtain flow-through tax treatment (like a partnership), while retaining limited liability under state law (like a corporation). The tax status chosen for the LLC will determine which of the rules outlined above will apply to the interests owned by and the assets held by the LLC.

D. Section 199A Deduction

TCJA 2017 added new Section 199A[18] to the Code, which for years 2018 through 2025, provides a potential deduction of up to 20 percent of qualified business income of a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. The Section 199A deduction may be taken by individuals and by non-grantor trusts and estates. For taxpayers whose income exceeds a statutorily-defined amount or "threshold," the deduction may be limited, or even lost, based upon the type of business, the amount of wages paid by the business, or the unadjusted basis of assets used in the business.[19] Note that partnerships, S corporations, and similar pass-through entities do not take the deduction themselves. Rather, they are required to provide owners of the entities with information so that the owners can compute their available deduction. Moreover, the limitations based upon taxable income apply at the owner and not the entity level, and in the case of partnerships and S corporations, Section 199A is applied at the partner or shareholder level, not at the entity level. If the owner of an entity happens to be an estate or trust, the deduction may be further passed through to the beneficiaries of the estate or trust. In that case, limitations based upon taxable income may apply at the beneficiary level to the extent items are passed through to them.

At what seems to be lightning speed, proposed Treasury regulations were issued by the Treasury Department and IRS on August 8, 2018 to provide rules for how an estate or trust's deduction is to be allocated, and the final Treasury regulations were published on February 8, 2019. According to the Treasury regulations, an estate or trust's Section 199A items are apportioned among the trust or estate and their beneficiaries based on the relative portion of DNI to be distributed, and DNI is calculated with regard to the separate share rule but without regard to any 199A deduction. Treas. Reg. § 1.199A-6(d)(3)(ii). In addition, in determining whether the trust or estate has reached or exceeded the Section 199A threshold amount that could limit any potential 199A deduction, its taxable income is calculated after taking any distribution deduction. Treas. Reg. § 1.199A-6(d)(3)(iv).

V. INCOME TAX ISSUES ASSOCIATED WITH FLOW-THROUGH ASSETS

A. Issues Unique to Estates

1. Basis and the Section 754 Election

a. Rationale for the Election. Upon the death of a partner, the partner's partnership interest is revalued based on its value on the partner's date of death or the alternate valuation date, if applicable. IRC § 1014(a). However,

[18] For a detailed discussion of Section 199A, see Willms, *Getting the 411 on 199A: Just the Facts, Ma'am*, 53 U. MIAMI HECKERLING INST. ON EST. PL. 2 (2019).

[19] Section 199A also allows individuals and some trusts and estates a deduction of up to 20 percent of their combined qualified real estate investment trust dividends and qualified publicly traded partnership income, including such income earned through pass-through entities.

this basis adjustment affects only the partner's outside basis in the partnership interest. It has no direct effect on the partnership's inside basis in its assets. IRC § 734. If the partnership sells an appreciated asset after the death of the deceased partner, the successor partner generally must report his or her share of any gain recognized at the partnership level as if no basis adjustment of the asset sold had occurred. IRC § 743. To alleviate this result, the Code offers a unique tax advantage to a successor of a decedent's partnership interest. Namely, upon a partner's death (or upon the sale or exchange of a partnership interest) the partnership's basis in property owned by the partnership is adjusted under Code Section 743 if the partnership makes (or has in effect) an election under Code Section 754. If the partnership makes an election under Code Section 754, the successor partner (but not the other partners) can change his or her share of the inside basis of partnership assets by the difference between the adjusted outside basis and the decedent's old share of the inside basis of the partnership assets. If the partner's outside basis in his or her partnership interest increases, this adjustment in inside basis allows the inheriting partner to recognize less gain (or more loss) when assets are later sold by the partnership. If there is depreciable property, the inheriting partner can claim higher depreciation deductions than the other partners based on the higher inside depreciable basis. Conventional wisdom thus usually suggests making the Section 754 election on the death of a partner. However, a Section 754 can be a two-edged sword. It has several disadvantages. As one might imagine, a Section 754 election can dramatically increase the partnership's record keeping requirements, especially if several partners die (or sell their interests). Second, the election may cause a *step-down* as well as a step-up in basis if the fair market value of the deceased partner's interest is less than the partnership's inside basis of its assets. Unfortunately, once the partnership makes a Section 754 election, it cannot be changed without the consent of the IRS. It forevermore affects all the other partners in the partnership when any other partner dies, or a distribution of property to any partner is made in later years. Finally, changes made by The Taxpayer Relief Act of 1997 to the basis allocation rules on liquidation of a partner's interest in a partnership and changes to Treasury regulations under Sections 754, 755, 743, 734, and 732 have caused advisors to reconsider the benefits of a Section 754 election. In some cases, a liquidation might offer preferential tax treatment over a Section 754 election. For a detailed discussion of these issues, see Cantrell, *Practical Income Tax Guidance on Forming, Operating, and Liquidating Your Family Limited Partnership*, State Bar of Texas 22nd Annual Advanced Estate Planning and Probate Course (1998).

b. Manner and Timing of Election. A Section 754 election is made by the partnership by attaching a written statement, signed by any one of the partners, to the partnership's timely filed (including extensions) tax return for the year in which the death of the partner occurred. Once made, the election is effective until revoked with the approval of the IRS. Treas. Reg. §§ 1.754-1(b), (c). If the partnership determines that a Section 754 election is desirable after the due date has passed, an automatic extension of twelve months from the original due date may be granted provided that the partnership files an original or amended partnership tax return attaching the required election statement with "FILED PURSUANT TO TREAS. REG. 301.9100-2T" printed at the top of IRS Form 1065 or the attached election statement. No user fees apply. If a partnership has other partnership interests as part of its portfolio, each partnership must make a separate election. Rev. Rul. 87-115, 1987-2 CB 163.

c. Application to Both Halves of the Community. Section 743(b) of the Code permits an adjustment to the basis of partnership property "in the case of a transfer of an interest in a partnership . . . upon the death of a partner." However, in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), the surviving spouse's interest in the partnership is not "transferred" upon the death of the decedent. Nevertheless, the IRS has ruled that the Section 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share. The ruling also states that the same result would apply if the non-partner spouse predeceased the partner spouse. Rev. Rul. 79-124, 1979-1 CB 224.

d. Tax Effects of Election. A basis adjustment in the partner's outside basis of the partnership interest may occur when a partner dies, regardless of whether a Section 754 election is made. A step-up in basis eventually provides tax savings for the successor-in-interest when the partnership interest is sold or liquidated. The effect of the Section 754 election is to accelerate the benefit of any step-up in basis by immediately passing it through to the inside basis of the individual assets as to the decedent partner's interest only. Thus, when a Section 754 election is made, if a partnership interest is transferred (including transfers arising at death), and if the basis of the transferee partner's partnership interest (the outside basis) is greater than the former partner's share of the partnership's "inside" basis in the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets. As a result, if the partnership thereafter depreciates an asset, the transferee partner's share of depreciation will be higher. Similarly, if the partnership later sells an asset, the transferee's share of gain on the sale of the asset will be lower. The successor partner will then benefit immediately, due to the higher basis in the decedent's share of assets inside the partnership, and as noted above, most commentators agree that it is advantageous to estate beneficiaries to have the partnership make a Section 754 election as of the year of death if the fair market value (and hence basis) of the decedent's interest in the partnership exceeds the decedent's share in the basis of the partnership's assets. The method by which the partner's increased (or decreased) basis is allocated among specific partnership assets is complex, involving first a separation of the partnership's ordinary income assets from its capital assets, followed by an allocation among specific assets within each class. This system yields rough justice, but does not truly put the transferee in the position of a purchaser of an undivided interest in partnership assets if some of the partnership's assets have appreciated and others have depreciated. The basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is a function of the relationship between the outside basis in the partnership interest and the partnership's inside basis in its assets which are allocable to that partner. If a partnership does not make a Section 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which might also be an event triggering a basis adjustment.[20]

2. Fiscal Year End Issues

As indicated above, an estate may select a fiscal year end. If the fiscal-year-end estate holds a majority interest in a partnership, the partnership must convert to the estate's fiscal year end. A partnership's tax year is not dictated by the terms of the partnership agreement. Instead, Section 706(a) of the Code requires that the partnership's tax year be determined by reference to the partners. IRC § 706(b)(1)(B). Once a partnership's tax year is selected, it ordinarily does not change. However, there are some exceptions to that rule.

a. Mandatory Change in Partnership Year Based on Majority Partner. A partnership's tax year must conform to that of the majority interest partners. A majority interest partner is any one or more partners with the same tax year whose interest(s) in the capital and profits of the partnership constitute more than 50% on the first day of the partnership taxable year (the "testing date"). IRC § 706(b)(4)(A)(i), (ii). When a partner of a calendar year partnership dies and his or her estate owns a majority interest and selects a tax year other than the calendar year, the partnership will be required to change its tax year to conform to the majority partner in the partnership's next tax year. The partnership does not "annualize" its income for the short period. Treas. Reg. § 1.706-1(b)(8)(i)(B). If a change is required under the provisions of Section 706(b)(1)(B)(i) due to a change in the majority interest partner's tax year, no further change will be required of the partnership for the two years following the year of change. IRC § 706(b)(4)(B). This required tax year change can result in some rather interesting planning opportunities for the executor in selecting the estate's tax year. Invariably, one or more beneficiaries of the estate's partnership interest will be a trust or an individual required to use a calendar year. If the beneficiary receives the partnership interest following the "testing date," then the recipient partner may obtain a deferral on reporting his or her share of partnership income for as many as two tax years before the partnership is again required to change tax years.

b. Selection of Estate's Tax Year for Maximum Deferral. An estate or electing trust with partnership interests should carefully examine the effects of its chosen tax year on the deferral opportunities afforded by virtue of the ownership of calendar year partnership interests. If the estate is a majority partner, the partnership will be required to change to the estate's tax year. For example, if the estate chooses a November 30 tax year, the estate's beneficiaries may obtain up to an eleven-month deferral of income each year for two years following the partner's death. If the estate is not a majority partner, so the partnership stays on the calendar year, and the estate chooses a November 30 tax year, the estate may obtain this eleven-month deferral for as long as it holds the partnership interest.

3. Requirement to Close Partnership and S Corporation Tax Years. When a partner or S corporation shareholder dies, the decedent must report his or her share of the entity's income for the year of death. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless the partners agree to allocate income on a per diem or other reasonable basis. *See* Treas. Reg. § 1.706-1(c)(2)(ii). Conversely, an S corporation shareholder's final return must include the decedent's pro rata share of the S corporation's income

[20] *See* Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter *Gorin's Business Succession Solutions*).

for the year on a per diem basis. IRC § 1377(a)(1). If all of the shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2).

4. Special Problems for Estates Holding Interests in S Corporations.

a. Eligibility Issues. A decedent's estate qualifies as an S corporation shareholder for the entire period of administration. IRC § 1361(b)(1)(B). For purposes of ensuring that the corporation has no more than 100 shareholders, the estate counts as only one shareholder. Treas. Reg. § 1.1361-1(e)(1). In addition, the fact that an estate has one or more beneficiaries who are not eligible to be S corporation shareholders does not disqualify the S election so long as the estate retains the stock and does not distribute it to the ineligible shareholder. These rules give an executor time to analyze the consequences of a distribution of stock, and to take necessary actions to ensure that the beneficiaries who receive the stock are eligible shareholders. These actions might include reforming a recipient trust to ensure that it is eligible to hold S corporation stock. Note, however, that the administration of an estate for tax purposes cannot be prolonged beyond the period necessary for its administration under state law. Treas. Reg. § 1.641(b)-3(a). If an estate is unduly prolonged, the IRS might assert that the estate has in effect become a trust, and therefore is no longer an eligible shareholder. *See Old Virginia Brick Co. v. Comm'r,* 367 F.2d 276 (4th Cir. 1966); *see also* Tenney and Belkap, *Postmortem Planning for Interests in Pass-Through Entities,* 27 EST. PLAN. J., No. 6, p. 250 (July 2000).

b. Avoiding Mismatches on Sale of S Corporation Assets. If the business of the S corporation will be discontinued after the death of the decedent, the executor (or remaining officers) may choose to sell the company. Buyers of operating concerns often prefer to purchase assets, and not stock (to avoid liability for past actions of the business and to facilitate an increased basis for acquired assets). Note, however, that the assets of the corporation do not receive a new cost basis at death. Only the stock held by the decedent receives a new basis. Unlike a partnership, no Section 754 election is permitted for S corporations to transfer their shareholders' adjusted stock basis through to the corporation's underlying assets. As a result, any gain realized by the corporation will be passed through to its shareholders, further increasing basis, which can then enable an offset upon liquidation. Timing here, however, is critical.

> **Example 9:** An estate holds all of the stock of an S corporation, whose fair market value on the date of death is $1,000,000. The executor thus has a basis in the stock of $1,000,000. The corporation holds assets with a fair market value of $1,000,000, and a basis of $100,000. If the corporation sells its assets, the corporation recognizes a gain of $900,000, which is passed through to the estate. The estate reports a capital gain of $900,000, and adds $900,000 to the basis of its stock, for a total basis of $1,900,000. If the corporation liquidates, transferring the $1,000,000 sales proceeds to the estate, it will apply its basis of $1,900,000, resulting in a $900,000 loss (which exactly offsets its gain). Note, however, that if the sale takes place in the estate's first fiscal year, and the liquidation occurs in the second, the estate will have to report, and pay tax on, the $900,000 gain in year one. The $900,000 loss in year two can be carried forward, but cannot be carried back to offset the prior year's gain.

5. Income Tax Consequences of Funding Bequests with Partnership Interests and S Corporation Stock

a. Satisfaction of Specific Bequests. If an estate make a distribution of property in kind, including a distribution of a partnership interest or S corporation stock, to satisfy a gift of a "specific dollar amount" or a gift of specific property with property other than that specified in the governing instrument, then the estate will recognize gain or loss, based on the difference between the fair market value of the asset on the date of the distribution and the date of death basis of the property. Treas. Reg. § 1.661(a)-2(f). This rule applies whether the gift is a fixed dollar amount or a formula fixed dollar amount. *See* Rev Rul. 60-87, 1960-1 CB 286. Thus, if an appreciated partnership interest is used to fund a pecuniary bequest, gain may be required to be recognized by the estate upon the funding of the bequest. Of course, a partnership interest or S corporation stock can decline in value as well as appreciate between date of death and date of funding. Generally, any losses realized from date of death values will be subject to the related party rules and be denied to non-electing trusts. However, an estate may recognize losses incurred in funding pecuniary bequests. IRC § 267(b)(13).

b. Basis Issues. Except for estates of decedents dying in 2010 whose executors opted out of the federal estate tax, the basis to the decedent's estate of a partnership interest or S corporation stock will be its fair market value on the decedent's date of death (or on the alternate valuation date, if the estate is eligible and the decedent's executor so elects). Treas. Reg. § 1.1014-1(a). When the estate distributes an asset to an individual or a trust, the basis is generally a carryover basis of the adjusted basis in the hands of the estate prior to distribution, adjusted by the income or losses recognized by the estate during the administration, and any gain or loss triggered on the distribution. IRC § 643(e)(1). If the distribution does not trigger gain or loss to the estate, then the beneficiary would expect to receive a carryover basis in the interest distributed. If, however, the distribution occurs pursuant to a will or other situation that triggers gain or loss recognition, the beneficiary will obtain an additional step-up or step-down in basis equal to the gain or loss recognized upon the distribution. In addition, since the distribution constitutes a sale or exchange, in the case of a partnership interest, the beneficiary will be afforded the opportunity to adjust the inside basis of assets as to the beneficiary if the partnership makes (or has made) a Section 754 election. IRC § 743(b). In situations where the discounts and potential step-down indicate that a Section 754 election might not have been desirable in the year of death, the potential benefit of a Section 754 election should be revisited in the year of distribution.

B. Trust Issues

1. Distribution of "All Income". As noted above, a simple trust is one which must distribute all of its "income" annually. "Income" for this purpose means *fiduciary accounting income* determined under local law—not taxable income. IRC § 643(b). In most states, "fiduciary accounting income" is determined under some version of the Uniform Principal and Income Act or the Revised Uniform Principal and Income Act and the relevant provisions of the governing instrument. The trust need not distribute all of its taxable or distributable net income. Naturally, in the context of stocks, bonds, and most other assets, the trustee can look to the governing instrument or local law to determine which items constitute principal or income.

2. Cash Flow Difficulties

a. If the Entity Makes No Distributions. If trust or an estate owns an interest in a pass-through entity that makes no distributions, serious liquidity problems may arise. Consider the following example:

> **Example 10:** An estate of a decedent who dies in 2019 holds as its only asset a limited partnership interest worth $6,000,000 at the date of death. The Will makes a formula bequest of $1,000,000 (one-sixth of the estate) to a QTIP trust, with the residue (five-sixths of the estate) passing to a bypass trust. The estate funds these bequests on November 30, 2019. Upon funding, the partnership closes its books and determines that the estate's share of partnership taxable income is $180,000. No distributions are made by the partnership to the estate. The estate reports taxable income and DNI of $180,000, and increases its basis in the partnership by this amount. The estate then distributes one-sixth of its limited partnership interest to the marital trust, and five-sixths of its interest to the bypass trust. These distributions entitle the estate to a distribution deduction of $180,000 (since all of the estate's taxable DNI is distributed) and the estate's taxable income is zero. The estate issues K-1s to the QTIP trust showing $30,000 (i.e., $1/6th of $180,000) of income, and to the bypass trust showing $150,000 of income. Each trust also receives a K-1 from the partnership for income earned by the partnership from December 1 to December 31, 2019. Assume for this example that partnership expenses offset income for the month of December, so no amounts are reportable on the K-1s issued by the partnership to the trusts. The QTIP trust, which has a mandatory income distribution requirement, calculates its fiduciary accounting income to be zero. (Even though post-death taxable income has been attributed to the estate, presumably no post-death fiduciary accounting income has been received by the estate or distributed to the trust.) The trust's only asset is a limited partnership interest which it held for one month during 2019. The partnership made no distributions to the trust in 2019. Therefore, the QTIP trust is not required to make any income distributions to the surviving spouse beneficiary in 2019. However, the marital trust has taxable income of $30,000 on which it must pay tax at fiduciary rates. The income is "trapped" in the trust (unless the trust agreement allows for, and the fiduciary actually makes, corpus distributions during December 2019 or within 65 days after the QTIP trust's year end under the 65-day rule). The trust has no cash, so how will the tax be paid?

As the example shows, the QTIP trust and bypass trust both have those serious liquidity problems. Their only assets are interests in a limited partnership from which they cannot demand a cash distribution. Perhaps the trusts could carve out and distribute partnership interests with a basis or value equal to their DNI (if the distributions are deemed to be necessary under the standards set forth in the trusts, and if the partnership agreement permits such an assignment). The effect of those distributions would be to shift the tax liability (and the liquidity problem) to the beneficiaries receiving the distributions. Query whether the trustee's fiduciary duty to the beneficiaries is violated by making in-kind distributions that carry out taxable income, without distributing sufficient cash to pay the resulting tax. If the trusts do not make any distributions, they are each faced with a significant federal income tax liability and no cash with which to pay it. Although the IRS now accepts credit card payments, it has not yet approved payment by way of partnership interests. Presumably, the trustees will be required to sell sufficient limited partnership interests to raise the required cash, or to borrow funds to pay taxes.

b. <u>If the Entity Distributes "Enough to Pay Taxes"</u>

(1) <u>Partnerships</u>. If a partnership owned by a simple trust makes a distribution during the year, but doesn't distribute all of its taxable income, a new cash flow problem arises. Suppose that a QTIP trust owns a 25% interest in a partnership that earns $1,000,000 in income, $250,000 of which is allocated to the trust. The managing partner decides to distribute $400,000 ($100,000 of which passes to the trust) to the partners so that they have funds with which to pay any resulting tax liability. The partnership sends the trust a K-1 for $250,000. For fiduciary accounting purposes, though, the income of the trust (if income is based upon receipts) is only $100,000. UNIF. PRIN. & INC. ACT § 401(b) (2000). As a result, the trust distributes $100,000 to the surviving spouse, and takes a $100,000 distribution deduction, leaving taxable income of $150,000 in the trust. The trust owes tax on that income of about $53,474 (using 2019 rates). Under Section 505 of UPIA as originally enacted, a tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionally (i) from income to the extent that receipts from the entity are allocated to income; and (ii) from principal to the extent that receipts from the entity are allocated to principal, *or to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity*. For this purpose, receipts must be reduced by the amount distributed to a beneficiary that generates a distribution deduction. Since the trust's share of taxable income exceeds the receipts from the entity, this tax is charged to principal. UNIF. PRIN. & INC. ACT § 505(c) (2000). Applying this rule, the trust owes tax not on proceeds, but on phantom income from the partnership, all of which is charged to principal on the trust's books. As a result, the trust may have a $53,474 cash shortfall. If the trustee ignores the statute and reduces fiduciary accounting income by *all* income taxes (or if the governing instrument permits or requires all taxes to be allocated to income), a rather curious set of interrelated computations arise: the distributable amount is reduced by taxes, which reduces that distribution (and the distribution deduction). This reduced deduction further increases taxes, etc. until the tax bill on almost the entire $250,000 is owed by the trust, generating a tax of about $98,344.37 leaving $1,655.63 of income to be distributed by the trust (for simplicity, using a flat 37% income tax rate). In other words, for tax purposes, the trust would have $250,000 of K-1 income, less a distribution deduction of $11,904.76, leaving taxable income of $238,095.24, yielding a tax of $88,095.24. From a fiduciary accounting income point of view (ignoring UPIA), the trust would have $100,000 of gross accounting income, less $88,095.24 in taxes, for net accounting income of $11,904.76 (equal to the imputed distribution deduction). As noted below, this is exactly the result in those jurisdictions that have adopted the 2008 changes to UPIA or have comparably amended their principal and income rules. The same result occurs if the governing instrument charges these income taxes to income.

(2) <u>ESBTs</u>. A similar problem arises if the entity involved is an S corporation and the trust has made an ESBT election. The trust will receive a K-1 from the S corporation showing taxable income of $250,000. The trust will owe tax of $92,500 ($250,000 x 37%). As with the preceding example, actual *proceeds* have been received by the trust, which should be characterized as income. UPIA Section 505 allocates taxes to the income account to the extent receipts are treated as income. Subsection 505(d) of UPIA provides that receipts allocated to income are reduced only for distributions yielding a distribution deduction, but an ESBT receives no distribution deduction. Therefore, the tax, to the extent it relates to income, should reduce fiduciary accounting income. If the trustee reduces fiduciary accounting income by the taxes attributable to income, the fiduciary accounting income will be $100,000, less the tax on that income ($37,000) or $63,000. The trust has only $100,000 of cash, but must write a check for $92,500 in tax, *and* make a distribution of $63,000. Thus, the trust will have a cash shortfall of $55,500 ($100,000-$92,500-$63,000) when it comes time to make its required distribution.

(3) <u>QSSTs</u>. If S corporation stock is held in a QSST, the S corporation should send the K-1 to the trust beneficiary, and not the trust. IRC § 1361(d)(1)(B); Treas. Reg. § 1.1361-1(j)(7). In that event, the $100,000 received by the trust is all fiduciary accounting income distributable to the beneficiary, who then has the cash flow with which to pay the tax.

(4) 2008 UPIA Changes. In 2008, the Uniform Law Commission finalized an amendment to Section 505 of UPIA to address the problem associated with trusts and estates holding interests in pass-through entities. The revised statute deletes the requirement that taxes be charged to principal to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity. It then adds a provision requiring the trustee to adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary. The rewritten statute requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This treatment assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) of UPIA recognizes that, except in the case of an ESBT, a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary. Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the rewritten rule effectively requires the trustee to apply the formula approach outlined below to determine the correct amount payable to a beneficiary. This formula must take into account that each time a distribution is made to a beneficiary, the trust's taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries. The comments to the revised statute provide two examples to illustrate these tax allocations. In the first example, Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T. The trustee allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing. In the second example, Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T. Again, the trustee allocates the receipts to income. As in the first example, Trust T's tax on $1 million of taxable income is $350,000. Under subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. However, the $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B. The total amount due to B could be solved by multiple iterations. Alternatively, the trustee can apply the following algebraic formula to determine the amount payable to B:

> D = (C-(R*K))/(1-R), where D = Distribution to income beneficiary; C = Cash paid by the entity to the trust; R = tax rate on income; and K = entity's K-1 taxable income

Applying this formula (keeping with the income tax rates used in the UPIA example), the distribution (D) would equal ($500,000-(.35*1,000,000))/(1-.35)= 230,769. The trust would thus report $1,000,000 of K-1 income less a $230,769 distribution deduction for a taxable income of $769,231. The tax on that income would be $269,231 (at a flat 35%). As a result, the $500,000 distributed to the trust would pass $230,769 to the beneficiary and $269,231 to the IRS. As of the date of this writing, the amended version of Section 505 has been adopted in the District of Columbia and 36 states: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah (although it has now adopted UFIPA), Vermont, Virginia, Washington, West Virginia, and Wisconsin.

VI. CONCLUSION

The income taxation of trusts and estates involves a myriad of sophisticated tax issues. Armed with a working knowledge of these issues, however, professionals who advise executors and trustees, and those that prepare their tax returns, can feel comfortable in administering and reporting these esoteric events. With proper attention and planning, clients can often recognize significant income tax savings, or at least properly plan for any potential tax consequences.