

# Fiduciary Income Tax Refresher and Update 2021

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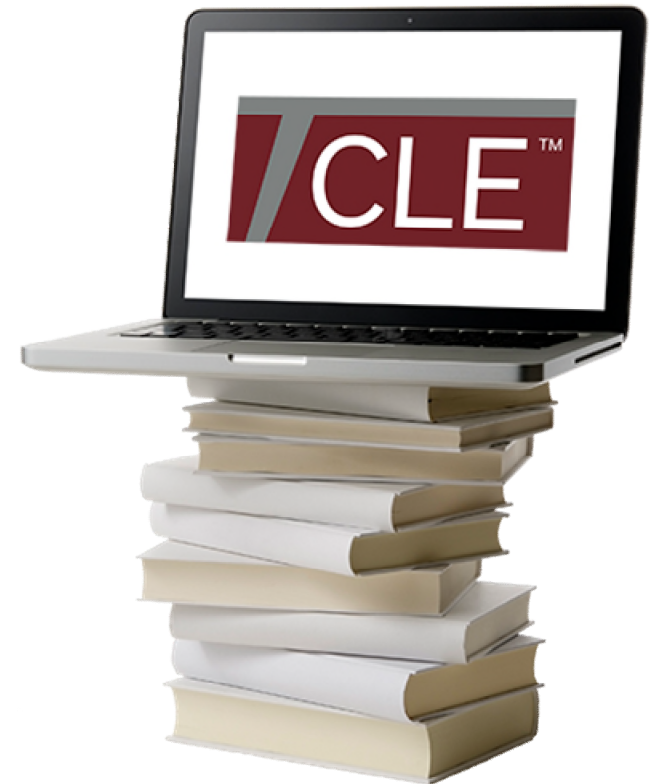
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# Review of Materials

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- Slides
  - Will cover most – rest is for reference
  - Focus on concepts rather than examples
  - More details in other webinars
- 2,800+ page PDF

# Overview

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- 2017 Tax Law Changes and Post-2017 Guidance About Them
- Strategic Income Tax Planning
- Integrating 2018 Changes to the Uniform Principal and Income Act
- Ten Tips for Fiduciary Income Tax Preparers

# 2017 Tax Law Changes

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- Overview
- ESBTs
- Itemized Deductions and Related Revamping of Excess Losses on Termination
- Code § 199A – Deduction for Qualified Business Income (QBI), etc.

# Trusts and 2017 Law (II.J.3.d., II.G.4./ii.)

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[parenthetical such as II.J.3.d. refers to supporting materials]

- Miscellaneous itemized deductions not deductible through 12/31/2025
- Trust administrative expenses – Code § 67(e) makes deductions not be itemized; final regulations confirm this conclusion
- State tax deduction under Code § 164(b)(6) – separate \$10,000 limitations; consider that property taxes but not income taxes are unlimited for trade or business or rental real estate

# Trusts and 2017 Law (II.J.3.d.)

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- ESBT may now have nonresident alien (NRA) as permissible current beneficiary; however, if NRA is a deemed owner of part or all of the trust, then NRA's deemed ownership of the S corporation portion is ignored and trust pays the tax (II.A.2.f.)
- ESBT deduction for charitable contributions on K-1 from S corporation now applies Code § 170 instead of Code § 642(c) (III.A.3.e.ii.(b).)

# Planning for Excess

## Losses (II.J.3.i.)

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- Code § 642(h)(1) provides for capital losses and net operating losses passing to beneficiaries
- Code § 642(h)(2) excess deductions on termination does not define what kind of deductions they are
- Until 2020 regulations, regs had treated excess deductions as miscellaneous itemized deductions (disallowed 2018-2025)

# Planning for Excess

## Losses (ll.J.3.i.)

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Final regulations (10/19/2020) classify excess deductions on termination as

- allowable in arriving at adjusted gross income,
- non-miscellaneous itemized deduction, or
- miscellaneous itemized deduction



# Planning for Excess

## Losses (ll.J.3.i.)

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Final regulations (10/19/2020):

- To the extent that deductions are allocable to taxable items, taxpayer may choose which deductions offset which income (ll.J.8.f.i.(a))
- Use less favorable deduction to offset income, which is the equivalent of deducting itemized deductions above-the-line

# Planning for Excess

## Losses (ll.J.3.i.)

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### Example:

- terminating trust has \$5,000 income, \$2,000 of tax prep fees, and \$4,000 of legal fees
- excess deductions are \$1,000 ( $\$5,000 - (\$2,000 + \$4,000)$ )
- both deductions are Code § 67(e) above-the-line deductions (in other words, deducted in arriving at gross income)

# Planning for Excess

## Losses (ll.J.3.i.)

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- Before the 2020 regs, this \$1,000 excess deduction would have been a miscellaneous itemized deduction
- Under the 2020 regs, the \$1,000 excess is an above-the-line deduction

# Planning for Excess

## Losses (II.J.3.i.)

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### Variation 1:

- Same example, but the \$4,000 in legal fees is replaced by \$4,000 in state income tax, which is an itemized deduction
- Excess deductions remain \$1,000
- When preparing the tax return, you choose to apply \$1,000 in tax prep fees and \$4,000 in state income tax to eliminate the \$5,000 income

# Planning for Excess

## Losses (ll.J.3.i.)

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### Variation 1:

- That leaves \$1,000 in tax prep fees
- Under the 2020 regs, the \$1,000 excess is an above-the-line deduction

# Planning for Excess

## Losses (II.J.3.i.)

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### Variation 2:

- Same as Variation 1, but you instead offset the income by \$2,000 in tax fees and \$3,000 in state income tax
- That leaves \$1,000 in state income tax
- Under the 2020 regs, the \$1,000 excess is a regular itemized deduction (not a miscellaneous itemized deduction)
- Variation 1 is better: \$1,000 is above-the-line

# Planning for Excess

## Losses (II.J.3.i.)

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Final regulations (10/19/2020):

- Consistent with explicit requirements of Code § 642(h)(2), personal exemption and Code § 642(c) charitable deduction are not excess deductions
- Preamble seems to confirm that an ESBT's charitable contributions, which are now Code § 170 deductions, are now excess deductions on termination

# Planning for Excess

## Losses (II.J.3.i.)

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Preamble to proposed regulations (5/11/2020):

“These proposed regulations apply to taxable years beginning after the date these regulations are published as final regulations in the Federal Register. However, estates, non-grantor trusts, and their beneficiaries may rely on these proposed regulations under Section 67 for taxable years beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register. Taxpayers may also rely on the proposed regulations under Section 642(h) for taxable years of beneficiaries beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register in which an estate or trust terminates.”



# Code § 199A Deduction and Taxable Income Thresholds (II.E.1.c.v.(a).)

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- \$315,000-\$415,000 for married filing jointly, \$157,500-\$207,500 for all other taxpayers, including trusts (subject to indexing). The threshold amounts are \$326,600 for 2020 for MFJ and \$329,800 for 2021 for MFJ, \$163,300 for 2020 and \$164,925 for 2021 for MFS, and \$163,300 for 2020 and \$164,900 for 2021 for all other returns
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply
- Benefits phase out over that range
- Phase-outs apply cumulatively

# Trusts and QBI (II.E.1.f.)

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- Grantor trusts are disregarded and their items attributed to their deemed owners
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income (“DNI”), determined after applying the separate share rules, if relevant

# Trusts and QBI (II.E.1.f.)

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- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.
- Taxable income thresholds are applied separately at the trust and beneficiary levels

# Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

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Rev. Proc. 2019-38 “provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business” solely for purposes of Code § 199A and the regulations thereunder, then says, “If an enterprise fails to satisfy the requirements of this safe harbor, it may be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A-1(b)(14).”

# Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

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- “To be responsible for maintenance activities” indicated that, for the lease to be a disfavored “triple net lease” under Notice 2019-7, the tenant had to not only pay for maintenance but also arrange the maintenance
- Rev Proc. 2019-38 eliminates the responsibility requirement by providing that mere payment of maintenance is enough connection to maintenance activity that, when combined with other factors in both tests, would make the lease a disfavored triple net lease
- This change knocks out most large shopping centers and large office buildings from safe harbor, but those activities do not appear to need a safe harbor anyway, given the level of service typically provided
- [Code § 199A Safe Harbor for Rental Real Estate; Partnership Structural Issues; Sale of Intangible Assets](#)

# Multiple Trust Rule (II.J.9.c.)

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- Reg. § 1.643(f)-1(a) – “... two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax.”
- Although the government eliminated the proposed regulations’ overreaching as ACTEC suggested, [ACTEC’s comments](#) point out various questions that remain based on the statute and legislative history

# Multiple Trust Rule (II.J.9.c.)

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- Legislative history seems to conflate which beneficiaries are considered in testing whether trusts have “substantially the same primary beneficiary or beneficiaries”
- Consider documenting nontax reasons for multiple trusts

# Strategic Income Tax Planning

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- Who Is Best Taxed on Gross Income
- Effect of Kiddie Tax on Rates
- Who Benefits Most from Deductions
- State and Local Income Tax
- Consider Trust Purposes



# Strategic Income Tax Planning

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- Effect on Future Years
- Flexibility in Trust Income Taxation
- Planning for Excess Losses
- Code § 645 Election to be Taxed as an Estate

# Who Is Best Taxed on Gross Income

(II.J.3.a.)

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Increasing a beneficiary's adjusted gross income (AGI) can cause the following tax issues:

- Reduction in Particular Itemized Deductions
- Phase Out of AMT Exemption
- Phase Out of Personal Exemption (2026+)
- Net Investment Income (NII) Tax

# Who Is Best Taxed on Gross Income

(II.J.3.a.)

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- Consider beneficiary loss carryovers to offset income – especially capital loss carryovers
- Thus, beneficiary in top bracket could effectively have lower rate because income offset by losses is not taxed

# Effect of Kiddie Tax on Rates

(II.J.3.b.)

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- Child taxed at parent rate on much of child's investment income
- No rule coordinating net investment income tax

# Who Benefits Most from Deductions

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- Administrative expenses above-the-line for trusts but temporarily disallowed for beneficiaries
- State tax deduction
- Charitable deduction limitations (discussed further below)
- Code § 1244 stock N/A to trusts
- Special rule for depreciation deductions

# State and Local Income Tax

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- Trust's vs. beneficiary's rates
- Nonresident trust escaping taxation
- Effect of grantor trust status on a trust's residence (including grantor later moving)

# State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

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*North Carolina Department of Revenue v. Kimberley Rice  
Kaestner 1992 Family Trust*, 588 U.S. \_\_\_ (2019)

- Unanimous decision that NC cannot subject to income tax a trust whose only ties consisted of a beneficiary who may at some point receive distributions in the trustee’s “absolute discretion”
- Holding limited to “the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income”

# State Fiduciary Income Taxation –

## *Kaestner* (II.J.3.e.ii.)

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- The Court did not address whether, if the trust had made distributions to Kaestner, NC could have taxed her
- The Court noted in passing and without pause that, in a year after the taxable year that was subject to the litigation, the trust was to terminate when the beneficiary reached age 40, but the trustee decanted into a new trust (in a year after the taxable year being litigated), with no objection from the primary beneficiary



# State Fiduciary Income Taxation –

## ***Kaestner*** (II.J.3.e.ii.)

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- “Today’s decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries, see, e.g., Cal. Rev. & Tax. Code Ann. § 17742(a).... We express no opinion on the validity of such taxes.”
- Thus, no impact on 2013 case, *McNeil Trust v. Commonwealth of Pennsylvania*, in which a Pa. court struck down taxation based solely on settlor’s residence

# State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

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Footnotes 12-13:

“The State directs the Court’s attention to 10 other state trust taxation statutes that also look to trust beneficiaries’ in-state residency ..., but 5 are unlike North Carolina’s because they consider beneficiary residence only in combination with other factors [citing statutes in Alabama, Connecticut, Missouri, Ohio, and Rhode Island]. Of the remaining five statutes, it is not clear that the flexible tests employed in Montana and North Dakota permit reliance on beneficiary residence alone .... Similarly, Georgia’s imposition of a tax on the sole basis of beneficiary residency is disputed .... Tennessee will be phasing out its income tax entirely by 2021 .... That leaves California, which (unlike North Carolina) applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent ....”

“The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed.”  
[citing California law]

# State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

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- Counsel for the state struggled to explain how state and federal income taxation are connected and later publicly admitted that he got raked over the coals by the Supreme Court justices
- The North Carolina bar has in the past proposed a statute that would pass muster, and the legislature declined to address the issue
- At least 400 protective claims for refunds had been filed by the end of June 2019
- On July 2, 2019 NC Department of Revenue established procedures for refund claims in cases governed by the case:  
[https://files.nc.gov/ncdor/documents/files/2019-7-2\\_Kaestner\\_Important\\_Notice.pdf](https://files.nc.gov/ncdor/documents/files/2019-7-2_Kaestner_Important_Notice.pdf)

# State Fiduciary Income Taxation –

## *Kaestner* (ll.J.3.e.ii.)

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- Court since declined to review *Fielding v. Commissioner*, 916 N.W.2d 323 (Minn. 2018)
- That case involved a trust that owned shares in an S corporation
- Nobody disputed Minnesota's ability to tax the trust's distributive share of the S corporation's Minnesota source income
- Rather, the dispute was taxing the other income when the trust's sole potentially meaningful contact with Minnesota regarding that other income was the grantor's residence

# State Fiduciary Income Taxation

(II.J.3.e.ii.)

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- The Minnesota Supreme Court held that taxing the trust on non-Minnesota source income solely on the basis of the grantor's Minnesota residency violated the Due Process Clauses of the U.S. and Minnesota Constitutions, which it viewed as identical to each other
- The very limited holding in *Kaestner* and denial of cert. to *Fielding* seems to indicate that the court looked into providing guidance then decided against it and no longer wishes to tackle the issue

# State Fiduciary Income Taxation

(II.J.3.e.ii.)

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## *Linn v. Department of Revenue* - Illinois Court of Appeals

- Due process analysis looks to contacts only for the taxable year being analyzed
- By exercising a limited power of appointment, the trustee was able to convert an Illinois trust to a trust governed by Texas law, with no Illinois contacts
- The fact that the deceased grantor of this inter vivos trust was an Illinois resident had no bearing
- Thus, consider decanting to move a trust out of state

# State Income Taxation of Business Income (II.G.3.)

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- An owner of an interest in a pass-through entity such as an S corporation or partnership (including an LLC) will report income taxable to the states in which the entity does business, or the entity will pay tax on the income taxable to one or more of its owners instead of its owners reporting that income
- States that tax income have various methods to apportion a business' income, which tend to consider one or more of sales, property, or wages within the taxing state
- Potential for double taxation – use Multistate Tax Commission

# State Income Taxation of Business Income (II.G.3.)

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- If the entity is a C corporation, it pays tax on its own income
- That avoids its owners needing to file income tax returns in multiple states
- C corporation deducts state income tax paid, but owner of a pass-through entity is subject to the \$10,000 limitation on deducting state and local taxes



# State Income Taxation of Business Income (II.G.3.)

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Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II. H.8.a., including II.H.8.a.ii.):

- When pass-through business sells its assets (or is deemed to do so), its owners are taxed wherever assets are sited, but their basis in their partnership/member interest or S corporation stock increases on account of that gain/income
- An owner's partnership/member interest or S corporation stock is sited to the state of the owner's residence
- If basis increase causes a loss on sale, it is deducted only in that state of residence

# State Income Taxation of Business Income (II.G.3.)

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Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II. H.8.a., including II.H.8.a.ii.):

- When a C corporation sells its assets (or is deemed to do so), it is taxed wherever assets are sited
- Its owners' stock's basis does not increase on account of that gain/income
- Stock is sited to the state of its owner's residence

# State Income Taxation of Business Income (II.G.3.)

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Other nuances:

- Code § 199A deduction is available in only a few states
- *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018), was a key decision regarding taxing nexus in the context of state sales tax
- The Council on State Taxation, [cost.org](http://cost.org), tracks not only the implications of that case but also which elements of federal law are integrated into state income taxation

## Consider Trust Purposes

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- Protecting Beneficiary from Third Parties
- Protecting Beneficiary from Self
- Avoiding Estate Tax at Beneficiary's Death (increased exemption might change this need)

## Effect on Future Years

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- Capital gain distribution election (discussed later)
- Turning on/off grantor trust powers (discussed later)

## Flexibility in Trust Income Taxation

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- Support – check for considering or ignoring other resources
- See whether distributions for welfare are permissible – check living client's estate plan for welfare and 5% withdrawal right (described further below)

## Planning for Excess Losses (II.J.3.i.)

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- Cannot pass through losses other than depreciation (II.J.11.A.ii.(B)); level at which the passive loss rules apply is uncertain when trust has net income (II.K.2.B.Iv.)
- Lose excess losses except for final year, net operating loss, or capital loss
- Passive loss rules might simplify due to suspended losses

## Code § 645 Election (II.J.7.)

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- Treat trust as an estate
- Allows fiscal year, charitable set-aside, and extended time to hold S corporation stock
- Terminates two years after the date of the decedent's death or six months after the date of the final determination of estate tax liability (12 months after closing letter)



# Tips for Fiduciary Income Tax Return

## Preparers (II.J.4.)

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- Distributions after yearend to carry out income to beneficiaries
- Capital gain elections
- Charitable distributions
- Possible change in beneficiary's residence
- Material participation for business or rental activities

# Tips for Fiduciary Income Tax Return

## Preparers (II.J.4.)

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- Making trust a partial grantor trust as to a beneficiary
- Making the trust a complete grantor trust as to the beneficiary
- Trapping income in trust notwithstanding distributions
- Modifying trust to make more income tax efficient

# Tips for Fiduciary Income Tax Return

## Preparers (II.J.4.)

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- Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure
  - Need to Provide Notices
  - Sample Notice

# Distributions after Yearend to Carry Out Income to Beneficiaries (II.J.4.a)

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- Rough draft of return in February
- Compare to beneficiaries' tax rates/posture
- Distributions by 65 days after yearend (March 6, 2021 for 2020 returns) (II.J.2.)
- Distributions can carry out capital gains (see below)
- When file return, can decide how much of post-yearend distributions to count for the year

## Capital Gain Elections (II.J.4.b)

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- Tax preparation software traps unless take special steps
- Next slides discuss strategic issues, law, and practical issues (II.J.8.)

## **Additional 5% Capital Gain Tax**

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	<u>2020</u>	<u>2021</u>
Single	\$441,450	\$445,850
Married filing jointly	\$496,600	\$501,600
Trust	\$ 13,150	\$ 13,250

# 3.8% Tax on Net Investment Income (II.I.3.)

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Single	\$200,000
Married	\$250,000
Trust	\$ 12,950 (\$13,050 for 2021)

Indexed for Trusts But Not Individuals

# Capital Gain is DNI Unless Excluded (ll.J.8.a.)

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Code § 643(a)(3): capital gain excluded only if:

- From sale of capital asset
- Allocated to corpus
- Not paid, credited, or required to be distributed to a beneficiary
- Paid, permanently set aside, or to be used for charitable purposes



## Capital Asset (ll.J.8.a.i.)

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### Not a capital asset:

- Code § 1231 property
- Amortized goodwill (self-created goodwill not amortizable is a capital asset)

# Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (ll.J.8.c.)

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1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

## Allocated to Income (II.J.8.c.i.)

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- “Power to adjust” principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Income & Principal Act) (Uniform Law Commission adopted in 2018)
- No duty of consistency from year to year except unitrust

# Materials

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- Uniform Law Commission:  
<https://www.uniformlaws.org/home>
- Web site for UFIPA:  
<https://www.uniformlaws.org/committees/community-home?CommunityKey=1105f9bb-eb93-4d4d-a1ab-a535ef73de0c>
- Web site for UFIPA has a Documents tab, with a link to the [Enactment Kit](#) that includes mapping Principal & Income Act to its UFIPA counterparts
- ACTEC/ALI-CLE: [Getting Money Out of Trusts: Drafting and Trust Administration Under UFIPA](#)

## **Power to Adjust** (II.J.5.b.ii.(a).)

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Under the Uniform Principal and Income Act, a trustee may adjust between principal and income to the extent the trustee considers necessary if:

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms 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 adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

## Power to Adjust (II.J.5.b.ii.(a).)

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- UFIPA § 203(a) requires only that the trustee determine that “the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially.”
- Thus, UFIPA requires only that the power to adjust will be helpful, not necessary.
- UFIPA - trustee not liable for failing to exercise the power
- UFIPA - trustee not liable for decision in good faith

## Power to Adjust (II.J.5.b.ii.(a).)

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Factors a fiduciary must consider (adjust or unitrust):

- the terms of the trust
- the nature, distribution standards, and expected duration of the trust
- the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7
- the desirability of liquidity and regularity of income
- the extent to which an asset is used or may be used by a beneficiary
- the increase or decrease in the value of principal assets, reasonably determined by the fiduciary

## Power to Adjust (II.J.5.b.ii.(a).)

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Factors a fiduciary must consider (adjust or unitrust):

- whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal
- the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods
- the effect of current and reasonably expected economic conditions
- the reasonably expected tax consequences of the exercise of the power



## **Power to Adjust** (II.J.5.b.ii.(a).)

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A fiduciary cannot adjust if would:

- Reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries
- Change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust
- Affect charitable set-aside

## Power to Adjust (II.J.5.b.ii.(a).)

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A fiduciary cannot adjust if would:

- Cause a person to be treated as the owner of all or part of the trust for federal income tax purposes (but can appoint special trustee)
- Cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes (but can appoint special trustee)
- Cause an individual to be treated as making a gift for federal gift tax purposes (but can appoint special trustee)
- Be done by fiduciary who is not an independent person
- Affect eligibility for public benefits
- Change a unitrust

# Unitrust (II.J.5.b.ii.(b).)

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- A fiduciary cannot convert to, modify, or turn off unitrust if would violate certain tax rules
- If trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%
- Terms of the trust may write rules, in whole or in part
- Trustee adopts unitrust policy, including:
  - the unitrust rate or the method for determining the unitrust rate
  - the method for determining the applicable value
  - the application of certain mandatory or permissive rules

# Unitrust (II.J.5.b.ii.(b).)

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Unitrust policy may include:

- Provide methods and standards for:
  - Determining the timing of distributions;
  - Making distributions in cash or in kind or partly in cash and partly in kind; or
  - Correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;
- Specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or
- Provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

# Comparing Power to Adjust to Unitrust

(II.J.5.b.ii.(c).)

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- Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally
- Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries
- However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate
- Unitrust probably generates capital gain on distribution in kind (definitely does for CRUT)
- Power to adjust more flexible for tax planning

## Allocated to Income

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- Trust agreement can allocate capital gain to income
- Cannot “depart fundamentally from traditional principles of income and principal” per Reg. § 1.643(b)-1
- 3%-5% should be OK

# Allocated to Corpus But Distributed Consistently (ll.J.8.c.ii.)

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- Existing trusts – probably did NOT allocate capital gain to DNI
- Solution discussed later
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

# Actual or Deemed Distribution

(II.J.8.c.iii.)

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- Tracing actual distribution often not practical unless terminate trust
- Referring to capital gain suffices – 65-day rule distribution when trustee refers to capital gain
- Can be inconsistent from year to year



## Fairness Issues (II.J.8.c.v.)

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- Fair for cash distribution to carry out taxable income
- If not, “gross up” distribution for taxes paid by distributee
- “Gross up” payment costs remaindermen less than if the trust paid the tax

## Are distributions advisable?

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- Are distributions available?
- Protective nature of trust

## Are distributions available?

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- Support vs. welfare
- Consider or not consider other resources

## Additional Tax Issues

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- Estate tax on beneficiary's estate
- Distribution in kind to include in beneficiary's estate for basis step-up  
(ll.J.8.d.)

## Protective Nature of Trust

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- Very real creditor or spousal issues
- Burning a hole in the beneficiary's pocket
- Beneficiary saves but might one day have creditors

## Consider Forming Partnership (II.J.8.e.)

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- Trust is General Partner
- Beneficiary is Limited Partner

# Partnership

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- Converts capital gain to trust accounting income
- Beneficiary can't spend the partnership interest if distributed to carry out capital gain
- Need to gross up beneficiary for capital gain if use distribution of partnership interest to carry out capital gain

## Ideal Trust Distribution Provisions

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- Distributions of income and principal for support
- Distributions of income and principal for welfare by independent trustee
- Consider 5% withdrawal right exercisable that trustee can turn off before the taxable year begins



## Using Distributions for Welfare

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- If appropriate, beneficiary can appoint person who is not a related or subordinate party (Code § 672(c))
- Distributions can carry out capital gain
- Can decant into more suitable trust or facilitate estate inclusion to get basis step-up at death

## Charitable Distributions (II.J.4.c.)

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- Reduce Adjusted Gross Income
- Exclusive Way For Charitable Deductions to Reduce NII
- More Liberal than 65-Day Rule - Contribution Made on or before Dec. 31, 2021 Can Count as a 2020 contribution
- From Gross Income (II.Q.7.c.i.(a))

# Look for Change in Beneficiary's Residence (II.J.4.d.)

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- Beneficiary Changing Residence Might Change Trust's Residence
- Generally, States Do Not Tax Nonbusiness Income Earned by a Nonresident Trust (II.J.3.e.i.)

# Material Participation for Business or Rental Activities (II.J.4.e.)

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- Passive (II.K.) = NII (II.I.8.)
- Document Trustee's Participation
- Even If Trust Taxed to Deemed Owner under Grantor Trust Rules, Consider Having Trustee Participate (discussed below)
- Beneficiary's Participation Can Trigger Depreciation (II.J.11.a.ii.(b).)

## Qualified Subchapter S Trust (QSST)

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Beneficiary taxed as deemed owner of S corporation stock **except** for gain on sale of stock or business assets

- Allows beneficiary to run through all the lower brackets before getting to higher brackets
- For sale of business, see II.J.15, ii.J.16., and II.J.17.

## Material Participation for Trusts

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### Trust Type

### Participant

QSST (normal operations)

Beneficiary

QSST (stock or asset sale)

Trustee\*

ESBT

Trustee

\* Per proposed regulations and IRS' litigation position on trust material participation

See II.K.2.

# Making Trust a Partial Grantor Trust as to a Beneficiary (II.J.4.f.)

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- Exercise Discretion to Declare a Distribution
- Credit Instead of Distribute
- Lapse Makes Beneficiary Partial Deemed Owner
- Portion Accumulates Over Time
- Cannot Turn Off

## Changing the Paradigm

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Gorin, “Taxing a Trust’s Income: When Distributions Are Surprisingly Not the Key,” *BNA Tax Management Estates, Gifts and Trusts Journal*, Vol. 46 (11/9/2017)



# Making Trust a Complete Grantor Trust as to a Beneficiary (ll.J.4.g.)

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- Trustee contributes assets to S corporation
- Convert to QSST
- Might increase beneficiary's rights, depending on how conversion is done
- Can turn off

## Qualified Subchapter S Trust (QSST)

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Similar to marital deduction trust (III.A.3.e.i.(a.):

- All income must be distributed annually to sole beneficiary
- Not as protective as trust that accumulates income
- No distribution of principal during life of sole beneficiary to anyone other than sole beneficiary

# Trapping Income in Trust

## Notwithstanding Distributions (II.J.4.h.)

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- Trustee contributes assets to S corporation
- Trustee makes ESBT election
- Can turn off

# Electing Small Business Trust (ESBT) (III.A.3.e.ii.)

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- Can be a sprinkle trust
- All S corporation income taxed at highest income tax bracket
  - Limited deductions
  - No income distribution deduction for S corporation items
- Flexible Trusts (III.A.3.e.iv.) Discussion Follows

## Flexible Trust Design – Spouses

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- In many cases, do ***not*** use sprinkle credit shelter trust, which locks one into ESBT
- Bequeath all assets into a QTIP-able trust to toggle between QSST and ESBT as appropriate
- Quick funding of QSST for spouse?
- Automatic QSST on spouse's death?

III.A.3.e.i.(b).

## Flexible Trust Design – Children

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- At drafting stage, make flexible as described above but only one beneficiary
- Can give beneficiary inter vivos power of appointment
- Might be able to modify ESBT and split into one or more QSSTs (III.A.3.e.v.)
- See materials for strategic advantages and disadvantages and implementation steps

# Flexible Trust Design

## Multiple Trusts

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- ESBT portion holds only S stock
- Hold any reinvested distributions in separate investment trust
- Distributions from S corporation trust do not carry out income
- Distributions from investment trust do carry out income
- Caution - multiple trust rules

## Toggling Between QSST and ESBT

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- First time toggling – no time restrictions
- Subsequent toggling – 36 month wait



# Modify Trust to Make More Income

## Tax Efficient (II.J.4.i.)

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- Settlor and beneficiaries (depends on state)
- Decanting (helpful if distributions for welfare)

# Helping the Trustee Provide Annual Notices to Reduce Exposure (II.J.4.j.)

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- Trustee liable 5 years after termination (Missouri or other UTC states)
- Providing notice cuts to 1 year
- Litigious beneficiaries
- Harmonious situation
- Sample notice – all records on flash drive; mail with table of contents and receipt

# Conclusion

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- [Gorin's Business Succession Solutions](#) (quarterly updates to 2,800+ page materials plus chance to subscribe to other publications)
- Other [free Thompson Coburn LLP resources](#)
- CPA Academy [webinar page](#), including:
  - How to Shift Income to Beneficiaries
  - Pass-through Entities Held By Trusts
  - Formula Transfers for Estate Planning (includes explanation of irrevocable grantor trusts)
  - Beneficiary Deemed-Owned Trusts