Fiduciary Income Tax

Refresher and Update 2020

(excerpted from
Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications)

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by Steven B. Gorin[*]

I. Introduction

This document is excerpted from "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," a PDF with over 2,300 pages that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

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All references to the "Code" are to the Internal Revenue Code of 1986, as amended. All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.

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You might also check out the author's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

II.E.1.c.v. Calculation of Deduction Generally

The preamble to final regulations explains:[798]

> As noted in the preamble to the proposed regulations, Section 199A was enacted on December 22, 2017, by section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97 (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.
>
> Section 199A provides a deduction of up to 20 percent of income from 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 some estates and trusts. A Section 199A deduction is not available for wage income or for business income earned through a C corporation (as defined in section 1361(a)(2)). For taxpayers whose taxable income exceeds a statutorily-defined amount (threshold amount), Section 199A may limit the taxpayer's Section 199A deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) the UBIA of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules based upon taxable income above the threshold amount.
>
> Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified REIT dividends and qualified PTP income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.
>
> The Section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.
>
> Additionally, Section 199A(g), as amended by the 2018 Act effective as of January 1, 2018, provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199. The Treasury Department and the IRS intend to issue a future notice of proposed rulemaking describing proposed rules

[798] T.D. 9847 (2/8/2019), part I.A.

for applying Section 199A to specified agricultural and horticultural cooperatives and their patrons.

Finally, the statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of Section 199A (Section 199A(f)(4)), and provides specific grants of authority with respect to: The treatment of acquisitions, dispositions, and short taxable years (Section 199A(b)(5)); certain payments to partners for services rendered in a non-partner capacity (Section 199A(c)(4)(C)); the allocation of W-2 wages and UBIA of qualified property (Section 199A(f)(1)(A)(iii)); restricting the allocation of items and wages under Section 199A and such reporting requirements as the Secretary determines appropriate (Section 199A(f)(4)(A)); the application of Section 199A in the case of tiered entities (Section 199A(f)(4)(B); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (Section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (Section 199A(h)(2)).

Taxpayers other than C corporations may deduct a portion of qualified business income ("QBI") and qualified cooperative dividends ("QCDs"). Code § 199A(a) provides:

In general. In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—

(1) the lesser of -

(A) the combined qualified business income amount of the taxpayer, or

(B) an amount equal to 20 percent of the excess (if any) of-

(i) the taxable income of the taxpayer for the taxable year, over

(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(2) the lesser of -

(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

Thus, the deduction relating to QBI is effectively limited to taxable income that is not taxed as long-term capital gain.[799]

The deduction for QCDs[800] is not a focus of this document,[801] nor do Prop. Reg. §§ 1.199A-1 through 1.199A-6 or Reg. §§ 1.199A-1 through 1.199A-6 address it,[802] except to provide special rules for QBI from any trade or business of a patron of a specified agricultural or horticultural cooperative.[803] Note the limitation related to net capital gain; it includes qualified dividends and also includes capital gains and qualified dividends that do not receive capital gain rates because they are treated as investment income under Code § 163(d)(4)(B)(iii).[804] This limitation seems

---

[799] This is a major limitation among others listed in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction, especially fn 727.

[800] Code § 199A(e)(4) provides:

> *Qualified Cooperative Dividend*. The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—
> (A) is includible in gross income, and
> (B) is received from—
> (i) an organization or corporation described in section 501(c)(12) or 1381(a), or
> (ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

[801] The Senate report explained (footnotes omitted) (remember that the Conference Committee reduced the deduction from 23% to 20%):

> A deduction is allowed under the provision for 23 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of section 751).

[802] Each of Prop. Reg. § 1.199A-1(a)(1) and Reg. § 1.199A-1(a)(1) concludes with:

> This section and §§ 1.199A-2 through 1.199A-6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.

[803] See Reg. § 1.199A-1(e)(7).

[804] Although Code § 199A(a)(1)(B)(ii) refers to Code § 1(h) to define "net capital gain," Code § 1(h) does not define the term. "Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. Code § 1222(11), which applies for purposes of subtitle A (Code §§ 1-1563). The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.1, reasons:

designed to keep the capital gain rate as the floor for a taxpayer's rate and not let the QBI/QCD deduction reduce that rate. Capital gains cannot be QBI.[805] In understanding how this limitation works, note that the QBI/QCD deduction is not a deduction in arriving at gross income, is not a deduction in arriving at adjusted gross income, and is not an itemized deduction.[806] When one calculates income tax, one calculates it on taxable income with and without net capital gain.[807] Thus, this limit on the QBI deduction is applied after all business and nonbusiness income and deductions are calculated to determine taxable income. Therefore, if capital gain can be QBI, the related deduction can be applied against any business or nonbusiness income that is not net capital gain.

The QBI-based deduction is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate QCDs.[808]

The combined QBI amount is (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus (B) "20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year."[809] By "qualified" I mean not a specified service trade or business (SSTB)[810] unless taxable income is below certain thresholds.[811]

> The final regulations provide a definition of net capital gain for purposes of section 199A. Section 1(h) establishes the maximum capital gains rates imposed on individuals, trusts, and estates that have a net capital gain for the taxable year. Section 1222(11) defines net capital gain as the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. Section 1(h)(11) provides that for purposes of section 1(h), net capital gain means net capital gain (determined without regard to section 1(h)(11)) increased by qualified dividend income. Accordingly, § 1.199A-1(b)(3) defines net capital gain for purposes of section 199A as net capital gain within the meaning of section 1222(11) plus any qualified dividend income (as defined in section 1(h)(11)(B)) for the taxable year.
>
> The Treasury Department and the IRS note that under section 1(h)(2), net capital gain is reduced by the amount that the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii). This reduction does not change the definition of net capital gain for purposes of section 1(h). Instead, it reduces the amount of gains that can be taxed at the maximum capital gains rates as a tradeoff for allowing a taxpayer to elect to deduct more investment interest under section 163(d). Consequently, capital gains and qualified dividends treated as investment income are net capital gain for purposes of determining the section 199A deduction.

[805] See Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[806] See fns 719-720 in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction.

[807] Code § 1(h).

[808] Code § 199A(a)(1).

[809] Code § 199A(b)(1). Fn 736 defines "qualified REIT dividend" and "qualified publicly traded partnership income." Reg. § 1.199A-1(d)(3)(i) provides:

> (i) *In general*. The qualified REIT dividend/qualified PTP income component is 20 percent of the combined amount of qualified REIT dividends and qualified PTP income received by the individual (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs).
>
> (ii) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of qualified PTP income generated by an SSTB is taken into account for purposes of determining the individual's section 199A deduction, including the determination of the combined amount of qualified REIT dividends and qualified PTP income

All of the analysis in this part II.E.1.c.v Calculation of Deduction Generally needs to be viewed in light of part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Parts II.E.1.c.v.(b) and II.E.1.c.v.(c) below provide details on this part II.E.1.c.v and refer to the threshold amount, which is described in part II.E.1.c.v.(a) Taxable Income "Threshold.

An overview of Reg. § 1.199A-6, "Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates," is provided in Reg. § 1.199A-6(a):

> This section provides special rules for RPEs, PTPs, trusts, and estates necessary for the computation of the Section 199A deduction of their owners or beneficiaries. Paragraph (b) of this section provides computational and reporting rules for RPEs necessary for individuals who own interests in RPEs to calculate their Section 199A deduction. Paragraph (c) of this section provides computational and reporting rules for PTPs necessary for individuals who own interests in PTPs to calculate their Section 199A deduction. Paragraph (d) of this section provides computational and reporting rules for trusts (other than grantor trusts) and estates necessary for their beneficiaries to calculate their Section 199A deduction.

See the introduction to part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income for general rules regarding RPEs. For trusts and estates, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

II.E.1.c.v.(a). Taxable Income "Threshold Amount"

The wage limitation[812] and the disqualification of SSTBs[813] are eased up or do not apply if the taxpayer's taxable income, computed without regard to the Code § 199A deduction,[814] is below the "threshold amount." The "threshold amount" is $315,000 for a joint return and $157,500 for any other return.[815] The "threshold amount" will be indexed for inflation in a manner similar to indexing the income tax brackets.[816] For taxable years beginning in 2019, the threshold amount

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> described in paragraph (d)(1) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of qualified PTP income generated by an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.

Reg. § 1.199A-1(d)(3)(iii), "Negative combined qualified REIT dividends/qualified PTP income," is reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

[810] See part II.E.1.c.iv Specified Service Trade or Business (SSTB).

[811] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

[812] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[813] See text accompanying fns. 793-794 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

[814] Code § 199A(e)(1).

[815] Code § 199A(e)(2)(A).

[816] Code § 199A(e)(2)(B) provides:

> *Inflation Adjustment*. In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—
>
> (i) such dollar amount, multiplied by

is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for any other returns.[817]

Reg. § 1.199A-1(b)(11) provides:

> *Threshold amount* means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code. [My addition not in the regulations:] For taxable years beginning in 2019, the threshold amount is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for any other returns.[818]

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **B. Computation of the Section 199A Deduction for Individuals With Taxable Income Below the Threshold Amount**
>
> **1. Basic Computational Rules**
>
> An individual with income attributable to one or more domestic trades or businesses, other than as a result of owning stock of a C corporation or engaging in the trade or business of being an employee, and with taxable income (before computing the Section 199A deduction) at or below the threshold amount, is entitled to a Section 199A deduction equal to the lesser of (i) 20 percent of the QBI (generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer) from the individual's trades or businesses plus 20 percent of the individual's combined qualified REIT dividends and qualified PTP income or (ii) 20 percent of the excess (if any) of the individual's taxable income over the individual's net capital gain. Proposed § 1.199A-1(c) contains guidance on calculating the amount of the deduction in these circumstances. If an individual's combined QBI is negative or combined qualified REIT dividends and PTP income is less than zero, proposed § 1.199A-1(c)(2) provides rules for the carryover of the losses.
>
> **2. Carryover Loss Rules for Negative Total QBI Amounts**
>
> If an individual has multiple trades or businesses, the individual must calculate the QBI from each trade or business and then net the amounts. Section 199A(c)(2) provides that, for purposes of Section 199A, if the net QBI with respect to qualified trades or

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(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

[817] Rev. Proc. 2018-57, § 3.27.

[818] Rev. Proc. 2018-57, § 3.27.

businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. Proposed § 1.199A-1(c)(2)(i) repeats this rule and provides that the Section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

3. Carryover Loss Rules if Combined Qualified REIT Dividends and Qualified PTP Income is Less Than Zero

One commenter stated it was not clear whether, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified PTP income (because a loss from a PTP exceeds REIT dividends and PTP income), the negative amount should be netted against any net positive QBI (regardless of source), or whether the negative amount should be segregated and subject to its own loss carryforward rule distinct from but analogous to the QBI loss carryforward rule. Section 199A contemplates that qualified REIT dividends and qualified PTP income are computed and taken into account separately from QBI and should not affect QBI. If overall losses attributable to qualified REIT dividends and qualified PTP income were netted against QBI, these losses would affect QBI. Therefore, a separate loss carryforward rule is needed to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. Additionally, commenters have expressed concern that losses in excess of income could create a negative Section 199A deduction, a result incompatible with the statute. Accordingly, proposed § 1.199A-1(c)(2)(ii) provides that if an individual has an overall loss after qualified REIT dividends and qualified PTP income are combined, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. In addition, the overall loss does not affect the amount of the taxpayer's QBI. Instead, such overall loss is carried forward and must be used to offset combined qualified REIT dividends and qualified PTP income in the succeeding taxable year or years for purposes of Section 199A.

Reg. § 1.199A-1(c), "Computation of the § 199A deduction for individuals with taxable income not exceeding threshold amount," provides:

(1) *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual's share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

(2) *Carryover rules*.

(i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Reg. § 1.199A-1(c)(3), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(c)(3)(i), Example (1), provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000*20% = $16,200).

Reg. § 1.199A-1(c)(3)(ii), Example (2), provides:

> Assume the same facts as in *Example 1* of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000¥$7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000*20% = $13,400).

Reg. § 1.199A-1(c)(3)(iii), Example (3), provides:

> B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss.

The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000*20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000*20% = $54,000).

Reg. § 1.199A-1(c)(3)(iv), Example (4), provides:

Assume the same facts as in *Example 3* of paragraph (c)(3)(iii) of this section except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Section 199A deduction is equal to $20,300, the lesser of:

(A) 20% of C's QBI from the business ($100,000*20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500*20% = $300); and

(B) 20% of B and C's total taxable for the taxable year ($271,500*20% = $54,300).

II.E.1.c.v.(b). Calculation When Taxable Income Does Not Exceed the Threshold Amount

Reg. § 1.199A-1(c)(1) combines the above, as well as the benefits of taxable income not exceeding the threshold amount:[819]

In general. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual's share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

Reg. § 1.199A-1(b)(13) provides:

Total QBI amount means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

Reg. § 1.199A-1(c)(3), "Examples," provides:

The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the

[819] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(c)(3)(i), Example (1) provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000*20% = $16,200).

Reg. § 1.199A-1(c)(3)(ii), Example (2) provides:

> Assume the same facts as in *Example 1* of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000-$7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000*20% = $13,400).

The difference between the facts in the two examples is that A's total taxable income minus net capital gain in Example (2) was only $67,000, which is $14,000 less than $81,000 in Example (1). Because in each example the total QBI amount exceeded total taxable income minus net capital gain, the change in total taxable income minus net capital gain is the sole difference accounting for the difference in the deduction. Multiplying this $14,000 difference by 20% equals $2,800, which equals the difference between the $16,200 deduction in Example (1) and the $13,400 deduction in Example (2).

Reg. § 1.199A-1(c)(3)(iii), Example (3) provides:

> B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000*20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000*20% = $54,000).

Example (3) points out that, even though B and C have income that is significantly higher than the $315,000 (subject to future indexing) threshold amount, their $270,000 taxable income is below that. For B's and C's wages not being QBI, see part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

Reg. § 1.199A-1(c)(3)(iv), Example (4) provides:

> Assume the same facts as in *Example 3* of paragraph (c)(3)(iii) of this section except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Section 199A deduction is equal to $20,300, the lesser of:
>
> (A) 20% of C's QBI from the business ($100,000*20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500*20% = $300); and
>
> (B) 20% of B and C's total taxable for the taxable year ($271,500*20% = $54,300).

II.E.1.c.v.(c). Calculation When Taxable Income Exceeds the Threshold Amount

Parts II.E.1.c.iv Specified Service Trade or Business (SSTB) and II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds apply when not fully protected by part II.E.1.c.v.(a) Taxable Income "Threshold Amount".

If the wage limitation reduces the QBI-related amount (20% of QBI income)[820] with respect to any qualified trade or business, and the taxpayer's taxable income does not exceed the threshold amount by $100,000 for a joint return or $50,000 for other returns, then the reduction is pro-rated.[821] The reduction is multiplied by the excess over the threshold divided by $100,000 or $50,000, as applicable.[822] Thus, the phase-out of the benefit of modest taxable income

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[820] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[821] Code § 199A(b)(3)(B)(i), "Phase-in of limit for certain taxpayers," provides:

> *In general*. If-
>
> (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and
>
> (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,
>
> then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

[822] Code § 199A(b)(3)(B)(ii) and (iii) provide:

> (ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as-
>
> (I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to
>
> (II) $50,000 ($100,000 in the case of a joint return).
>
> (iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of-
>
> (I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

occurs initially from $315,000-$415,000 for married filing jointly and $157,500-$207,500 for all others (all subject to future indexing).

If an SSTB is excluded from being QBI, the taxpayer having taxable income below the threshold removes the exclusion, so that the trade or business qualifies for the deduction.[823] If the taxpayer's taxable exceeds the threshold, the deduction is phased out using a $100,000 or $50,000 calculation similar to that described above:[824]

> only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

The "applicable percentage" is 100% minus the ratio of the excess taxable income to the $100,000 or $50,000 threshold.[825]

Applying these concepts, Reg. § 1.199A-1(b) includes the following definitions:

> (2) *Applicable percentage* means, with respect to any taxable year,100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).
>
> (4) *Phase-in range* means a range of taxable income between the threshold amount and the threshold amount plus $50,000 (or $100,000 in the case of a joint return).
>
> (9) *Reduction amount* means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(9), the *excess amount* is the amount by which 20 percent of QBI exceeds the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

[823] Code § 199(d)(3)(A)(i) provides, "any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," so one needs to go to Code § 199(d)(1)(A).

[824] Code § 199A(d)(3)(A)(ii).

[825] Code § 199A(d)(3)(B) provides:

Applicable percentage. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

Reg. § 1.199A-1(d)(1) explains:

> *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component described in paragraph (d)(2) of this section and the qualified REIT dividends/qualified PTP income component described in paragraph (d)(3) of this section (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

Note the reference to "the QBI component" for individuals with taxable income above the threshold amount, contrasted with Reg. § 1.199A-1(c)(1) referring to "20 percent of the total QBI amount" for individuals with taxable income below the threshold amount. Reg. § 1.199A-1(d)(2), "QBI component," provides:

> An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the following computational rules, which are to be applied in the order they appear.
>
> (i) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of QBI, W-2 wages, and UBIA of qualified property for each SSTB is taken into account for all purposes of determining the individual's Section 199A deduction, including the application of the netting and carryover rules described in paragraph (d)(2)(iii) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of QBI, W-2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual's Section 199A deduction.
>
> (ii) *Aggregated trade or business*. If an individual chooses to aggregate trades or businesses under the rules of § 1.199A-4, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the netting and carryover rules described in paragraph (d)(2)(iii) of this section and the W-2 wage and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

Reg. § 1.199A-1(d)(2)(iv), "QBI component calculation," provides:

> (A) *General rule*. Except as provided in paragraph (d)(2)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business (or aggregated trade or business). For each trade or business (or aggregated trade or business) (including trades or businesses operated through RPEs) the individual must determine the lesser of -
>
> (1) 20 percent of the QBI for that trade or business (or aggregated trade or business); or
>
> (2) The greater of—
>
> (i) 50 percent of W-2 wages with respect to that trade or business (or aggregated trade or business), or

(ii) the sum of 25 percent of W-2 wages with respect to that trade or business (or aggregated trade or business) plus 2.5 percent of the UBIA of qualified property with respect to that trade or business (or aggregated trade or business).

(B) *Taxpayers with taxable income within phase-in range*. If the individual's taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(2) of this section for a trade or business (or aggregated trade or business) is less than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section for that trade or business (or aggregated trade or business), the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business (or aggregated trade or business) is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(2) of this section, the QBI component for the trade or business (or aggregated trade or business) is the amount determined under paragraph (d)(2)(iv)(A)(1) of this section reduced by the reduction amount as defined in paragraph (b)(9) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(2) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section (in which circumstance the QBI component for the trade or business (or aggregated trade or business) will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(1) of this section).

Reg. § 1.199A-1(d)(3)(iii), "Negative combined qualified REIT dividends/qualified PTP income," is discussed in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Reg. § 1.199A-1(d)(4), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (d). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(11) of this section and § 1.199A-5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c). Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(d)(4)(i) provides Example (1):

> D, an unmarried individual, operates a business as a sole proprietorship. The business generates $1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no qualified property for use in the business. After allowable deductions unrelated to the business, D's total taxable income for 2018 is $980,000. Because D's taxable income exceeds the applicable threshold amount, D's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. D's Section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

This example illustrates part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

Reg. § 1.199A-1(d)(4)(ii) provides Example (2):

> Assume the same facts as in *Example 1* of paragraph (d)(4)(i) of this section, except that D holds qualified property with a UBIA of $10,000,000 for use in the trade or business. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is $3,980,000. Because D's taxable income is above the threshold amount, the QBI component of D's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the business has no W-2 wages, the QBI component of D's Section 199A deduction is limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D's Section 199A deduction is thus limited to $250,000. D's Section 199A deduction is equal to the lesser of:
>
> (A) 20% of the QBI from the business as limited ($250,000); or
>
> (B) 20% of D's taxable income ($3,980,000*20% = $796,000). Therefore, D's Section 199A deduction for 2020 is $250,000.

See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Reg. § 1.199A-1(d)(4)(iii) provides Example (3):

> E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reports QBI of $3,000,000. The LLC pays total W-2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E's taxable income is $880,000. Because E's taxable income is above the threshold amount, the QBI component of E's Section 199A deduction will be limited to the lesser of 20% of E's share of LLC's QBI or the greater of the W- 2 wage or UBIA of qualified property limitations. Twenty percent of E's share of QBI of $900,000 is $180,000. The W-2 wage limitation equals 50% of E's share of the LLC's wages ($300,000) or $150,000. The UBIA of qualified property limitation equals $75,750, the sum of 25% of E's share of LLC's wages ($300,000) or $75,000 plus 2.5% of E's share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of E's Section 199A deduction is thus limited to $150,000, the lesser of 20% of QBI ($180,000) and the greater of the limitations amounts ($150,000). E's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($150,000) or 20% of E's taxable income ($880,000*20% = $176,000). Therefore, E's Section 199A deduction is $150,000 for 2018.

Reg. § 1.199A-1(d)(4)(iv) provides Example (4):

> F, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. In 2018, Z reports QBI of $6,000,000. Z pays total W-2 wages of $2,000,000, and its total UBIA of qualified property is $200,000. For the 2018 taxable year, F reports $3,000,000 of QBI from Z. F

is not an employee of Z and receives no wages or reasonable compensation from Z. After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), F's taxable income is $1,880,000. Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction will be limited to the lesser of 20% of F's share of Z's QBI or the greater of the W-2 wage and UBIA of qualified property limitations. Twenty percent of F's share of Z's QBI ($3,000,000) is $600,000. The W-2 wage limitation equals 50% of F's share of Z's W-2 wages ($1,000,000) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of 25% of F's share of Z's W-2 wages ($1,000,000) or $250,000 plus 2.5% of E's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of F's Section 199A deduction is thus limited to $500,000, the lesser of 20% of QBI ($600,000) and the greater of the limitations amounts ($500,000). F reports a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss from the PTP against QBI. Instead, the portion of F's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F's section is 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($500,000) or 20% of F's taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F's Section 199A deduction is $376,000 for 2018. F must also carry forward the ($10,000) qualified loss from a PTP to be netted against F's qualified REIT dividends and qualified PTP income in the succeeding taxable year.

Reg. § 1.199A-1(d)(4)(v) provides Example (5), "Phase-in range":

(A) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B's share of the M's QBI is $300,000 in 2018. B's share of the W-2 wages from M in 2018 is $40,000. C earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C's taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus $100,000, or $415,000. Consequently, the QBI component of B and C's Section 199A deduction may be limited by the W-2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(B) Because M does not hold qualified property, only the W-2 wage limitation must be calculated. In order to apply the W-2 wage limitation, B and C must first determine 20% of B's share of M's QBI. Twenty percent of B's share of M's QBI of $300,000 is $60,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $40,000 is $20,000. Because 50% of B's share of M's W- 2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C must determine the QBI component of their Section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W-2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C's Section 199A deduction

is equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000. B and C's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($36,000) or 20% of B and C's taxable income ($375,000*20% = $75,000). Therefore, B and C's Section 199A deduction is $36,000 for 2018.

Reg. § 1.199A-1(d)(4)(vi) uses Example (6) to explain how the phase-in works when the business is an SSTB and has insufficient wages (or wages and UBIA):

(A) Assume the same facts as in *Example 5* of paragraph (d)(4)(v) of this section, except that M is engaged in an SSTB. Because B and C are within the phase-in range, B must reduce the QBI and W-2 wages allocable to B from M to the applicable percentage of those items. B and C's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000. Their applicable percentage is 40%. The applicable percentage of B's QBI is ($300,000*40% =) $120,000, and the applicable percentage of B's share of W-2 wages is ($40,000*40% =) $16,000. These reduced numbers must then be used to determine how B's Section 199A deduction is limited.

(B) B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI as limited by paragraph (d)(4)(vi)(A) of this section. Twenty percent of B's share of M's QBI of $120,000 is $24,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $16,000 is $8,000. Because 50% of B's share of M's W-2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C's must determine the QBI component of their Section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, as adjusted in paragraph (d)(4)(vi)(A) of this section or $24,000, over 50% of B's share of M's W-2 wages, as adjusted in paragraph (d)(4)(vi)(A) of this section, or $8,000. Thus, the excess amount is $16,000. The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of B and C's Section 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600. B and C's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000*20% = $75,000). Therefore, B and C's Section 199A deduction is $14,400 for 2018.

The $14,400 deduction in Example (6) is 40% of the $36,000 deduction in Example (5). Being 60% through the phase-in range leaves 40% of the benefit of the threshold remaining when applying the SSTB limitation.

Reg. § 1.199A-1(d)(4)(vii) provides Example (7):

(A) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4.

For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each business. For Business X, the lesser of 20% of QBI ($1,000,000*20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000*50% = $250,000) is $200,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($1,000,000*20% = $200,000) and 50% of its W-2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000*20% = $400) and 50% of W-2 wages ($500,000*50% = $250,000) is $400.

(C) Next, F must then combine the amounts determined in paragraph (d)(4)(vii)(B) of this section and compare that sum to 20% of F's taxable income. The lesser of these two amounts equals F's Section 199A deduction. The total of the combined amounts in paragraph (d)(4)(vii)(B) of this section is $200,400 ($200,000 + zero + 400). Twenty percent of F's taxable income is $544,400 ($2,722,000*20%). Thus, F's Section 199A deduction for 2018 is $200,400.

Note that $100,000 of Business X's wages were wasted, in that Business X needed only $400,000 of wages to support a $200,000 deduction. Similarly, all but $800 ($400 deduction divided by 50%) of Business Z's $500,000 of wages were wasted. Thus, $599,200 of wages are wasted ($100,000 + $500,000 minus $800).

Reg. § 1.199A-1(d)(4), Example (8) provides:

(A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000*20%) and 50% of W-2 wages from the aggregated businesses, which is $500,000 ($1,000,000 x 50%). F's Section 199A deduction is equal to the lesser of $400,400 and 20% of F's taxable income ($2,722,000*20% = $544,400). Thus, F's Section 199A deduction for 2018 is $400,400.

Example (8) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A – a $400,400 deduction in

Example (8) instead of the $200,400 deduction in Example (7). Although Example (8) has more wages than necessary to support the $400,400 deduction, aggregation enabled F to use most of wages that were wasted in Example (7).

Reg. § 1.199A-1(d)(4), Examples (9) through (12) are reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business

Part II.E.1.e.i General Rules Regarding U.S. Real Estate describes the definitions of a trade or business generally applied to real estate.

For nonresident aliens, Part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules explains when real estate may be eligible for a Code § 199A deduction.

Before analyzing the rules for whether real estate qualifies as a business, consider whether one really wants to do so. Real estate tends to generate ordinary losses, which may reduce the Code § 199A deduction from other businesses.[890] Much of the profit tends to be capital gain on sale, which is not eligible for the deduction.[891] A partner in the national office of a Big Four CPA firm told me that the percentage of real estate investors who benefitted materially from Code § 199A with respect to their real estate was in the single digits, and the burdens of recordkeeping for UBIA[892] were often more costly than the benefits.

II.E.1.e.i. General Rules Regarding U.S. Real Estate under Code § 199A

To constitute qualified business income, the income must be from a trade or business.[893] However:

- Rental activity that is not a trade or business can qualify as if it were a trade or business if it is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), meaning that the same person or group of persons, directly or by attribution under Code §§ 267(b) or 707(b),[894] owns 50% percent or more of the renting trade or business, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.[895] This is described in

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[890] See part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

[891] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[892] See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A, which is within part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[893] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

[894] For Code §§ 267(b), see part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships

[895] Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 787, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.

part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A [896] and illustrated in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A, [897] but it applies whether or not the real estate is aggregated (see fn 896).

- On the other hand, if rental is tied too closely to a specified service trade or business (SSTB), part or all of the rental income could be disqualified, even the rental on its own qualifies as a trade or business. See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

As to the first bullet point, the preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.c, "Special Rule for Renting Property to a Related Person Real Estate Activities as a Trade or Business," explains:

> In one instance, the proposed regulations and the final regulations extend the definition of trade or business for purposes of section 199A beyond section 162. Solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). This rule also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property if all of the requirements of proposed § 1.199A-4 are met.
>
> One commenter asked for clarification regarding whether this rule applies to situations in which the rental or licensing is to a commonly controlled C corporation. Another commenter suggested that the rule in the proposed regulations could allow passive leasing and licensing-type activities to benefit from section 199A even if the counterparty is not an individual or an RPE. The commenter recommended that the exception be limited to scenarios in which the related party is an individual or an RPE and that the term related party be defined with reference to existing attribution rules under sections 267, 707, or 414. The final regulations clarify these rules by adopting these recommendations and limiting this special rule to situations in which the related party is an individual or an RPE. Further, as discussed in part V.B. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the related party rules under sections 267(b) or 707(b) will be used to determine relatedness for purposes of § 1.199A-4 and this special rule.

The preamble to the final regulations also considers whether the taxpayer treats the activity as a trade or business for other tax purposes.[898]

Each RPE separately determines whether its real estate qualifies as a trade or business. Real estate owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[899]

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[896] See Reg. § 1.199A-1(b)(14), which is reproduced in full in fn 760 in that part.

[897] Within that part, see text accompanying fn 791, analyzing Reg. § 1.199A-4(d)(8), Example (8) and Reg. § 1.199A-4(d)(9), Example (9).

[898] See text preceding fn 759 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

[899] See text accompanying fn 716.

The rest of the discussion in this part II.E.1.e.i discusses:

- Whether real estate activity constitutes a trade or business under Code § 162. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business.

- Whether separate real estate businesses can combine their QBI, W-2 wages, and UBIA. See part II.E.1.e.i.(b) Aggregating Real Estate Businesses.

II.E.1.e.i.(a). Whether Real Estate Activity Constitutes A Trade Or Business

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 2203-2214. Another discussion on what is a trade or business is in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162. See also part II.G.27.b Real Estate as a Trade or Business.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.b, "Rental Real Estate Activities as a Trade or Business," explains:

> A majority of the comments received on the meaning of a trade or business focus on the treatment of rental real estate activities. Commenters noted inconsistency in the case law in determining whether a taxpayer renting real estate is engaged in a trade or business. Some commenters suggested including safe harbors, tests, or a variety of factors, which if satisfied, would qualify a rental real estate activity as a trade or business. A number of commenters suggested that all rental real estate activity should qualify as a trade or business. Further, one commenter suggested that rental income from real property held for the production of rents within the meaning of section 62(a)(4) should be considered a trade or business for purposes of section 199A. Another commenter suggested that final regulations provide that an individual whose taxable income does not exceed the threshold amount will be considered to be conducting a trade or business with respect to any real estate rental of which the individual owns at least ten percent and in which the individual actively participates within the meaning of section 469(i).
>
> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).
>
> Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of section 199A. However, the Treasury Department and IRS recognize the difficulties taxpayers and practitioners may have in determining whether a taxpayer's rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a section 162 trade or business. Accordingly, Notice 2019- 07, 2019-9 IRB, released concurrently with these final regulations, provides notice of a proposed revenue

procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business for purposes of section 199A if at least 250 hours of services are performed each taxable year with respect to the enterprise. This includes services performed by owners, employees, and independent contractors and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or constructing long-term capital improvements, and traveling to and from the real estate are not considered to be hours of service with respect to the enterprise. The proposed safe harbor also would require that separate books and records and separate bank accounts be maintained for the rental real estate enterprise. Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under section 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor may be treated as a trade or business solely for purposes of section 199A and such satisfaction does not necessarily determine whether the rental real estate activity is a section 162 trade or business. Likewise, failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business.

Examples 1 and 2 of proposed § 1.199A-1(d)(4) describe a taxpayer who owns several parcels of land that the taxpayer manages and leases to airports for parking lots. The Treasury Department and the IRS are aware that some practitioners and taxpayers questioned whether the use of the lease of unimproved land in these examples was intended to imply that the lease of unimproved land is a trade or business for purposes of section 199A. Proposed § 1.199A-1(d)(4) provides that for purposes of the examples all businesses described in the examples are trades or business for purposes of section 199A. Example 1 was intended to provide a simple illustration of how the calculation would work if a taxpayer lacked sufficient W-2 wages or UBIA of qualified property to claim the deduction. Example 2 built on the fact pattern by adding UBIA of qualified property to the facts. The examples in the proposed regulations were not intended to imply that the lease of the land is, or is not, a trade or business for purposes of section 199A beyond the assumption in the examples. In order to avoid any confusion, the final regulations remove the references to land in both examples.

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.[900] "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)."[901]

[900] Rev. Proc. 2019-38, § 1.
[901] Rev. Proc. 2019-38, § 1. Rev. Proc. 2019-38, § 3.01 reiterates this:

Below we will describe the safe harbor and then discuss actions to take if not within the safe harbor.

Rev. Proc. 2019-38, § 3.01 describes who may use the safe harbor:

> This safe harbor is available to taxpayers who seek to claim the deduction under section 199A with respect to a rental real estate enterprise as defined in section 3.02. If the safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business as defined in section 199A(d) for purposes of applying the regulations under section 199A, including the application of the aggregation rules in § 1.199A-4. RPEs, as defined in § 1.199A-1(b)(10),[902] may also use this safe harbor. In order to rely upon the safe harbor, taxpayers and RPEs must satisfy all of the requirements of this revenue procedure.

Rev Proc. 2019-38, § 3.02, "Rental real estate enterprise," provides:

> Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The taxpayer or RPE relying on this revenue procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code.
>
> Except for those property interests described in paragraph .05 of this section, taxpayers and RPEs may either treat each interest in similar property held for the production of rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise. For purposes of applying this revenue procedure, properties held for the production of rents are similar if they are part of the same rental real estate category. The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.
>
> Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor. However, a taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.
>
> An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of

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> Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or the Service from otherwise establishing that an interest in rental real estate is a trade or business for purposes of section 199A.

[902] [My footnote:] Reg. § 1.199A-1(b)(10) is reproduced in the text accompanying fn 711 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

> this revenue procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.
>
> Each rental real estate enterprise that satisfies the requirements of this safe harbor is treated as a separate trade or business for purposes of applying section 199A and the regulations thereunder.

The first two paragraphs of § 3.02 closely follow Notice 2019-7, and the rest is elaboration. Providing that commercial and residential real estate may not be part of the same enterprise is consistent with Reg. § 1.199A-4(d)(17), Example (17), which is reproduced in part II.E.1.e.i.(b) Aggregating Real Estate Businesses (the latter also including other commentary about delineating between separate real estate businesses).

Rev Proc. 2019-38, § 3.03, "Safe harbor," provides:

> The determination to use this safe harbor must be made annually. Solely for the purposes of section 199A, each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:
>
> (A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;
>
> (B) For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and
>
> (C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS.

The second sentence of each of (A) and (C) above were not in Notice 2019-7.

Although the IRS steadfastly rejects using the passive loss rules for Code § 199A, cases under those rules may give a clue to how courts approach documenting work. See part II.K.1.a.vi Proving Participation. I view the regulations under the passive loss rules as a

little less strict than the rules provided above, so please read part II.K.1.a.vi keeping that in mind.

Rev Proc. 2019-38, § 3.03(D) provides more details about what the taxpayer must attach:

> The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:
>
> (1) A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
>
> (2) A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
>
> (3) A representation that the requirements of this revenue procedure have been satisfied.

That requirement lessens the burden of Notice 2019-7, which required a statement signed under penalties of perjury.

Rev Proc. 2019-38, § 3.04, "Rental services," provides:

> Rental services for purpose of this revenue procedure include, but are not limited to: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property, including the purchase of materials and supplies; (vi) management of the real estate; and (vii) supervision of employees and independent contractors. Rental services may be performed by owners, including owners of an RPE, or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property under § 1.263(a)-3(d); or hours spent traveling to and from the real estate.

The above is essentially the same as what was in Notice 2019-7.

Rev Proc. 2019-38, § 3.05, "Certain rental real estate arrangements excluded," provides:

> The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:
>
> (A) Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under section 280A(d).
>
> (B) Real estate rented or leased under a triple net lease. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or

lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities.

(C) Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i).

(D) The entire rental real estate interest if any portion of the interest is treated as an SSTB under § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB).

Subparagraph (B) is narrower than Notice 2019-7, which provided:

> For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

"To be responsible for maintenance activities" indicated to me that, for the lease 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 triple net lease. My understanding is that this change will knock most large shopping centers and large office buildings out of the safe harbor; however, those activities do not appear to need a safe harbor anyway, given the level of service typically provided. I am more concerned about real estate with only one or a very few tenants, where the IRS seems to want the landlord to take more risk

Subparagraph (d) is new, greatly expanding the scope of the anti-abuse rules described in part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules. For example, suppose a real estate developer owned a building through an LLC and used separate S corporations to run its development business, its engineering affiliate, its architectural affiliate, and its furniture leasing affiliate. Because these are different types of businesses,[903] they would be segregated under the anti-abuse rules, and only real estate rental payments received from the furniture leasing affiliate would constitute income from an SSTB.[904]

In addition to making sure that one provides enough qualifying services, beware of the possible cost of providing services beyond what a landlord provides in a traditional long-term lease. Although traditional services should be exempt from self-employment (SE) tax, services beyond that may be subject to SE tax. See part II.L.2.a.ii Rental Exception to SE Tax, especially the text accompanying fns 3146-3149.

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[903] They would constitute separate businesses even if in the same RPE - see part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items.

[904] Reg. § 1.199A-5(c)(iii)(B), Example (2) segregates SSTBs from non-SSTB's so that the former do not contaminate the latter even when the former is not de minimis. Furthermore, Reg. § 1.199A-5(c)(2) disqualifies self-rental to an SSTB only to the extent of payments the landlord receives from the SSTB.

Rev Proc. 2019-38, § 4, "Effective Date," provides:

> This revenue procedure applies to taxable years ending after December 31, 2017. Alternatively, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-07, 2019-09 IRB 740, for the 2018 taxable year. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2020. However, taxpayers are reminded that they bear the burden of showing the right to any claimed deductions in all taxable years. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84; 112 S.Ct. 1039, 1043) (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281 (1943). See also I.R.C. § 6001; Treas. Reg. § 1.6001-1(a) and (e).

Prop. Rev Proc. § 3.05 provides that triple net leases do not qualify for the safe harbor. (It assumes that a tenant does all of the work in a triple net lease, but it is also common for a landlord to actively maintain the property on a substantial and continuous basis that would qualify as a business, while still requiring tenants to reimburse the landlord for all annual operating costs, which is also a triple net lease.) Instead of the tenant arranging for and paying for maintenance, have the landlord take care of that and obtain reimbursement from the tenant. Consider having the landlord hire the janitors and maintenance staff and the tenant reimburse the landlord for those expenses, which helps not only move the real estate toward being a trade or business but also may improve the landlord's Code § 199A deduction:

- The tenant may have plenty of wages for purposes of the wage limitation for the Code § 199A deduction, whereas paying those wages may provide the landlord with a higher Code § 199A deduction (because the wage limitation will not reduce the deduction as much).[905] However, if the real estate activity is aggregated with a business under common control,[906] that business' wages and property count toward the Code § 199A deduction relating to the real estate's income.
- If the landlord and tenant have similar ownership, then moving duties from one entity to another may be an easy decision. On the other hand, if they have different owners and the landlord does not want an increased role, these changes may be impractical.
- Consider asset protection issues. If the landlord hires janitors and maintenance staff, the landlord would be liable if they fail to remedy any hazardous conditions. Furthermore, if an owner of the landlord is personally involved in hiring decisions, that owner may be personally liable for negligent hiring. Liability insurance may ameliorate these concerns, and every landlord should have such insurance anyway to try to avoid corporate veil piercing. This is very much a judgment call. For more on asset protection, see part II.F Asset Protection Planning.

Even the long-term rental of one property to one tenant can constitute a trade or business.[907] For further thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.b.iii Excess Passive

[905] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[906] See fns 896-895.
[907] See part II.I.8.c.iii Rental as a Trade or Business, fn 2210.

Investment Income. A triple net lease in which the landlord did nothing except collect rents would not work for that test, but incurring expenses and having them reimbursed by the tenant may work.[908] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

Ultimately, one needs to decide whether the effort of and exposure from rearranging lease arrangements are worth the potential tax benefits, and it is impossible to provide a one-size-fits-all solution.

II.E.1.e.i.(b). Aggregating Real Estate Businesses

This part II.E.1.e.i.(b) applies to real estate the rules of part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A. For the assumptions to Example (16), Example (17), and Example (18), see the introduction to Reg. § 1.199A-4(d), reproduced in part II.E.1.c.iii.(d).[909]

Reg. § 1.199A-4(d)(16), Example (16) provides:

(i) *Facts.* PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.

(ii) *Analysis.* PRS1 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 may aggregate its commercial rental office buildings because the businesses provide the same type of property and share accounting, legal, and human resource functions.

Example (16) helpfully demonstrates that real estate activities in different states can be aggregated.

Reg. § 1.199A-4(d)(17), Example (17) provides:

(i) *Facts.* S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

(ii) *Analysis.* S owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Although both businesses share significant centralized business elements, S cannot show that another factor under paragraph (b)(1)(v) of this section is present because the two building operations are not of the same type of property. S must treat the residential condominium building and the commercial rental office building as separate trades or businesses for purposes of applying § 1.199A-1(d).

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[908] See fns 3652-3655.
[909] See text accompanying fn 790.

Example (17) demonstrates that the IRS views residential and commercial rental as separate businesses, even if operated and managed by the same owner. Reg. § 1.199A-4(b)(1)(v) provides that trades or businesses may be aggregated only if an individual or RPE can demonstrate that -

> The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):
>
> (A) The trades or businesses provide products, property, or services that are the same or customarily offered together.
>
> (B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
>
> (C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Thus, to aggregate, they need not only similar management (satisfying (B)) but also one other factor in (A) or (C). Reg. § 1.199A-4(d)(18), Example (18) includes another factor, providing:

> (i) *Facts*. M owns 75% of a residential apartment building. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a residential condominium building and 80% of the interests in a residential apartment building. PRS2's residential condominium building and residential apartment building operations share centralized back office functions and management. M's residential apartment building and PRS2's residential condominium and apartment building operate in coordination with each other in renting apartments to tenants.
>
> (ii) *Analysis*. PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because the businesses are of the same type of property and share centralized back office functions and management. M may also add its residential apartment building operations to PRS2's aggregated residential condominium and apartment building operations. M owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because the businesses operate in coordination with each other.

Thus, renting similar real estate (residential) is a sufficient other factor, as is operating in coordination with each other.

See also part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items. Applying 2017 tax reform to determine separate businesses is relevant not only for Code § 199A but also for Code § 512(a)(6) (preventing a tax-exempt entity from uses losses from one business against income from a separate business), which is discussed in part II.E.1.f.viii Tax-Exempt Trusts. Under that guidance, for now the IRS will consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under section 3.02 of this notice. The NAICS is an industry classification system for purposes of

collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. Here are some codes for real estate:

- 531110 Lessors of Residential Buildings and Dwellings
- 531120 Lessors of Nonresidential Buildings (except Miniwarehouses)
- 531130 Lessors of Miniwarehouses and Self-Storage Units
- 531190 Lessors of Other Real Estate Property
- 531210 Offices of Real Estate Agents and Brokers
- 531311 Residential Property Managers
- 531312 Nonresidential Property Managers
- 531320 Offices of Real Estate Appraisers
- 531390 Other Activities Related to Real Estate

I am not suggesting any authority directly applying these codes for Code § 199A. However, given that guidance on how to delineate separate businesses leaves a lot of room for interpretation, using these codes may show a good-faith attempt to delineate between businesses. Furthermore, the regulations assume that residential and commercial real estate are separate businesses, and these codes tend to support that assumption.

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules

A nonresident alien may be eligible for the Code § 199A deduction only for income qualifying under Part II.E.1.c.ix QBI and Effectively Connected Income. Within that part, the text accompanying and immediately preceding fn 861 cross-references Code § 871(a)(1)(A), which taxes rents (among other income) and therefore is the subject of this part II.E.1.e.ii. Below is guidance on when rent constitutes QBI.

Rev. Rul. 73-522 discussed the following situation involving triple net leases:

> The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties

> owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Rev. Rul. 73-522 held:

> Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular. *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); *Elizabeth Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962).
>
> In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.
>
> Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business.[910] Compare *Adolph*

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[910] [My footnote, not from the ruling:] *Neill v. Commissioner*, 46 B.T.A. 197 (1942), found that a net lease held by a NRA did not constitute carrying on a business. The facts were:

> … It is held under a long term lease by a tenant who, under the terms of that lease, erected a building thereon and is obligated under the lease to pay taxes and insurance and maintain the property.
>
> The property referred to is encumbered by a mortgage …, the ground lease on the property having been assigned at that time to the mortgagee as collateral security for the mortgage. For many years petitioner has employed a firm of attorneys with offices in Philadelphia, to whom the tenant pays the rentals due petitioner under her direction. These attorneys then pay for her the interest due upon the mortgage and such incidental expenses for which petitioner may be obligated.

The Board of Tax Appeals held:

> The ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent. *Cf. Higgins v. Commissioner*, 312 U.S. 212. We think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section. *McCoach v. Minehill & Schuylkill Haven Railroad Co.*, 228 U.S. 295; *Stafford Owners, Inc. v. United States*, 39 Fed.(2d) 743.

For a discussion of *Higgins*, see part II.G.4.I.i.(a) "Trade or Business" Under Code § 162, fn 1209.

> *Schwarcz*, 24 T.C. 733, *acq.* 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.
>
> With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.
>
> Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, *i.e.*, amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

Note that the taxpayer held more than one property with triple-net-leases, and the taxpayer's triple-net-lease was not part of a trade or business notwithstanding the taxpayer owning multiple properties.

Also note that expense reimbursements constituted rent.

As to rental that is not a triple-net-lease, *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), cited with approval in Rev. Rul. 73-522, stated, "We take it to be well settled that the operation of even a single parcel of rental realty may constitute the regular operation of a business."[911] Furthermore, the "fact that the taxpayer operates the rental property through an agent does not prevent him from being regularly engaged in the business,[912] and "the rule applies even though the property and the agent are in a foreign country (Austria)."[913] The court concluded:

> The record shows that petitioner actively managed the properties prior to his departure for the United States and that he was in frequent contact with his partner who managed the properties after petitioner left. We are of the opinion, accordingly, that petitioner was regularly engaged in the business of operating the … properties ….

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[911] The court continued:

> In *Anders I. Lagreide*, 23 T.C. 508, 511 , we said:
>
> > The first issue to be considered is whether or not the renting out in 1949, by Alice Lagreide, of a single piece of residential real estate, amounted to the operation by her of a trade or business regularly carried on. She inherited the property from her mother in 1948 and never occupied or maintained it as her own residence. Since the time of the mother's death, the property was either rented or available for renting, and was actually rented during part of 1948 and almost all of 1949.
> >
> > It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. *Leland Hazard*, 7 T.C. 372 (1946). See also *Quincy A. Shaw McKean*, 6 T.C. 757 (1946); *N. Stuart Campbell*, 5 T.C. 272 (1945); *John D. Fackler*, 45 B.T.A. 708, 714 (1941), *affd.* (C.A. 6, 1943) 133 F.2d 509. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (see *Industrial Commission v. Hammond*, 77 Colo. 414, 236 Pac. 1006, 1008). It is clear, also, that the business was "regularly" carried on, there having been no deviation, at any time, from the obviously planned use.

[912] Citing "*Gilford v. Commissioner*, 201 F.2d 735, affirming a Memorandum Opinion of this Court."

[913] Citing *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955).

The NRA handling repairs – even through an agent – seemed to be a tipping point in *Amodio v. Commissioner*, 34 T.C. 894 (1960) (trade or business found),[914] *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*. 221 F.2d 227 (9th Cir. 1955) (trade or business found),[915] and *Herbert v. Commissioner*, 30 T.C. 26, 33 (1958) (isolated minor repairs not a trade or business).[916] Letter Ruling 7904019 asserted that paying mortgages and reimbursing tenant expenses was insufficient to move the taxpayer out of the holding of Rev. Rul. 73-522.[917] However, *Pinchot v.*

[914] The court held:

> The properties were managed by local real estate agents who negotiated or renewed leases, arranged for repairs, collected rents, paid taxes and assessments, and remitted net proceeds to Fidelity after deducting commissions. From the proceeds Fidelity or the local agent paid principal and interest on the mortgages, insurance premiums, and taxes. Fidelity retained its commissions and amounts to be applied on Amodio's income taxes and the remainder was sent to him. The acts of the agents are attributable to Amodio. These activities were beyond the scope of mere ownership of property and the receipt of income. They were considerable, continuous, and regular, as in the *Lewenhaupt* case. Such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States. Amodio is taxable as a nonresident alien engaged in trade or business in the United States.

[915] The Tax Court described the agent's activities:

> LaMontagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties, executing an option to purchase the El Camino Real property, and executing the sale of the Modesto property. In addition, the agent conducted a regular correspondence with the petitioner's father in England who held a power of attorney from petitioner identical with that given to LaMontagne; he submitted monthly reports to the petitioner's father; and he advised him of prospective and advantageous sales or purchases of property.
>
> The aforementioned activities, carried on in the petitioner's behalf by his agent, are beyond the scope of mere ownership of real property, or the receipt of income from real property. The activities were considerable, continuous, and regular and, in our opinion, constituted engaging in a business within the meaning of section 211(b) of the Code. See *Pinchot v. Commissioner*, 113 F.2d 718.

[916] The Tax Court held:

> In the instant case the real property consisted of one building rented in its entirety to one tenant who has occupied it since 1940, has complete charge of its operation, and is responsible for all repairs except as to outer walls and foundation. This property (the only real property owned by petitioner in the United States) was acquired by petitioner 50 years ago, not as the result of a business transaction entered into for profit (*cf. Fackler v. Commissioner*, 133 F.2d 509) but by gift from petitioner's father when she was a very young girl (see *Grier v. United States*, 120 F.Supp. 395). During the taxable years her only activities, in addition to the receipt of rentals, were the payment of taxes, mortgage principal and interest, and insurance premiums. See *Evelyn M. L. Neill*, *supra*. The record also shows that petitioner executed a lease of the property in 1940 and a modified renewal thereof in 1946, and made minor repairs to the walls and roof in 1954 and 1955.
>
> We are of the opinion that petitioner's activities with regard to the real property here involved, which might be considered as "beyond the scope of mere ownership of real property, or the receipt of income from real property," were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable." We therefore conclude that petitioner was "not engaged in trade or business in the United States" during the taxable years within the meaning of article IX (1) of the United States-United Kingdom tax convention.

[917] The IRS pointed out:

> The Lease between Corp M and Corp P, although not identical to the net leases described in Rev. Rul. 73-522, differs only in three respects. One, the lessor rather than the lessee pays real

Commissioner, 113 F.2d 718 (2nd Cir. 1940), held that maintaining a portfolio of 11 rental properties, which probably were not triple-net leases, constituted a business;[918] *Lewenhaupt* cited *Pinchot* with approval.[919]

A small interest in oil & gas that did not influence annual operations did not contribute a trade or business.[920]

> estate taxes imposed on the leased property; two, the lessor rather than the lessee pays installments on existing encumbrances; and three, the lessor, Corp M, pays a yearly fee to the lessee as reimbursement for grass, pest, and weed control and fertilization.

The IRS reasoned:

> With respect to the payment of a yearly fee by Corp M to Corp P as reimbursement for grass, pest, and weed control and fertilization, we note that Corp M does not supervise or participate in any way in the activities for which it pays the fee. Further, the fee is paid once each year and does not involve Corp M in the farming of the land. Consequently, the payment of the fee is sporadic, irregular, and minimal and does not, in and of itself, cause Corp M to be engaged in a trade or business within the United States.

918 The court summarized the facts and reasoned:

> The essential facts were stipulated and, so far as now important, are that the decedent, Antoinette Eno Johnstone, died July 1, 1934, a British subject and a non-resident. Much of her property in this country consisted of improved real estate in the City of New York owned in common by her and her two brothers of whom one is her executor and the petitioner herein. This real estate was made up of eleven parcels of which the decedent's share had a gross value of about one million dollars. The petitioner, Amos R.E. Pinchot, managed the properties for her and the third owner under broad powers of attorney which included also the management of certain personal property owned by the three. He bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions. This management "consisted of the leasing and renting of the properties when they became idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of eighteen years five parcels of real estate had been sold and five had been purchased. There were no sales or purchases during the last three years before the decedent's death.
>
> Though the stipulation does not show the number or the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney in fact. *Richards v. Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of federal tax statutes is a federal question which cannot be controlled by state decisions. *Lyeth v. Hoey*, 305 U.S. 188, 59 S.Ct. 155, 83 L.Ed. 119, 119 A.L.R. 410. It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389, Ann.Cas.1912B, 1312, and within the commonly accepted meaning of that word. We think the Board was right in deciding that this decedent was engaged in business in this country at the time of her death. The bank deposits in the United States were, therefore, properly treated as property in this country. Our decision in *Higgins v. Commissioner*, 2 Cir., 111 F.2d 795, did not touch the question of real estate management as a business.

919 See text at end of fn 915.

II.E.1.f. Trusts/Estates and the Code § 199A Deduction

Estates and nongrantor trusts may present special opportunities in working with the taxable income thresholds described in part II.E.1.c.v.(a) Taxable Income "Threshold Amount".

Estates and nongrantor trusts would have the same taxable income threshold as a single individual.

Beware that part II.J.9.c Multiple Trusts Created for Tax Avoidance would undermine the use of multiple trusts.

Grantor trusts are disregarded, and their items attributed to their deemed owners. See part II.E.1.f.iii Grantor Trusts (Including QSSTs).

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.[921]

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[920] After citing *Pinchot*, which was discussed in fn 918, *Di Portanova v. U.S.*, 690 F.2d 169 (Ct. Cl. 1982), held:

> In this respect, an oil lease is similar to real estate. "Whether coownership in a mineral lease constitutes the carrying on of a 'trade or business' is dependent upon all the facts and circumstances in the particular case." Rev. Rul. 58-166, 1958-1 C.B. 324, 325.
>
> The oil and gas business is complex. "The proper development of an oil and gas lease requires a high degree of skill and discretion." Rev. Rul. 58-166, 1958-1 C.B. at 326. To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business. *Cataphote Corp. v. United States*, 210 Ct.Cl. 125, 143-46, 535 F.2d 1225, 1235-37 (1976); *Wier v. Enochs*, 64-1 U.S.T.C. ¶ 9387 at 92,009, 92,011 (S.D. Miss. 1963); *aff'd* per curiam, 353 F.2d 211 (5th Cir. 1965); *Nemours Corp. v. Commissioner*, 38 T.C. 585, 601 & n.3 (1962) *aff'd* per curiam, 325 F.2d 559 (3d Cir. 1963); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963).
>
> (3.) The government properly has conceded that the activities of the trusts regarding the properties subject to the 1953 and 1965 agreements do not constitute a trade or business and we so hold. The activities are functionally indistinguishable from the mere receipt of income from investments and the payment of expenses incidental to that receipt. The trusts do not manage or control the field operations or participate actively in them. Indeed, the agreements give Quintana exclusive control over "all operations of every kind." The trusts have little power under the agreements. Moreover, in view of their meager percentage of the total interest and the plaintiff's estrangement from the Cullen family, they also have virtually no informal influence over the operations.
>
> Although the trusts have the right to receive their actual share of the oil and gas produced and Quintana negotiates the sale of the minerals as an agent of the trusts, the Service by its concession recognizes that this is not enough to constitute a trade or business. Considering all the circumstances, we hold that the trusts' activities under the 1953 operating agreement and its amendments did not constitute trade or business.

[921] See parts II.E.1.f.i.(d) Separate Shares, II.J.8.f.i.(a) Allocating Deductions to Various Income Items, II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It, and II.J.9.a.ii Separate Share Rule.

The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

B. Application to Trusts, Estates, and Beneficiaries

Proposed § 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), including qualified subchapter S trusts (QSSTs) with respect to which the beneficiary has made an election under section 1361(d), the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.

In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, proposed § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

In addition, proposed § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.

Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, proposed § 1.199A-6(d)(3)(v) provides that trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.

The Treasury Department and the IRS request comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Such comments should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III, "Special Rules for Trusts and Estates," explains:

> Section 1.199A-6 provides guidance that certain specified entities (for example, trusts and estates) may need to follow to enable the computation of the Section 199A deduction of the entity and each of its owners. Section 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. The August Proposed Regulations expressly requested comments, and comments were submitted, on whether and how certain trusts and other entities would be able to take a deduction under Section 199A. These proposed regulations take those suggestions into consideration in proposing rules applicable to those particular situations identified by commenters.
>
> In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's QBI and W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.
>
> In addition, § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportions as is the DNI of the trust or estate. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.
>
> Under § 1.199A-6(d)(3)(iv), the threshold amount is determined at the trust level after taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, § 1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of receiving a deduction under Section 199A will not be respected for purposes of determining the threshold amount under Section 199A.

For nongrantor trusts or estates, Reg. § 1.199A-6(d)(1) provides:

> *In general*. A trust or estate computes its section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT

> dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A- 1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

This last sentence is important not just as a matter of calculation but also because it allows estates with fiscal years straddling 2017-2018 to pass to their beneficiaries 2017 business income that gets treated as QBI.[922]

Consistent with the Code § 199 rules regarding grantor trusts, Reg. § 1.199A-6(d)(2) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

Reg. § 1.199A-6(d)(3)(i), "Calculation at entity level," provides:

> A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)-3(a), and deductions not directly attributable within the meaning of § 1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)-3(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items and II.J.8.f.i.(a) Allocating Deductions to Various Income Items. See also part II.J.11.a Depreciation Advantages and Disadvantages.

Reg. § 1.199A-6(d)(3)(ii), "Allocation among trust or estate and beneficiaries," provides:

> The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199A. If the trust or estate has no DNI

[922] See part II.E.1.c.i What Kind of Deduction; Maximum Impact of Deduction, especially the paragraph accompanying fn 705.

for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

In determining how much income to report on a K-1 to a beneficiary, an estate or nongrantor trust first nets expenses against that income. See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. Although this process determines how much business income appears as an income item on a beneficiary's K-1, it does not apply to expenses that are not from the qualified trade or business. Instead, QBI is allocated according to DNI without regarding to the amount of QBI the trust reports as income to the beneficiary after allocating expenses that are unrelated to QBI. For example, Reg. § 1.199A-6(d)(3)(ii) above provides that negative QBI can be reported on a K-1, as does the Example in Reg. § 1.199A-6(d)(3)(viii) below. However, losses cannot be carried out to beneficiaries except on the estate or trust's final return. See part II.J.3.i Planning for Excess Losses. Thus, the regulations view QBI as a mere informational item to be allocated, rather than bearing any particular relationship to amount of business income or loss actually passing through to any beneficiary on a K-1.

Thus, a trust/estate with small DNI can allocate significantly larger amounts of QBI to a beneficiary, and distributions that are relatively small compared to QBI but are a high percentage of DNI can cause what may seem to be a disproportionately large amount of QBI to the beneficiary. Although this may seem to be a great income tax planning opportunity, note that it works only if and to the extent that the beneficiary has taxable income taxed at ordinary income rates.[923]

Reg. § 1.199A-6(d)(3)(iii) is reserved. Prop. Reg. § 1.199A-6(d)(3)(iii) is quoted and discussed in part II.E.1.f.i.(d) Separate Shares.

Reg. § 1.199A-6(d)(3)(iv), "Threshold amount," provides:

> The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in § 1.199A-1(b)(12). For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

Reg. § 1.199A-6(d)(3)(v) is reserved. Prop. Reg. § 1.199A-6(d)(3)(v) is quoted and discussed in part II.E.1.f.vii Charitable Remainder Trusts and Other Split-Interest Trusts.

Reg. § 1.199A-6(d)(3)(vi), "Electing small business trusts," is quoted and discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.6, "Section 199A Anti-Abuse Rule," changed the proposed regulations to the final regulation reproduced below:

> One commenter requested clarification on whether a trust with a reasonable estate or business planning purpose would be respected. Another commenter argued that the rule is overbroad and lacks clarity as to what would be abusive and what the consequences

[923] See fn 727 in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction, which is among factors that make the Code § 199A deduction less beneficial than a casual observer might realize.

> would be of not respecting the trust for section 199A purposes. The commenter also stated that the rule is not needed because of § 1.643-1 and if both rules are retained, they should use the same test (principal versus significant purpose). Finally, the commenter asked for clarification on whether the rule applies to a single trust and suggested it should apply on an annual basis. This last suggestion has not been adopted because the test goes to the creation of the trust, factors which would not change in later years. The final regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount. If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A.

Reg. § 1.199A-6(d)(3)(vii), "Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount," provides:

> A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A. *See also* § 1.643(f)-1 of the regulations.

Because Reg. § 1.199A-6(d)(3)(vii), is contained within the paragraph covering nongrantor trusts, Reg. § 1.199A-6(d)(3), rather than the paragraph covering grantor trusts, Reg. § 1.199A-6(d)(2), I believe that the anti-abuse rule applies only to nongrantor trusts and not to grantor trusts.

Although the literal language of the regs does not expressly address your question, I think its placement is prima facie evidence of the intent to apply the anti-abuse rules only to nongrantor trusts.

Reg. § 1.643(f)-1 is discussed in part II.J.9.c Multiple Trusts Created for Tax Avoidance.

Reg. § 1.199A-6(d)(3)(viii), Example (1)(A) (the only example), begins with (1), "Computation of DNI and inclusion and deduction amounts":

> (i) *Trust's distributive share of partnership items*. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. A and B, Trust's beneficiaries, own the remaining 75% of PRS directly. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $45,000 (including W-2 wages of $25,000, and miscellaneous expenses of $20,000) to Trust. These items are properly included in Trust's DNI. PRS distributes $10,000 of cash to Trust in 2018.
>
> (ii) *Trust's activities*. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produces $100,000 of gross income and $155,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, miscellaneous expenses of $25,000, and depreciation deductions of $5,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of section 199A.) Trust maintains a reserve of $5,000 for depreciation. Trust also has $125,000 of UBIA of

qualified property in the bakery. For purposes of computing its section 199A deduction, Trust and its beneficiaries have properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under § 1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust's DNI:

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

(iii) *Allocation of deductions under § 1.652(b)-3* (*Directly attributable expenses)*.

In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($45,000 from PRS and $155,000 from the bakery) . In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)-3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(iv) *Allocation of deductions under § 1.652(b)-3* (*Non-directly attributable expenses)*.

The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(v) *Amounts included in taxable income*. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.5, "Allocation between Trust or Estate and Beneficiaries," corrected a mistake in the proposed regulations relating to depreciation:

One commenter argued that proposed § 1.199A-6(d)(3)(v)(C) and (D) and the accompanying example are wrong in allocating the whole depreciation deduction to the trust. Instead, the commenter said that the depreciation should be allocated based on fiduciary accounting income. Another commenter stated that the QBI net loss should be allocated entirely to the trust or estate and not passed through to the beneficiaries. Another commenter stated that the example in proposed § 1.199A-6(d)(3)(vi) overlooks section 167(d) and that final regulations should clarify whether reporting of depreciation is being changed. An additional commenter stated that a charitable lead trust's threshold amount should be the same as other trusts after the charitable deduction. Based on comments received, the final regulations provide that the treatment of depreciation applies solely for purposes of section 199A, and the example has been revised to clarify the allocation of QBI and depreciation to the trust and the beneficiaries. As an RPE, the final regulations continue to require that a trust or estate allocates QBI (which may be a negative amount) to its beneficiaries based on the relative portions of DNI distributed to its beneficiaries or retained by the trust or estate.

Reg. § 1.199A-6(d)(3)(viii)(A), Example (1) (the only example), ends with (2), "Section 199A deduction":

(i) *Trust's W-2 wages and QBI*. For the 2018 taxable year, prior to allocating the beneficiaries' shares of the section 199A items, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has $125,000 of UBIA of qualified property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)-3(a)).

(ii) *A's Section 199A deduction computation*.

Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under § 1.199A-4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A also has $62,500 of UBIA from Trust and $25,000 of UBIA of qualified property from the trade or business outside of Trust for $87,500 of total UBIA of qualified property. A has $100,000 of QBI from the non-Trust trade or businesses in which A owns an interest.

Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income is $357,500, which exceeds A's applicable threshold amount for 2018 by $200,000. A's tentative deductible amount is $15,300 (20% * $76,500 of QBI), limited to the greater of (i) $20,000 (50% * $40,000 of W-2 wages), or (ii) $12,187.50 ($10,000, 25% * $40,000 of W-2 wages, plus $2,187.50, 2.5% * $87,500 of UBIA of qualified property). A's section 199A deduction is equal to the lesser of $15,300, or $71,500 (20% ´ $357,500 of taxable income). Accordingly, A's section 199A deduction for 2018 is $15,300.

(iii) *B's Section 199A deduction computation.*

For 2018, B's taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

(iii) *Trust's Section 199A deduction computation.*

For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

(B) is reserved.

Prop. Reg. § 1.199A-6(e), "Effective/applicability date," provides:

(1) *General rule.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions.*

(i) *Anti-abuse rules.* The provisions of paragraph (d)(3)(v) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE.* For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

II.E.1.f.i. Nongrantor Trusts Other Than ESBTs

II.E.1.f.i.(a). How Qualified Business Income Flows to Beneficiaries

By managing their taxable income through the income distribution deduction, trusts may be able to get below the desired threshold to qualify for a better deduction. Planning for estates and nongrantor trusts generally is discussed in part II.J Fiduciary Income Taxation.

Suppose a partnership distributes its entire $1 million K-1 income (all "QBI" - qualified business income) to a trust. Suppose the partnership then distributes enough income so that its taxable income, before the Code § 199A deduction, is $157,500. The trust's allocable portion of QBI

receives the 20% deduction, without regard to the wage limitation[924] and without regard to whether the partnership conducts otherwise disqualified professional services.[925] The beneficiary's K-1 income from the trust pushes the beneficiary's taxable income way above the taxable income threshold. The beneficiary might very well have been above the taxable income threshold anyway.

Thus, we might have two taxpayers that might have been above the taxable income threshold, yet one of them gets the full benefit of being below the threshold.

Suppose each of the trust and beneficiary has zero taxable income but for a $315,000 K-1 that the trust receives. If the trust distributes to the beneficiary $157,500 plus all of its other income, each of the trust and the beneficiary may have $157,500 of taxable income. Thus, each one should be able to qualify fully for all of the benefits that taxable income below the thresholds provides,[926] even though if the trust had retained all of the K-1 income it would have not received any of those benefits (with $315,000 taxable income, which is above $207,500).

II.E.1.f.i.(b). When to Shift Qualified Business Income (QBI) to Beneficiaries

Before focusing on QBI, consider planning for the trust and beneficiaries generally. See part II.J Fiduciary Income Taxation, especially part II.J.3 Strategic Fiduciary Income Tax Planning.

Generally, distributions effectively shift the trust's income to its beneficiaries.[927]

After allocating deductions to the trust's income,[928] the trustee usually needs to allocate all items of distributable net income to beneficiaries in proportion to the distributions they receive,[929] subject to the separate share rule.[930] As the latter, see part II.E.1.f.i.(d) Separate Shares.

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924 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

925 See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

926 The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.4, "Inclusion of Trust Distributions in Taxable Income," reversed a rule in the proposed regulations that would have disallowed the distribution deduction in computing the trust's taxable income threshold:

> Multiple commenters suggested that distributions should not be counted twice in determining whether the threshold amount is met or exceeded, saying this is counter to the statute and beyond the regulatory authority of the Treasury Department and the IRS. Further, sections 651 and 661 are fundamental principles of fiduciary income taxation and the possible duplication of the threshold is better addressed in anti-abuse provisions. Another commenter suggested that double counted income should be ignored, arguing that double counting is punitive because it fails to take into account the economic consequences of distributions and is inconsistent with the longstanding fundamental principles of subchapter J. Another commenter recommended that the distribution deduction should be given effect in computing thresholds, consistent with section 1411 and fiduciary obligations. The Treasury Department and IRS agree with the commenters that distributions should reduce taxable income because the trust is not taxed on that income. The final regulations remove the provision that would exclude distributions from taxable income for purposes of determining whether taxable income for a trust or estate exceeds the threshold amount. The final regulations specifically provide that for purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

927 See part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.

Be sure to consider planning opportunities described in part II.J.11.a Depreciation Advantages and Disadvantages.

A beneficiary may have business losses, deductions against gross income, or the itemized or standard deduction against which to offset income, so that shifting income to the beneficiary may provide more.

Also, if a beneficiary is a married person filing jointly, then the beneficiary's taxable income threshold is double that of a trust's, so shifting QBI to the beneficiary may allow a more favorable threshold, even if the beneficiary's losses and deductions don't make much of a difference.

II.E.1.f.i.(c). Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs

Suppose a trust holds a partnership but would like to take advantage of the benefits provided for S corporation shareholders by part II.E.1.f.ii Electing Small Business Trusts (ESBTs) or II.E.1.f.iii Grantor Trusts. It could contribute its partnership interest to an S corporation and then take advantage of those benefits. See parts II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary and II.J.4.h Trapping Income in Trust Notwithstanding Distributions – ESBT. This possibility is discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

Such a strategy would also have the benefit of qualifying the partnership from electing out of the Bipartisan Budget Act partnership audit rules that became effective for years beginning after December 31, 2017. See part II.G.20.c Audits of Partnership Returns. I don't view being able to elect out of those rules to be a substantial benefit, if beneficial at all.

However, given that an S corporation that does not itself conduct a business cannot be divided tax-free, consider creating the same number of S corporations as there are remaindermen. That way, each remainderman will have his or her own S corporation and independently determine distributions from the S corporation or whether the S corporation should sell the partnership interest. For more thoughts on this, see part III.A.3.e.vi.(b), the title of which focuses on QSSTs, but which also applies to ESBTs.

II.E.1.f.i.(d). Separate Shares

For context, see part II.J.9.a.ii Separate Share Rule.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III.C, "Separate shares," explains:

> Although no comments were received with respect the application of the threshold amount to separate shares, the Treasury Department and the IRS believe that clarification with respect to this issue may be necessary. These proposed regulations provide that, in the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such separate shares will not be

[928] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.
[929] See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.
[930] See part II.J.9.a.ii Separate Share Rule.

treated as separate trusts for purposes of applying the threshold amount. Instead, the trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. The purpose of the separate share rule in section 663(c) is to treat distributions of trust DNI to trust beneficiaries as independent taxable events solely for purposes of applying sections 661 and 662 with respect to each beneficiary's separate share. The rule determines each beneficiary's share of DNI based on the amount of DNI from that beneficiary's separate share, rather than as a percentage of the trust's DNI.

> Nevertheless, under the separate share rule, if a trust retains any portion of DNI, the trust will be subject to tax as a single trust with respect to the retained DNI. Only trusts with retained DNI will be eligible for the section 199A deduction, because a trust will be allocated QBI, qualified REIT dividends, and qualified PTP income only in proportion to the amount of DNI retained by the trust for the taxable year. For this reason, a trust, regardless of the number of separate shares it has for its beneficiaries under the separate share rule of section 663(c), will be treated as a single trust for purposes of applying the threshold amount under section 199A. To the extent that a taxable beneficiary of a trust receives a distribution of DNI from the beneficiary's separate share of the trust which includes section 199A items, the beneficiary would apply its own threshold amount to those section 199A items in computing its section 199A deduction in accordance with the rules of § 1.199A-6(d).

Accordingly, Prop. Reg. § 1.199A-6(d)(3)(iii), "Separate shares," provides:

> In the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.

II.E.1.f.ii. Electing Small Business Trusts (ESBTs)

As described in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview,[931] ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of Subtitle A of the Code. The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust. The grantor trust rules trump this treatment. However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. (A side benefit is that the $10,000 limit on state income tax deductions would apply separately to the S portion and the non-S portion, allowing the trust to deduct up to $20,000 in state income tax.)[932]

Code § 641(c)(2) limits the deductions that an ESBT can take. However, Code § 641(c)(2)(C)[933] and Reg. § 1.641(c)-1(d)(2)(i)[934] provide that one takes into items reported on Schedule K-1 that

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we[931] This is part of part III.A.3.e.ii ESBTs.

[932] See text accompanying fns 5659-5662 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[933] Code § 641(c)(2)(C) provides:

> The only items of income, loss, deduction, or credit to be taken into account are the following:
> (i) The items required to be taken into account under section 1366….

[934] Reg. § 1.641(c)-1(d)(2)(i) provides:

the S corporation issues to the trust.[935] Code § 199A(f)(1)(B) refers back to Code § 199 for the apportionment of W-2 wages and the apportionment of unadjusted basis.[936] Code § 199 items were separately stated on Schedules K-1.[937] Consistent with this framework, Reg. § 1.199A-6(d)(3)(vi), "Electing small business trusts," provides:

> An electing small business trust (ESBT) is entitled to the deduction under section 199A. Any section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust. *See* § 1.641(c)-1.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.3, "ESBTs," explains:

> One commenter supported the proposed regulation's position on ESBT's eligibility for the deduction. Another commenter stated that based on § 1.641(c)-1(a) and its reference to an ESBT being two separate trusts for purposes of chapter 1 of subtitle A of the Code (except regarding administrative purposes), the S portion and non-S portion should each have its own threshold. The Treasury Department and the IRS disagree with this comment. Although an ESBT has separate portions, it is one trust. Therefore, in order to provide clarity, the final regulations state that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount.

> *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

[935] Reg. § 1.1366-1(a)(2) provides:

> Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

[936] Code § 199A(f)(1)(B) is reproduced in fn 834 in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.

[937] Reg. § 1.1366-1(a)(2)(x) provides that among the items a shareholder takes into account is:

> Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

2017 Instructions for Form 1120S, Schedule K-1, Box 12, page 15, includes:

> **Code P. Domestic production activities information.** The corporation will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. For details, see the Instructions for Form 8903.

2017s Instructions for Form 1120S, Schedule K-1, Box 17, Codes V through Z, provide details on those codes on pages 19-20.

It's ironic that the regulation implementing this explanation is followed by a cross-reference to Reg. § 1.641(c)-1, which contradicts that regulation by providing that the S portion and non-S portion are treated as separate trusts for all income tax purposes (other than using one Form 1041).[938]

Any planning regarding ESBTs should be in conjunction with part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iii. Grantor Trusts (Including QSSTs)

"Grantor trust" means that one or more person is treated for income tax purposes as owning the trust's assets. Often this person is the grantor, but it can also be a beneficiary. See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.h How to Make a Trust a Grantor Trust and III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

The most common grantor trust is the revocable trust, but that's just a probate avoidance tool that doesn't inform planning. During the settlor's life, we often look to whether the settlor of an irrevocable trust may be the deemed owner, although significant tools allow us to plan to have the primary beneficiary be the deemed owner. After the settlor's death, making the beneficiary the deemed owner is the only grantor trust planning option.

Given that all Code § 199A items are attributable to the relevant grantor(s), a grantor trust is helpful when the beneficiary has low income.

Suppose a trust has huge taxable income, as well as having a partnership K-1 with no more than $157,500 of taxable income (before applying Code § 199A). As discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs)II.E.1.f.ii, the trust could form an S corporation, contribute the partnership interest to the S corporation, and make an ESBT election, thereby qualifying for the full Code § 199A deduction – but at the highest taxable income rates. Another alternative is to do the same, only the beneficiary elects QSST taxation.[939] All of the partnership's K-1 items are reported directly on the beneficiary's return, using the beneficiary's taxable income threshold and being taxed at the beneficiary's income tax rates. Before considering this, carefully read part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iv. Interaction with Net Investment Income Tax

The 3.8% tax on net investment income (NII) applies not only to investments but also to passive business income. See part II.I.8 Application of 3.8% Tax to Business Income.

To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business. See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

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[938] See fn 5650 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview
[939] See part III.A.3.e.i.(a) QSSTs Generally.

If the trust is a QSST, then consider also having the trustee sufficiently participate, to avoid NII tax in case the business is sold. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.E.1.f.v. Example Using Trusts to Split Income

Suppose Marla Alexander, a widow, owns an S corporation, which annually generates $1.5 million of taxable income each year.

Being in a state with a 5% income tax rate, Marla pays $75,000 of state income tax each year. Unfortunately, for any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits her deductions for state taxes to $10,000.[940] Given that Marla pays some real estate tax on her residence, more than $65,000 of her state income tax deduction is disallowed.

Marla has two children, Sam and Dolly. Marla needs only 60% of her stock to live quite comfortably. After converting the stock in 5 shares of voting and 95 shares of nonvoting stock,[941] Marla gifts 40 shares of nonvoting stock, 10 into each of four trusts: a discretionary trust for Sam, a QSST for Sam, a discretionary trust for Dolly, and a QSST for Dolly. See part III.A.3.e QSSTs and ESBTs.

Each ESBT will deduct its $7,500 share of state income tax. Because QSSTs are taxable as grantor trusts, each of Sam and Dolly will deduct up to $7,500 of state income tax if he or she itemizes deductions ("up to" because they may have real estate tax or other state tax deductions). Although part II.J.9.c Multiple Trusts Created for Tax Avoidance is concerning, Marla's desire to distribute some income and accumulate the rest of the income, combined with the fact that a QSST must distribute all of its income, may suffice. More conservative from an income tax viewpoint would be to make gifts outright instead of using QSSTs, but that might not meet Marla's estate planning objectives.

Also consider that each trust's distributive share of income is $150,000 (10% of $1.5 million). This means that each ESBT's taxable income will be less than $157,500; thus, in computing their Code § 199A deduction, any disallowance of specific service business income[942] and any limitations placed on insufficient wages[943] would not apply. See part II.E.1.f.ii Electing Small Business Trusts (ESBTs). Whether Sam and Dolly will benefit from eliminating these potential disallowances regarding the QSST's distributive shares that are taxed to them depends on their other income and deductions; see part II.E.1.f.iii Grantor Trusts (Including QSSTs).

Also consider part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income:

- If Sam or Dolly's adjusted gross income exceeds $200,000 so that the 3.8% NII tax may apply to them, does Sam or Dolly work enough in the business to prevent the NII tax from

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[940] It does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business). See part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.
[941] See part II.A.2.i.i Voting and Nonvoting Stock.
[942] See part II.E.1.c.iv Specified Service Trade or Business.
[943] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

applying to his or her distributive share of business income through his or her QSST? Working more than 100 hours per year – a mere 2 hours per week – may suffice; see part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

- Because an ESBT's threshold for the NII tax is so low, we also need to consider whether the trustee of each ESBT works enough in the business on behalf of the relevant trust to avoid NII tax. See part II.J.14 Application of 3.8% NII Tax to ESBTs. If the trustee works in the business as an individual, on audit the IRS is likely to assert that work as an individual does not count – it needs to be work expressly as a trustee. However, one can plan to avoid that argument. For all of these issues, see part II.K.2.b Participation by an Estate or Nongrantor Trust.

- The trustee of the QSSTs should also consider the planning mentioned for the ESBT. That's because the gain on sale of S corporation stock is taxed to the trust itself, rather than to the beneficiary; see parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

Suppose, instead of Marla's business being in an S corporation, it were held in an LLC taxed as a partnership. Let's first consider the state income tax issue, then consider the QBI issue.

Because there is no partnership income tax equivalent of a QSST, the mandatory income trust would apply the state income deduction at the trust level rather than at the beneficiary level. That may be more favorable, given that Sam's and Dolly's other state tax issues would not impinge on the benefits of the deduction for state income tax on the pass-through income. On the other hand, it may be more difficult to justify two separate trusts, given that a trust holding a partnership interest does not have the same type of drafting considerations that a QSST would have; therefore, one may be more wary of possible application of part II.J.9.c Multiple Trusts Created for Tax Avoidance. In response to this concern, one may consider the mandatory income trust placing the partnership in an S corporation, with the trust's beneficiary electing QSST treatment; query, however, whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Moving to the QBI issues, issues with the specific service business income[944] and any limitations placed on insufficient wages[945] would be divided between the trust and beneficiaries who receive distributions, as described in part II.E.1.f.i Nongrantor Trusts Other Than ESBTs. However, if the LLC does not distribute much more than enough to pay taxes, then the beneficiaries might not receive much of a distribution, because the trust would use all or most of the distribution to pay the trust's own taxes; see parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation. To shift half of the gifted distributive shares of income to Sam or Dolly, one may need to consider having a separate mandatory income trust that places its LLC interest in an S corporation, with the trust's beneficiary electing QSST treatment; again, consider whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

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[944] See part II.E.1.c.iv Specified Service Trade or Business.
[945] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

Also consider the same NII tax issues we did for the ESBTs.

II.E.1.f.vi. Ownership Restrictions

If an ownership interest cannot be transferred to a trust because it is a professional firm, consider which services can be split off into an entity that does not require professional ownership.

For example, CPA firms could split off their tax return and personal financial planning services.

However, if the business is inside a corporation, consider whether goodwill is personal or corporate,[946] the latter causing taxation when moving the line of business unless one can do a tax-free split-up.[947]

II.E.1.f.vii. Charitable Remainder Trusts and Other Split-Interest Trusts

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.1, "Charitable Remainder Trust Beneficiary's Eligibility for the Deduction," explains:

> The preamble to the proposed regulations requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing proposed regulations under section 199A (REG-134652-18) that address the eligibility of taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interests trusts to receive the section 199A deduction.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III, "Special Rules for Trusts and Estates," explains:

> In the August Proposed Regulations, the Treasury Department and the IRS requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. The request for such comments indicated that such comments should include explanations of how amounts that may give rise to the section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

[946] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

[947] See part II.Q.7.f Corporate Division into More Than One Corporation.

A. CHARITABLE REMAINDER TRUST BENEFICIARY'S ELIGIBILITY FOR THE DEDUCTION

A few commenters suggested that a charitable remainder trust under section 664 should be allowed to calculate the deduction at the trust level and that the charitable remainder trust should be treated as a single taxpayer for purposes of the thresholds for taxable income, W-2 wages, and UBIA of qualified property.

Several commenters recommended that, if unrelated business taxable income (UBTI) is qualified business income, the section 199A deduction should be allowed before the UBTI excise tax is imposed. However, other commenters disagreed. Another commenter stated that the section 199A deduction should not be allowed when calculating UBTI because it is not a deduction directly connected with carrying on the trade or business and is allowable only for purposes of chapter 1, while the excise tax on UBTI is imposed under chapter 42 (that is, it is not an income tax). Another commenter said the UBTI excise tax under section 664(c) should not affect QBI because that tax is charged to principal.

One commenter recommended that QBI should be allocated to the ordinary income tier. Another recommended that QBI should be the bottom of the first tier (last to be distributed) and section 199A items should be reported on the Schedule K-1 when QBI is deemed distributed. Another commenter stated that a charitable remainder trust has no taxable income and no DNI, so the allocation of QBI, W-2 wages, and UBIA of qualified property should be allocated to beneficiaries based on the percentage of distributions from the ordinary income tier, with QBI allocated to the charitable remainder trust remaining a tier one item. Another commenter stated that QBI cannot be a separate tier because it is a deduction, rather than a rate difference.

The Treasury Department and the IRS believe that, because a charitable remainder trust described in section 664 is not subject to income tax, and because the excise tax imposed by section 664(c) is treated as imposed under chapter 42, the trust does not either have or calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. Furthermore, application of section 199A to effectively reduce the 100 percent rate of tax imposed by section 664(c) on any UBTI would be inconsistent with the intent of section 664(c) to deter trusts from making investments that generate significant UBTI. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A, taking into account any annuity or unitrust amounts received from the trust. Therefore, a taxable recipient of a unitrust or annuity amount from a charitable remainder trust may take into account QBI, qualified REIT dividends, and qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such section 199A items under § 1.664-1(d).

In order to determine the order of distribution of the various classes of income of the trust for purposes of applying § 1.664-1(d), QBI, qualified REIT dividends, and qualified PTP income of a charitable remainder trust will be allocated to the classes of income within the category of income described in § 1.664-1(d)(1)(i)(a)(1) based on the rate of tax that normally would apply to that type of income, not taking into account the characterization of that income as QBI, qualified REIT dividends, or qualified PTP

income for purposes of section 199A. Accordingly, any QBI, qualified REIT dividends, and qualified PTP income will be treated as distributed from the trust to a unitrust or annuity recipient only when all other classes of income within the ordinary income category subject to a higher rate of tax (not taking into account section 199A) have been exhausted. The unitrust or annuity recipient will be treated as receiving a proportionate amount of any QBI, qualified REIT dividends, and qualified PTP income that is distributed along with other income in the same class within the ordinary income category. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of the total of QBI, qualified REIT dividends, and qualified PTP income distributed for that year. The amount of any W-2 wages or UBIA of qualified property of the charitable remainder trust in a taxable year will be allocable to unitrust or annuity recipients based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year.

Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and § 1.664-1(c) requires that tax to be allocated to the corpus of the trust. Certain other rules relating to charitable remainder trusts are provided.

B. SPLIT-INTEREST TRUSTS

The August Proposed Regulations requested comments on whether any special rules were necessary with respect to split-interest trusts. One commenter suggested that additional rules may be necessary for split-interest trusts other than charitable reminder trusts. After considering the comment and studying other split-interest trusts in more depth after the publication of the August Proposed Regulations, the Treasury Department and the IRS have determined that special rules for other split-interest trusts, such as non-grantor charitable lead trusts or pooled income funds, are not necessary because such trusts are taxable under part I, subchapter J, chapter 1 of the Code, except subpart E. Such split-interest trusts would apply the rules for non-grantor trusts and estates set forth in § 1.199A-6(d)(3) to determine any applicable section 199A deduction for the trust or its taxable beneficiaries.

Accordingly, Prop. Reg. § 1.199A-6(d)(3)(v), "Charitable remainder trusts," provides:

A charitable remainder trust described in section 664 is not entitled to and does not calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such section 199A items under § 1.664-1(d). For example, if a charitable remainder trust has investment income of $500, qualified dividend income of $200, and qualified REIT dividends of $1,000, and distributes $1,000 to the recipient, the trust would be treated as having income in two classes within the category of income described in § 1.664-1(d)(1)(i)(a)(1), for purposes of § 1.664-1(d)(1)(ii)(b). Because the annuity amount first

> carries out income in the class subject to the highest income tax rate, the entire annuity payment comes from the class with the investment income and qualified REIT dividends. Thus, the charitable remainder trust would be treated as distributing a proportionate amount of the investment income ($500/(1,000+500)*1,000 = $333) and qualified REIT dividends ($1000/(1,000+500)*1000 = $667) because the investment income and qualified REIT dividends are taxed at the same rate and within the same class, which is higher than the rate of tax for the qualified dividend income which is in a separate class. The charitable remainder trust in this example would not be treated as distributing any of the qualified dividend income until it distributed all of the investment income and qualified REIT dividends (more than $1,500 in total) to the recipient. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of the total of QBI, qualified REIT dividends, or qualified PTP income distributed for that year. The trust allocates and reports any W-2 wages or UBIA of qualified property to the taxable recipient of the annuity or unitrust interest based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year. Accordingly, if 10 percent of the QBI of a charitable remainder trust is distributed to the recipient and 90 percent of the QBI is retained by the trust, 10 percent of the W-2 wages and UBIA of qualified property is allocated and reported to the recipient and 90 percent of the W-2 wages and UBIA of qualified property is treated as retained by the trust. However, any W-2 wages retained by the trust do not carry over to subsequent taxable years for section 199A purposes. Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and that tax must be allocated to the corpus of the trust under § 1.664-1(c).

II.E.1.f.viii. Tax-Exempt Trusts

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.2, "Tax Exempt Trusts," explains:

> One commenter requested guidance on whether "exempt trust organizations" (that is, trusts that are exempt from income tax under section 501(a) or "tax exempt trusts") are entitled to a section 199A deduction in computing their unrelated business taxable income. The commenter also requested confirmation regarding whether the method of determining or separating trades of businesses is the same for sections 199A and 512(a)(6). The Treasury Department and the IRS decline to adopt these comments here because they are beyond the scope of these final regulations. The Treasury Department and the IRS continue to study this issue and request comments on the interaction of sections 199A and 512. We will consider all comments and decide whether further guidance on these issues, including as part of a forthcoming notice of a proposed rulemaking under section 512(a)(6), is warranted.

Notice 2018-67 provides guidance in separating businesses, setting forth "interim guidance and transition rules relating to" Code § 512(a)(6), and Section 3 of the Notice "outlines general concepts for identifying separate trades or businesses for purposes of § 512(a)(6) and provides

interim reliance on a reasonable, good-faith standard for making such a determination."[948] Section 3, "Separate Trade Or Business," provides:

> *.01. In General*
>
> In the case of any exempt organization with more than one unrelated trade or business, § 512(a)(6)(A) requires the organization to calculate UBTI, including for purposes of determining any NOL deduction (discussed in section 9 of this notice), separately with respect to each such trade or business. In enacting § 512(a)(6), Congress did not provide criteria for determining whether an exempt organization has more than one unrelated trade or business or how to identify separate unrelated trades or businesses for purposes of calculating UBTI. The Treasury Department and the IRS intend to propose regulations for determining whether an exempt organization has more than one unrelated trade or business for purposes of § 512(a)(6) and how to identify separate trades or businesses for purposes of calculating UBTI under § 512(a)(6)(A).
>
> *.02. Reasonable, Good-Faith Interpretation of §§ 511 through 514*
>
> Pending issuance of proposed regulations, and pursuant to additional interim guidance provided in section 6 of this notice, exempt organizations may rely on a reasonable, good-faith interpretation of §§ 511 through 514, considering all the facts and circumstances, when determining whether an exempt organization has more than one unrelated trade or business for purposes of § 512(a)(6). A reasonable, good-faith interpretation includes using the North American Industry Classification System 6-digit codes described in section 3.03.
>
> The Treasury Department and the IRS note that the fragmentation principle in § 513(c) and § 1.513-1(b), and related guidance, may also provide helpful guidance. Prior to the passage of § 512(a)(6), the fragmentation principle was primarily used to separate unrelated trades or businesses from exempt activities, but it might also have utility in identifying separate trades or businesses for purposes of § 512(a)(6)(A). The fragmentation principle provides that an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of an organization. For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its status as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of § 513(a)(2) (stating, in part, that the term "trade or business" does not include any trade or business that is carried on by an organization described in § 501(c)(3) or a state college or university primarily for the convenience of its members, students, patients, officers, or employees). See § 1.513-1(b). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose their statuses as trades or businesses even though the advertising is published in an exempt organization periodical that contains editorial matter related to the exempt purposes of the organization. *Id.* Additionally, several revenue rulings provide examples of how the fragmentation principle has been applied. *See, e.g.*, Rev. Rul. 78-145, 1978-1 C.B. 169 (regarding the sale of blood products by a blood bank).

[948] Notice 2018-67, § 1.

.03. Possible Methods for Identifying Separate Trades or Businesses

There is no general statutory or regulatory definition defining what constitutes a "trade or business" for purposes of the Internal Revenue Code. Whether an activity constitutes a trade or business may vary depending on which Code section is involved. See generally *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987). The Treasury Department and the IRS request comments regarding rules to identify separate trades or businesses that achieve the intent of Congress in enacting § 512(a)(6) and are administrable for exempt organizations and the IRS.

Several Code sections describe factors for determining whether an organization is engaged in a trade or business or a line of business, including §§ 132, 162, 183, 414, and 469 (see also section 5.02 of this notice), and the regulations thereunder. The Treasury Department and the IRS have considered these Code sections and are concerned that they do not provide useful models for identifying separate trades or businesses for purposes of § 512(a)(6). Nonetheless, the Treasury Department and the IRS request comments describing whether and how these and other Code sections (and the regulations thereunder) may aid in determining how to identify an exempt organization's separate trades or businesses for purposes of § 512(a)(6)(A).

Although some commenters have suggested the creation of a facts and circumstances test to identify separate trades or businesses for purposes of § 512(a)(6), the Treasury Department and the IRS would like to set forth a more administrable method than a facts and circumstances test alone for identifying separate trades or businesses for purposes of § 512(a)(6). A facts and circumstances test would increase the administrative burden on exempt organizations in complying with § 512(a)(6) because such organizations would have to perform a fact-intensive analysis with respect to each of their trades or businesses, document the analysis, and then track and keep records consistent with such analysis. Additionally, such a test would likely result in inconsistency across the exempt organization sector in light of differing approaches in budgeting and staffing and thus create unequal burdens and cause exempt organizations to make business decisions such as budgeting and staffing solely to avoid the requirements of § 512(a)(6). Finally, such a test would also increase the administrative burden on the IRS in implementing and enforcing § 512(a)(6) because verifying whether an exempt organization calculated its UBTI correctly would require a fact-intensive analysis of the organization's trades or businesses and the determinations made with respect to identifying separate trades or businesses for purposes of calculating UBTI under § 512(a)(6)(A).

To provide additional guidance in proposed regulations for determining whether an exempt organization has more than one unrelated trade or business for purposes of § 512(a)(6) and how to identify separate trades or businesses for purposes of calculating UBTI under § 512(a)(6)(A), the Treasury Department and the IRS are considering the use of North American Industry Classification System (NAICS) codes. Prior to proposed regulations, the Treasury Department and the IRS will consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under section 3.02 of this notice.

The NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at

> https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. For example, under a NAICS 6-digit code, all of an exempt organization's advertising activities and related services (NAICS code 541800) might be considered one unrelated trade or business activity, regardless of the source of the advertising income. Use of all 6 digits of the NAICS codes would result in more specific categories of trades or businesses whereas use of fewer than 6 digits of the NAICS codes would result in broader categories of trades or businesses. Exempt organizations filing Form 990-T, "Exempt Organization Business Income Tax Return," already are required to use the 6-digit NAICS codes when describing the organization's unrelated trades or businesses in Block E. The Treasury Department and the IRS request comments regarding whether using less than 6 digits of the NAICS codes, or combining NAICS codes with other criteria, would appropriately identify separate trades or businesses for purposes of achieving the objective of § 512(a)(6). The Treasury Department and the IRS also request comments on the utility of this method, other methods, or a combination of methods that could be used for making this determination.

Groetzinger, cited above, is discussed in the text accompanying fns 1209-1212 in part II.G.4.I.i.(a) "Trade or Business" Under Code § 162.

Notice 2018-67, Section 6, "Interim And Transition Rules For Partnership investments," provides special rules for Code § 512(a)(6) that are inconsistent with Code § 199A and therefore are not given further attention here. For more on Code § 512(a)(6), see IRS training, "Unrelated Business Taxable Income Computed Separately for Each Trade or Business –"Siloing," found at https://www.irs.gov/pub/newsroom/3-ubti-siloing-computed-separately-each-trade-business-511-13702_508.pdf.

II.G.3. State Income Taxation

Generally, 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. Of course, if the entity is a C corporation, it pays tax on its own income, and only the gain on sale of the S corporation stock may be taxable to the owner, but only in the jurisdiction in which the owner is a resident. In any event, 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. Because states may use different methods to apportion income, these different methods may lead to double (or worse) taxation. To avoid unfair duplication, consider how the Multistate Tax Commission can help.[1084] Also note that each owner needs to file state income tax returns (or the pass-through entity needs to pay tax

[1084] From http://www.mtc.gov/The-Commission:

> The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:
>
> - Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
> - Promoting uniformity or compatibility in significant components of tax systems;
> - Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;
> - Avoiding duplicative taxation.

on that owner's behalf, generally at the highest marginal state income tax rate that would apply to that income); whereas, with a C corporation, only the corporation needs to file.

For various permutations of income taxation when businesses are sold, see parts II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, and II.Q.9 Trust Selling a Business. Also consider part II.H.8.a.ii State Income Tax Disconnect, found within part II.H.8.a Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly.

An additional consideration is that the Code § 199A deduction[1085] is available in only a few states. See part II.E.1.c.i.(c) Effect (if any) of Code § 199A on State Income Taxation.

Illinois imposes an income tax, called the "replacement tax," on partnerships, S corporations and C corporations.[1086] LLCs that are treated as disregarded entities do not appear to be subject to this tax.[1087]

For the leading U.S. Supreme Court case and other issues relating to state fiduciary income taxation, see part II.J.3.e.ii When a State Can or Does Tax a Trust's Income.

States impose franchise tax and other taxes, some of which vary according to the type of entity. This includes differences between general partnerships, limited partnerships, and LLCs.[1088]

Also, *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018), was a key decision regarding taxing nexus in the context of state sales tax. The Council on State Taxation, cost.org, tracks not only the implications of that case but also which elements of federal law are integrated into state income taxation of C corporations and pass-through entities.

[1085] See generally part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[1086] 35 ILCS 5/201(c).

[1087] Illinois taxes LLCs as corporations or partnerships if they are classified as such for federal income tax purposes. 35 ILCS 5/1501(a)(4), (16); IL Admin. Code § 100.9750(b), (d)(1). IL Admin. Code § 100.9750(b)(1)(A) provides that a corporation and its federally disregarded subsidiary are taxed as a single corporation.

[1088] See, *e.g.*, Ely, Thistle, and Rhyne, "State Tax Treatment of LLCs and LLPs: Update for 2014," *Journal of Multistate Taxation and Incentives* (5/2014). Other resources include not only various state tax treatises, such as Hellerstein & Hellerstein, *State Taxation*, and Fenwick, McLoughlin, Salmon, Smith, Tilley, Wood, *State Taxation of Pass-Through Entities and Their Owners*, but also magazines, such the *Journal of Business Entities*. Before starting new operations, one might explore state and local tax incentives.

II.I. 3.8% Tax on Excess Net Investment Income (NII)

For the IRS' basic overview, see http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

II.I.1. Taxpayers and Years Affected

For taxable years beginning after December 31, 2012,[2065] net investment income in excess of certain thresholds is subject to a 3.8% tax.[2066] The preamble to the final regulations explains:[2067]

> Section 1402(a)(1) of the HCERA added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

II.I.2. Regulatory Framework

The preamble to the final regulations described the regulatory framework:[2068]

> On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the Federal Register (REG-130507-11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the Federal Register (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at www.regulations.gov[2069] or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.
>
> In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the Federal Register (REG-130843-13) relating to the Net Investment Income Tax.

The preamble to the final regulations explained taxpayer reliance on proposed and final regulations:[2070]

> These regulations are effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.

[2065] P.L. 111-152, section 1402(b)(3).
[2066] Code § 1411(a).
[2067] T.D. 9644.
[2068] T.D. 9644.
[2069] A more direct link is http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;dct=PS;D=IRS-2012-0049.
[2070] T.D. 9644.

Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.

For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411. See § 1.1411-1(f). However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with these final regulations, and such position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, then such taxpayer must make reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted. For example, reasonable adjustments may be required to ensure that no item of income or deduction is taken into account in computing net investment income more than once, and that carryforwards, basis adjustments, and other similar items are adjusted appropriately.

Effective/Applicability Date

These final regulations apply to taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012.

The final regulations were issued with additional proposed regulations, the preamble to which explained the regulatory background:[2071]

The Treasury Department and the IRS received comments on the 2012 Proposed Regulations requesting that they address the treatment of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners for section 1411 purposes, and certain capital loss carryovers. After consideration of all comments received, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these items in regulations. Because such guidance had not been proposed in the 2012 Proposed Regulations, it is being issued for notice and comment in these new proposed regulations.

The Treasury Department and the IRS also received comments on the simplified method for applying section 1411 to income recipients of charitable remainder trusts (CRTs) that was proposed in the 2012 Proposed Regulations. The comments recommended that the section 1411 classification incorporate the existing category and class system under section 664. These proposed regulations provide special rules for the application of the section 664 system to CRTs that derive income from controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) with respect to which an election under § 1.1411-10(g) is not in place. Specifically, these proposed regulations coordinate the application of the rules applicable to shareholders of CFCs and PFICs in § 1.1411-10 with the section 664 category and class system adopted in § 1.1411-3(d)(2) of the 2013 Final Regulations.

[2071] REG-130843-13.

> Furthermore, these proposed regulations allow CRTs to elect to apply the section 664 system adopted in the 2013 Final Regulations or the simplified method set forth in the 2012 Proposed Regulations. Some comments responding to the 2012 Proposed Regulations requested that we provide an election. The Treasury Department and the IRS request comments with regard to whether or not taxpayers believe this election is preferable to the section 664 system adopted in the 2013 Final Regulations. If it appears that there is no significant interest in having the election, the Treasury Department and the IRS may omit it from the regulations when finalized, and the simplified method contained in the 2012 Proposed Regulations would no longer be an option.
>
> These proposed regulations also address the net investment income tax characterization of income and deductions attributable to common trust funds (CTFs), residual interests in real estate mortgage investment conduits (REMICs), and certain notional principal contracts.
>
> The Treasury Department and the IRS also received comments on the 2012 Proposed Regulations questioning the proposed regulation's methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. In view of these comments, the 2013 Final Regulations removed § 1.1411-7 of the 2012 Proposed Regulations and reserved § 1.1411-7 in the 2013 Final Regulations.
>
> This notice of proposed rulemaking proposes revised rules regarding the calculation of net gain from the disposition of a partnership interest or S corporation stock (each a "Passthrough Entity") to which section 1411(c)(4) may apply.

The preamble to the 2013 proposed regulations explained effective dates:[2072]

> These regulations are proposed to apply for taxable years beginning after December 31, 2013, except that § 1.1411-3(d)(3) is proposed to apply to taxable years beginning after December 31, 2012.

II.I.3. Tax Based on NII in Excess of Thresholds

The preamble describes how to calculate the tax:[2073]

> In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under

[2072] REG-130843-13.
[2073] T.D. 9644.

> section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411-2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.
>
> In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of: (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Section 1.1411-3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

Thus, the threshold amount is not indexed for inflation for individuals but is for trusts.[2074]

Short taxable years use the full threshold,[2075] without proration,[2076] unless the short year results from a change in the annual accounting period.[2077]

II.I.4. Calculating NII - General Overview Provided by Preambles

The preamble describes how to calculate net investment income:[2078]

> Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411-4 and 1.1411-10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).
>
> Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is: (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).
>
> Section 1.1411-5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).
>
> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is

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[2074] Compare Code §§ 1411(a)(1)(B)(ii) and 1411(b) (fixed dollar amounts for individuals) with Code § 1411(a)(2)(B)(ii) (referring to the annually indexed top bracket for trusts and estates).
[2075] Reg. § 1.1411-1(d)(1) sets forth the thresholds.
[2076] Reg. § 1.1411-1(d)(2).
[2077] Reg. § 1.1411-1(d)(3).
[2078] T.D. 9644.

subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.
>
> Section 1411(c)(5) provides that net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1.1411-8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).
>
> Section 1411(c)(6) provides that net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1.1411-9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Regarding properly allocable deductions in excess of investment income, the preamble to the final regulations provides:[2079]

> Proposed § 1.1411-4(f)(1)(ii) provided that any deductions described in § 1.1411- 4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.
>
> The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

Regarding net operating losses (NOLs), the preamble to the final regulations provides:[2080]

> Proposed § 1.1411-4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net

[2079] T.D. 9644.
[2080] T.D. 9644.

> investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a "net investment loss" for a loss year (for example, using a ratio of the portion of the loss attributable to "net investment loss" to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.
>
> The final regulations adopt a modified version of the commentator's approach in § 1.1411-4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the section 1411 NOL amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to net investment income.

Reg. § 1.1411-4(h) describes Code § 1411 NOLs.

See also part II.J.14 Application of 3.8% NII Tax to ESBTs.

II.I.5. What is Net Investment Income Generally

Except as otherwise provided, all provisions that apply for Chapter 1 of the Code purposes in determining taxable income[2081] also apply in determining net investment income ("NII").[2082]

[2081] As defined in Code § 63(a)

[2082] Reg. § 1.1411-1(a). However, Code § 1411 treatment does not affect treatment under any provision of the Code other than Code § 1411. Reg. § 1.1411-1(c). Also, credits generally allowable against income tax or other taxes are not creditable against the tax on NII. Reg. § 1.1411-1(e).

NII[2083] is the excess (if any) of:[2084]

1. The sum of:

   a. Gross income from interest,[2085] dividends,[2086] annuities,[2087] royalties,[2088] and rents,[2089] except to the extent excluded by the ordinary course of a trade or business exception;[2090]

To add some levity to your day, note that approximately 30 years ago NII was suggested to be a very bad word. If you don't believe me, see https://www.youtube.com/watch?v=zIV4poUZAQo (short version) or https://www.youtube.com/watch?v=QTQfGd3G6dg (long version) from *Monty Python and the Holy Grail*.

[2083] Reg. § 1.1411-1(d)(8) provides:

The term net investment income (NII) means net investment income as defined in section 1411(c) and § 1.1411-4, as adjusted pursuant to the rules described in § 1.1411-10(c).

[2084] Reg. § 1.1411-4(a).

[2085] Reg. § 1.1411-1(d)(6) provides:

The term gross income from interest includes any item treated as interest income for purposes of chapter 1 and substitute interest that represents payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

[2086] Reg. § 1.1411-1(d)(3) provides:

The term gross income from dividends includes any item treated as a dividend for purposes of chapter 1. See also § 1.1411-10 for additional amounts that constitute gross income from dividends. The term gross income from dividends includes, but is not limited to, amounts treated as dividends--

(i) Pursuant to subchapter C that are included in gross income (including constructive dividends);
(ii) Pursuant to section 1248(a), other than as provided in § 1.1411-10;
(iii) Pursuant to § 1.367(b)-2(e)(2);
(iv) Pursuant to section 1368(c)(2); and
(v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

[2087] Reg. § 1.1411-1(d)(1) provides:

The term gross income from annuities under section 1411(c)(1)(A) includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e). In the case of a sale of an annuity, to the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income from an annuity within the meaning of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i). However, if the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income from an annuity described in section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i) and the excess of the sales price over the surrender value as gain from the disposition of property included in section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii). The term gross income from annuities does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i).

[2088] Reg. § 1.1411-1(d)(11) provides:

The term gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

[2089] Reg. § 1.1411-1(d)(10) provides:

b. Other gross income derived from a passive trade or business;[2091] and

c. Net gain from the disposition of property,[2092] except to the extent attributable to property held in an active trade or business[2093] or otherwise provided,[2094]

over

2. Deductions allowable for income tax purposes that are properly allocable to such gross income or net gain.[2095]

The corollary to self-employment income being excluded from NII is that items excluded from SE income might constitute NII.[2096] Note also that wages are not among the type of income constituting NII.

The term gross income from rents includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

[2090] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[2091] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[2092] Reg. § 1.1411-4(d)(1) provides:

Definition of disposition. For purposes of section 1411 and the regulations thereunder, the term disposition means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under section 877A).

Reg. § 1.1411-4(d)(2) provides:

Limitation. The calculation of net gain may not be less than zero. Losses allowable under section 1211(b) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

Reg. § 1.1411-4(d)(3)(i) provides:

General rule. Net gain attributable to the disposition of property is the gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by losses deductible under section 165, including losses attributable to casualty, theft, and abandonment or other worthlessness. The rules in subchapter O of chapter 1 and the regulations thereunder apply. See, for example, § 1.61-6(b). For purposes of this paragraph, net gain includes, but is not limited to, gain or loss attributable to the disposition of property from the investment of working capital (as defined in § 1.1411-6); gain or loss attributable to the disposition of a life insurance contract; and gain attributable to the disposition of an annuity contract to the extent the sales price of the annuity exceeds the annuity's surrender value.

[2093] See generally part II.I.8.b 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets and also part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[2094] Reg. § 1.1411-4(d)(4)(ii) provides:

Other gains and losses excluded from net investment income. Net gain, as determined under paragraph (d) of this section, does not include gains and losses excluded from net investment income by any other provision in §§ 1.1411-1 through 1.1411-10. For example, see § 1.1411-7 (certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations) and § 1.1411-8(b)(4)(ii) (net unrealized appreciation attributable to employer securities realized on a disposition of those employer securities).

[2095] Reg. § 1.1411-4(f). See part II.I.6 Deductions Against NII.

[2096] Reg. § 1.1411-9(a) provides:

General rule. Except as provided in paragraph (b) of this section [income derived from a trade or business of trading in financial instruments or commodities], net investment income does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, taken into account means income included and deductions allowed in determining net earnings

II.I.6. Deductions Against NII

The following deductions in determining regular adjusted gross income also apply to NII:

- Deductions allocable to gross income from rents and royalties included in NII.[2097]
- Deductions allocable to gross income from trades or businesses included in NII, to the extent the deductions have not been taken into account in determining self-employment income.[2098]
- Penalty on early withdrawal of savings.[2099]
- Net operating loss arising from NII items.[2100]

The following itemized deductions also apply to NII:

- Investment interest expense.[2101]
- Investment expenses.[2102]

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from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)-(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus may be included in net investment income if such amounts are described in § 1.1411-4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see § 1.1402(a)-2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

[2097] Reg. § 1.1411-4(f)(2)(i).

[2098] Reg. § 1.1411-4(f)(2)(ii).

[2099] Reg. § 1.1411-4(f)(2)(iii).

[2100] Reg. § 1.1411-4(f)(2)(iv), cross-referencing Reg. § 1.1411-4(h).

[2101] Reg. § 1.1411-4(f)(3)(i) , cross-referencing Code § 163(d)(3), which provides:

Investment interest. For purposes of this subsection—

(A) *In general*. The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.

(B) *Exceptions*. The term "investment interest" shall not include—

(i) any qualified residence interest (as defined in subsection (h)(3)), or

(ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

(C) *Personal property used in short sale*. For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

Reg. § 1.163-8T provides interest tracing rules, which provide taxpayer with significant latitude to trace loan proceeds as they wish. Notice 88-74 provides guidance on various issues relating to the home mortgage interest deduction under Code § 163(h)(3).

[2102] Reg. § 1.1411-4(f)(3)(ii), cross-referencing Code § 163(d)(4)(C).

- State, local, and foreign income, war profits, and excess profit taxes that are allocable to net investment income.[2103]

- Deduction for unrecovered investment in an annuity in the decedent's final income tax return if the annuity was NII.[2104]

- Deductions for estate GST tax allocable to income in respect of a decedent that is NII.[2105]

- Deductions in connection with the determination, collection, or refund of any tax arising from NII.[2106]

- Amortizable bond premium on a taxable bond.[2107]

- Fiduciary expenses.[2108]

Other deductions include:

- Loss deductions.[2109]

[2103] Reg. § 1.1411-4(f)(3)(iii), cross-referencing Code § 164(a)(3). For the effect of refunds of those taxes, see Reg. § 1.1411-4(g)(2).
[2104] Reg. § 1.1411-4(f)(3)(iv).
[2105] Reg. § 1.1411-4(f)(3)(v).
[2106] Reg. § 1.1411-4(f)(3)(vi) provides:

> Amounts described in section 212(3) and § 1.212-1(*l*) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(*l*) provides:

> Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

[2107] Reg. § 1.1411-4(f)(3)(vii).
[2108] Reg. § 1.1411-4(f)(3)(viii) provides:

> In the case of an estate or trust, amounts described in § 1.212-1(i) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(i) provides:

> Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

Such fees include the trust's reimbursement of legal fees paid by the beneficiaries to change the trustee and improve the investment of the trust's assets. Letter Rulings 201642027, 201642028.
[2109] Reg. § 1.1411-4(f)(4)(i) provides:

> *General rule*. Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain

- Ordinary loss deductions for certain debt instruments.[2110]

- Other deductions not yet announced.[2111]

Generally, deductions limited for regular income tax purposes are also limited for NII purposes.[2112]

If a properly allocable deduction is allocable to both NII and taxable items of income that are not NII, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method.[2113] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. When using expenses to offset taxable items of income, consider which items of income constitute NII,[2114] as well as the overall federal and state income tax rates that apply to those items.

If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a deduction against NII in a prior year, and such amount is not otherwise included in NII in the year of recovery, the amount of the recovery will reduce the taxpayer's total deductions against NII in the year of recovery (but not below zero).[2115]

> described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

[2110] Reg. § 1.1411-4(f)(5) provides:

> An amount treated as an ordinary loss by a holder of a contingent payment debt instrument under § 1.1275-4(b) or an inflation-indexed debt instrument under § 1.1275-7(f)(1).

[2111] Reg. § 1.1411-4(f)(6) provides:

> Any other deduction allowed by subtitle A that is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as properly allocable to gross income or net gain under this section.

[2112] Reg. § 1.1411-4(f)(7) provides:

> *Application of limitations under sections 67 and 68*. Any deductions described in this paragraph (f) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose, section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

[2113] Reg. § 1.1411-4(g)(1) provides:

> *Deductions allocable to both net investment income and excluded income.* In the case of a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method. Examples of reasonable methods of allocation include, but are not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411-4(a)(1) to the amount of the taxpayer's adjusted gross income (as defined under section 62 (or section 67(e) in the case of an estate or trust)). In the case of an estate or trust, an allocation of a deduction pursuant to rules described in § 1.652(b)-3(b) (and § 1.641(c)-1(h) in the case of an ESBT) is also a reasonable method.

[2114] See part II.I.5 What is Net Investment Income Generally.

[2115] Reg. § 1.1411-4(g)(2) provides additional details how this works.

Deductions in respect of a decedent also count against NII if they are described in any of the preceding paragraphs.[2116]

Deductions on termination of a trust or estate generally receive NII treatment consistent with their character.[2117]

Special rules apply to losses allowed in computing taxable income by reason of the rules governing former passive activities[2118] or losses allowed when a passive activity is disposed of.[2119]

II.I.7. Interaction of NII Tax with Fiduciary Income Tax Principles

Generally,[2120] a trust or estate is taxed on the lesser of its undistributed net investment income (UNII) or the excess (if any) of its adjusted gross income[2121] over the taxable income threshold[2122] for its highest marginal income tax bracket.[2123]

[2116] Reg. § 1.1411-4(g)(3) provides:

> *Deductions described in section 691(b).* For purposes of paragraph (f) of this section, properly allocable deductions include items of deduction described in section 691(b), provided that the item otherwise would have been deductible to the decedent under § 1.1411-4(f). For example, an estate may deduct the decedent's unpaid investment interest expense in computing its net investment income because section 691(b) specifically allows the deduction under section 163, and § 1.1411-4(f)(3)(i) allows those deductions as well. However, an estate or trust may not deduct a payment of real estate taxes on the decedent's principal residence that were unpaid at death in computing its net investment income because, although real estate taxes are deductible under section 164 and specifically are allowed by section 691(b), the real estate taxes would not have been a properly allocable deduction of the decedent under § 1.1411-4(f).

[2117] Reg. § 1.1411-4(g)(4), referring to Code § 642(h) items. See part II.J.3.i Planning for Excess Losses.

[2118] Reg. § 1.1411-4(g)(8), referring to losses under Code § 469(f)(1).

[2119] Reg. § 1.1411-4(g)(9), referring to losses under Code § 469(g)(1). Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity

[2120] Reg. § 1.1411-3(a)(1)(i). Reg. § 1.1411-3(b)(1) exempts the following trusts from the tax:

> (i) A trust or decedent's estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).
> (ii) A trust exempt from tax under section 501.
> (iii) A charitable remainder trust described in section 664. However, see paragraph (d) of this section for special rules regarding the treatment of annuity or unitrust distributions from such a trust to persons subject to tax under section 1411.
> (iv) Any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A. For example, see sections 220(e)(1), 223(e)(1), 529(a), and 530(a).
> (v) A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.
> (vi) Electing Alaska Native Settlement Trusts subject to taxation under section 646.
> (vii) Cemetery Perpetual Care Funds to which section 642(i) applies.
> (viii) Foreign trusts (as defined in section 7701(a)(31)(B) and § 301.7701-7(a)(2)) (but see §§ 1.1411-3(e)(3)(ii) and 1.1411-4(e)(1)(ii) for rules related to distributions from foreign trusts to United States beneficiaries).
> (ix) Foreign estates (as defined in section 7701(a)(31)(A)) (but see § 1.1411-3(e)(3)(ii) for rules related to distributions from foreign estates to United States beneficiaries).

Regarding grantor trusts, the tax is imposed on the deemed owner rather than the trust:[2124]

- Thus, the beneficiary of a qualified subchapter S trust (QSST)[2125] would include the S corporation's income in the beneficiary's income and determine the applicability of the tax based on the beneficiary's tax attributes and participation in the S corporation's activity. Consider switching from an ESBT to one or more QSSTs in light of not only issues relating to the 3.8% tax but also increases in the top income tax bracket (to which all ESBT S corporation income is subject) relative to the beneficiaries' income tax rates.[2126] For more about ESBTs and QSSTs, see parts II.J.14 Application of 3.8% NII Tax to ESBTs and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

- See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts regarding other trusts that are deemed owned by beneficiaries rather than grantors, including part III.B.2.i.vi Portion Owned When a Gift (discussing how to compute the portion deemed owned by the beneficiary during and after the lapse of a withdrawal right). A minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in the minor, notwithstanding that no guardian has been appointed for the minor.[2127]

- See part III.B.2.h How to Make a Trust a Grantor Trust, regarding how to make the settlor the deemed owner.

UNII[2128] is the estate's or trust's NII reduced by distributions of net investment income to beneficiaries[2129] and by charitable deductions[2130] (but note that the charitable deduction does not reduce DNI allocated to mandatory income beneficiaries).[2131]

A charitable remainder trust's beneficiaries are taxed when the CRT distributes to them NII the CRT received for all taxable years that begin after December 31, 2012. Reg. § 1.1411-3(d)(iii). Although in the past a CRT that had a huge capital gain tier would have been neutral to whether to harvest losses (because accumulated capital gain would exceed distributions whether or not the losses were taken), now one should consider the 3.8% tier as well. Thus, consider recognizing losses to offset post-12/31/2012 gains.

[2121] As defined in Code § 67(e) and as adjusted under Reg. § 1.1411-10(e)(2), if applicable.

[2122] Code § 1(e).

[2123] Reg. § 1.1411-3(a)(1)(ii).

[2124] Reg. § 1.1411-3(b)(1)(v).

[2125] See part III.A.3.e.i QSSTs.

[2126] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[2127] Rev. Rul. 81-6.

[2128] Reg. § 1.1411-3(e)(2). Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual. Reg. § 1.1411-3(e)(1). Reg. § 1.1411-3(e)(5) provides examples.

[2129] Reg. § 1.1411-3(e)(3) provides:

> (i) In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in § 1.1411-1(d)(4)), the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and

To the extent that the rules governing the allocation of deductions for regular income tax purposes conflict with their NII counterparts, the regular income tax rules control.[2132] See parts II.I.6 Deductions Against NII (especially the text accompanying fns. 2113-2114) and II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

The beneficiary's NII includes the beneficiary's share of distributable net income (DNI) distributed to the beneficiary, as described in the rules governing inclusion in the beneficiary's income under the regular income tax rules, to the extent that the character of such income constitutes NII.[2133] The trustee may also declare a distribution and give the beneficiary the right

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excluded income constituted amounts not includible in gross income. See § 1.661(c)-1 and Example 1 in paragraph (e)(5) of this section.

(ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411. The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662, as applicable, from foreign estates and foreign nongrantor trusts.

[2130] Reg. § 1.1411-3(e)(4) provides:

Deduction for amounts paid or permanently set aside for a charitable purpose. In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income, the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and Example 2 in paragraph (e)(5) of this section.

If the trust does not sufficiently authorize distributions to charity, consider forming a partnership (which also might have benefits under part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries) that makes gifts deductible to the charity under Rev. Rul. 2004-5, which is discussed in fn. 4498, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Query whether the trustee would be violating fiduciary duties in allowing the partnership to make donations to charity and whether a beneficiary who fails to object is deemed to be the donor for income tax purposes. A safer approach in planning mode would be granting the noncharitable beneficiaries an inter vivos power to appoint gross income to charity; if the trust is already in place, consider decanting to grant the beneficiary such an inter vivos power (see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting). Letter Ruling 200906008. However, under 2017 tax reform, which was adopted after the NII regulations were finalized, Code § 642(c) does not apply to an ESBT; see fn 5664 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 5663 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation.

[2131] See fns. 2352 and 2353 in part II.J.4.c Charitable Distributions.

[2132] Reg. §§ 1.1411-1(c) (NII rules do not affect regular income rules), 1.1411-3(e)(3) (if any NII comprises all or part of a distribution for which an NII distribution deduction is allowed, such items retain their character as NII for purposes of computing the recipient's NII). Reg. § 1.652(b)-3(b), reproduced in fn. 2580, controls the allocation of deductions to items comprising DNI for regular income tax purposes.

[2133] Reg. § 1.1411-4(e)(1)(i) provides:

Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraphs (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in § 1.1411-3(e).

to withdraw the declared distribution – a process known as crediting that is described, along with a planning opportunity, at part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

Trustee fees are not NII to the recipient and do not constitute self-employment income unless the trustee is engaging in a trade or business.[2134] Paying reasonable trustee fees[2135] to a

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For how the rules of Code §§ 652 and 662 work, see fn. 2590 and the discussion in part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries).

[2134] Rev. Rul. 58-5 held:

> In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not a person is engaged in a trade or business is dependent upon all of the facts and circumstances in the particular case. However, the following will serve as guides in determining this question in the case of fiduciaries of decedents' estates:
>
> (1) Professional fiduciaries will always be treated as being engaged in the trade or business of being fiduciaries, regardless of the assets contained in the estate.
>
> (2) Generally, nonprofessional fiduciaries (that is, for example, persons who serve as executor or administrator in isolated instances, and then as personal representative for the estate of a deceased friend or relative) will not be treated as receiving income from a trade or business unless all of the following conditions are met:
>
> (a) There is a trade or business among the assets of the estate,
>
> (b) The executor actively participates in the operation of this trade or business,
>
> (c) The fees of the executor are related to the operation of the trade or business.

After citing some examples, including imposing self-employment tax on a trustee who manages a trade or business (see fn. 3057, found in part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues), the ruling concluded with a caveat:

> In some cases the activities of the executor of a single estate may constitute the conduct of a trade or business even though the assets of the estate do not include a trade or business as such. If, for example, an executor manages an estate which requires extensive management activities on his part over a long period of time, an examination of the facts may show that such activities are sufficient in scope and duration to constitute the carrying on of a trade or business. If doubt exists concerning the status of a fiduciary believed to be in this category, the complete facts should be transmitted to the National Office for consideration. See Rev. Rul. 54-172, C.B. 1954-1, 394.

[2135] For authority on constructive receipt of trustee fees, see Rev. Ruls. 56-472 (waiver by executor did not constitute gift or assignment of income), 64-225 (waiver after serving for many years not respected when, under the circumstances, the services performed by the trustees were not intended to be rendered gratuitously), and 66-167 (waiver made six months after beginning to serve given retroactive effect); see *Breidert v. Commissioner*, 50 T.C. 844 (1968), which held:

> Not only did petitioner waive his right to executor's fees, he did not even have sufficient cash on hand in the estate after paying the claims of creditors and the expenses of administration to pay himself such fees had he desired them. In fact, the cash on hand was insufficient to cover the fees of the attorney and the accountants who rendered substantial services to the estate. There was never any point at which executor's fees in the amount of $9,100.20, or any other sum, were credited to petitioner's account, set apart for him, or otherwise made available to him either by the estate or by the legatees and devisees of the estate. See sec. 1.451-2, Income Tax Regs. Thus, there is no factual basis here for application of the doctrine of constructive receipt. See *Mott v. Commissioner*, 85 F.2d 315, 317-318 (C.A. 6), *affirming on this issue* 30 B.T.A. 1040, 1044-1045; *Estate of W. H. Kiser*, 12 T.C. 178, 180; *S.A. Wood*, 22 B.T.A. 535, 537, *Cf. Weil v. Commissioner*, 173 F.2d 805 (C.A. 2).
>
> Although the Government's principal contention is based upon "constructive receipt," a doctrine that we have found inapplicable on the facts of this case, it also suggests that petitioner must be

trustee who is a beneficiary would reduce NII while maintaining the same aggregate taxable income between the trust and beneficiary, subject to the following caveats:

- If the trust has tax-exempt income, some of the trustee fees will be disallowed as a deduction.[2136]
- If and to the extent that trustee fees reduce qualified dividend income or other income taxed at lower rates, the tax rate on the trustee might exceed the tax benefit of the deduction.

See also part II.J.3.a Who Is Best Taxed on Gross Income, for some strategic considerations regarding whether income is best trapped inside the trust or allocated to the beneficiaries to the extent influence by overall income tax, whether federal income tax, NII tax, or state income tax.

For a description of special NII rules governing charitable remainder trusts, see the text accompanying fn. 2071 in part II.I.2 Regulatory Framework.

The AICPA has resources on the Estate and Trust Impact of 3.8% Net Investment Income Tax.[2137]

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charged with the executor's fees because he "earned" them. It does not go so far as to argue that an executor may never waive his fees so as to prevent them from being included in his gross income, but it relies upon certain revenue rulings (Rev. Rul. 66-167, 1966-1 C.B. 20; *cf.* Rev. Rul. 64-225, 1964-2 C.B. 15; Rev. Rul. 56-472, 1956-2 C.B. 21) to support its position that petitioner must in any event be accountable for the executor's fees. The precise theory of these rulings is not clear. Rev. Rul. 66-167, *supra*, appears to indicate that an executor may waive his right to compensation without incurring income tax liability, and the test is whether the waiver "will at least primarily constitute evidence of an intent to render a gratuitous service" (p. 21). Accordingly, if a waiver is made "within a reasonable time" after commencing to serve, it is regarded as "consistent with an intention to render gratuitous service" (headnote), but "if the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof" (p. 21). We need not consider whether this represents sound theory, because from our appraisal of the evidence we think petitioner never had any intention to receive compensation for his services, and that the factual foundation for applying the ruling against him is absent.

To be sure, the record before us contains material that is confusing and contradictory in respect of petitioner's intentions. Much of the confusion is attributable to the bungling manner in which petitioner's counsel handled the matter. But we are satisfied from the evidence as a whole, with particular reliance upon our impression of petitioner himself on the witness stand, notwithstanding contradictions in his testimony, that petitioner never in fact intended to receive any executor's fees, and that the subsequent written waiver merely formalized that intention.

We hold that petitioner could render gratuitous services without subjecting himself to income tax liability therefor and that the factual basis does not exist on this unusual record to charge him with having realized income on the theory of the revenue rulings, whatever that may be.

[2136] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2579.

[2137] See http://www.aicpa.org/InterestAreas/Tax/Resources/TrustEstateandGift/ToolsandAids/Pages/EstateandTrustImpactof38MedicareSurtax.aspx.

II.I.8. Application of 3.8% Tax to Business Income

II.I.8.a. General Application of 3.8% Tax to Business Income

Gross income from interest,[2138] dividends, annuities, royalties,[2139] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[2140] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2141] Gain from the sale of an asset is

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[2138] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

> Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

As described in fn. 2141, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[2139] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[2140] Reg. § 1.1411-4(b), which provides:

> Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5….

[2141] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital…

Reg. § 1.469-2T(c)(3)(ii) treats only the following as gross income derived in the ordinary course of a trade or business:

> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
>
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
>
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
>
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
>
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
>
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[2142] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2143] Other gross income from a trade or business is NII if it a passive activity.[2144]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[2145]

Income from a trade or business of trading in financial instruments[2146] or commodities[2147] is also subject to NII tax.[2148] This rule applies to traders – not to dealers or investors.[2149]

> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

[2142] Reg. § 1.1411-4(a)(1)(iii).

[2143] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See ... § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

It also provides an example showing how strict this rule is: The taxpayer uses an interest-bearing checking account at a local bank to make daily deposits of the restaurant's cash receipts and to pay the restaurant's recurring ordinary and necessary business expenses. The account's average daily balance is approximately $2,500, but at any given time the balance may be significantly more or less than this amount, depending on the business' short-term cash flow needs. Any interest the account generates constitutes NII.

[2144] Reg. § 1.1411-4(c).

[2145] Reg. § 1.1411-5(b)(1)(ii).

[2146] Reg. § 1.1411-5(c)(1) provides:

> *Definition of financial instruments.* For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

[2147] Reg. § 1.1411-5(c)(2) provides:

> *Definition of commodities.* For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

[2148] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[2149] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**
>
> Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*,

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[2150] Although a partnership's income from a trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[2151] one should consider that exit strategies[2152] and basis step-up issues[2153] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[2154]

II.I.8.a.i. Passive Activity Recharacterization Rules

Various passive activity recharacterization rules also provide NII exclusions for trade or business activity:

- Significant participation activities (more than 100 hours of participation).[2155]
- Certain rental activities.[2156]

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721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous." *Boatner v. Comm'r*, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).

An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one's own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.

For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

[2150] See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 2155.

[2151] See part II.L.1 FICA: Corporation.

[2152] See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.16 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.

[2153] See part II.H.2 Basis Step-Up Issues.

[2154] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[2155] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 2979 of part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[2156] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 2963 and 2922, respectively, within part II.K.1.e Rental Activities.

- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity[2157] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[2158] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[2159]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or business constitutes a passive activity solely with respect to such recharacterized income or gain.[2160] The relevant portfolio income provision is either:

    - the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[2161] or

    - the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[2162]

II.I.8.a.ii. Passive Activity Grouping Rules

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[2163]

> Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

[2157] Reg. § 1.469-2(c)(2)(iii), which provides, generally:

> If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either:
>
> (1) 20 percent of the period during which the taxpayer held the interest in property; or
>
> (2) The entire 24-month period ending on the date of the disposition.

An interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120% of the adjusted basis of the interest. Reg. § 1.469-2(c)(2)(iii)(C).

[2158] Reg. § 1.469-2(c)(2)(iii)(F).

[2159] Reg. § 1.1411-5(b)(2)(i).

[2160] Reg. § 1.1411-5(b)(2)(iii).

[2161] Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).

[2162] Reg. § 1.469-2(c)(2)(iii)(F).

[2163] Part 6.B.1.(b)(4) of the preamble.

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[2164]

For more information about the Code § 469 grouping rules, including regrouping as a result of the NII tax, see part II.K.1.b Grouping Activities.

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII

Certain self-charged interest[2165] or rent[2166] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[2167]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[2168] to satisfy the self-rental exception of footnote 2166:

- Although significant participation (more than 100 hours) suffices for other business income,[2169] it does not for the self-rental exception. If this contrast in treatment (between

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[2164] Reg. § 1.1411-5(b)(3), Example (2).

[2165] Reg. § 1.1411-4(g)(5) provides:

> Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

[2166] Reg. § 1.1411-4(f)(6)(i) provides:

> Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

See fn. 2206 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).

See fn. 2922 for the text of Reg. § 1.469-2(f)(6).

[2167] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[2168] See part II.K.1.a.ii Material Participation.

material participation and significant participation) is significant (particularly if the property is about be sold)[2170] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.6 Recommended Partnership Structure – Flowchart,[2171] perhaps migrating as depicted in part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[2172]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[2173]

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities

If an individual, estate, or trust owns or engages in a trade or business,[2174] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[2175]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[2176]

- whether gross income is a passive trade or business activity is determined at the owner level; and

- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[2177] is determined at the entity level.

[2169] See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[2170] See fn. 2173
[2171] This structure often is ideal; see part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.
[2172] See fn. 2921 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2173] Reg. § 1.1411-4(f)(6)(ii) provides:

> Gain or loss from the disposition of property. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

See fns. 2206 and 2924 regarding Reg. § 1.469-2(f)(6).
[2174] Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.
[2175] Reg. § 1.1411-4(b)(1).
[2176] Reg. § 1.1411-4(b)(2).
[2177] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

II.I.8.a.v. Working Capital Is NII

II.I.8.a.v.(a). Policy of Working Capital as NII

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[2178] The preamble to the proposed regulations explains:[2179]

> Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.
>
> The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.
>
> A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[2180]

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception would be moot.[2181]

[2178] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.
[2179] Part 7 of the preamble.
[2180] T.D. 9644.
[2181] Reg. § 1.1411-5(b)(3), Example (5).

II.I.8.a.v.(b). What Is Working Capital

Reg. § 1.1411-6(a) provides:[2182]

> *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411- 4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

To place context on this reference to Reg. § 1.469-2T(c)(3)(ii), Reg. § 1.469-2T(c)(3)(i) excludes from passive activity gross income items of portfolio income and further provides:

> For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—
>
> (A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));
>
> (B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));
>
> (C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

---

[2182] Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

(D) The disposition of property held for investment (within the meaning of section 163(d)).

Reg. § 1.469-2T(c)(3)(ii) provides:

> *Gross income derived in the ordinary course of a trade or business*. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—
>
> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
>
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
>
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
>
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
>
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
>
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
>
> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

As to (G) above, it has been suggested that the IRS has informally indicated its intention to broaden the definition of mineral royalty income derived in a trade or business, but taxpayers should request a ruling to receive a proper determination.[2183] The same author said that several private letter rulings held that "float revenue, as a substitute for service fees, is derived in the ordinary course of a trade or business."[2184]

[2183] Sutton & Howell-Smith, ¶ 12.03[3][a] Royalties, *Federal Income Taxation of Passive Activities* (WG&L).

[2184] Sutton & Howell-Smith, ¶ 2.02[1][f][vii] Other income identified by the Commissioner, *Federal Income Taxation of Passive Activities* (WG&L), pointing to Letter Rulings 199924020, 199924022, and 199924023.

II.I.8.a.vi. What is a "Trade or Business"?

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[2185]

> Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.
>
> As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.
>
> In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.
>
> One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.
>
> The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining

[2185] T.D. 9644.

whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

For further analysis, see part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

II.I.8.a.vii. Former Passive Activities – NII Implications

The preamble to the final regulations addressed former passive activities:[2186]

> The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.
>
> For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the

[2186] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.k Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

> If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).
>
> Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411-4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411-4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

Reg. § 1.1411-4(g)(8) provides the details described above. For more information on former passive activities, see part II.K.1.k Former Passive Activities.

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[2187] trade or business.[2188]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[2189]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[2190] the portion of the sale proceeds attributable to business assets does qualify.[2191]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2192] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[2193]

[2187] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 2145.
[2188] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[2189] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital, which is described in part II.I.8.a.v Working Capital Is NII.
[2190] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[2191] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2192] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[2193] Reg. § 1.1411-4(d)(4)(i)(B)(3).

II.I.8.c. Application of 3.8% Tax to Rental Income

As mentioned above, rental income is NII unless it is self-rental[2194] or not only is from a trade or business but also nonpassive.[2195]

Because the self-rental exception is relatively straightforward, this part II.I.8.c focuses on whether the rental not only is from a trade or business but also is nonpassive.

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[2196] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[2197] if the taxpayer materially participates.[2198]

[2194] See fn. 2166.

[2195] See fn. 2140. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d.*

[2196] See part II.K.1.e Rental Activities.

[2197] Reg. § 1.1411-5(b)(3), Example (3) provides:

> *Application of the rental activity exceptions*. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents (within the meaning of § 1.1411-4(a)(1)(i)). While $275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, and the rents are not described in § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the $25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

[2198] Reg. § 1.1411-5(b)(3), Example (4) provides:

> Application of section 469 and other gross income under § 1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals

The general rule that rental is per se passive does not apply to certain real estate professionals.[2199] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[2200]

> The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411-4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[2201]

> and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

[2199] See fns. 2913-2929.

[2200] T.D. 9655.

[2201] Reg. § 1.1411-4(g)(7) provides:

> (7) *Treatment of certain real estate professionals*
>
> (i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—

Also, Reg. § 1.1411-4(g)(7)(ii)(B) does not require that each rental activity owned by the real estate professional be a trade or business. On June 16, 2014, I informally confirmed with a drafter of the regulation that, if a real estate professional groups activities so that real estate trade or business undertakings are grouped with real estate undertakings that are not trade or business undertakings, the latter nevertheless receive treatment as not constituting NII. For example, suppose a real estate professional actively manages several real estate properties that are trade or business undertakings and also owns several properties rented using triple-net leases. If the professional groups all of those undertakings as a single activity, income from the triple-net leases does not constitute NII.

See also part II.G.27 Real Estate Special Issues.

II.I.8.c.iii. Rental as a Trade or Business

If rental activity is nonpassive under special exceptions or by reason of the taxpayer being a real estate professional, the taxpayer would apply the concepts below in conjunction with the rules of part II.I.8.a General Application of 3.8% Tax to Business Income.

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business. [2202]

The preamble to the final regulations explains how the IRS views rental as a trade or business (emphasis added):[2203]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically,

---

> (A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and
>
> (B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.
>
> (ii) *Definitions*—
>
> (A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.
>
> (B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.
>
> (iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

[2202] Part 6.B.1.(b)(4) of the preamble explains:

> … a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

[2203] T.D. 9655.

commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as Fackler v. Commissioner, 45 BTA 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.

The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[2204]

Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

[2204] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

> Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

That regulation does not say that rental is not a trade or business (although it appears in a regulation designed for activities that do not constitute trades or businesses. Rather, that regulation points out that property formerly held for personal use can later be used for the production or collection of income.

The example cited above is as follows (emphasis added):[2205]

> Rental activity. A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of $50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of $50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[2206]

> With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.
>
> Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.

[2205] Reg. § 1.1411-5(b)(3), Example 1.

[2206] T.D. 9655. Reg. § 1.1411-4(g)(6)(i):

> To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

> However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[2207] However, one of three inherited properties leased to chain stores on triple-net-leases did not constitute a trade or business;[2208] same with an inherited residential property in which the tenant was also inherited.[2209] It has been further suggested that the Board of Tax Appeals and Tax

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[2207] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

[2208] *Union National Bank of Troy v. U.S.*, 195 F.Supp. 382 (N.D. NY 1961), held:

> The record discloses that Louis Gross, the deceased taxpayer, was the distinguished Bank President of the Union National Bank in that city since 1939. It was there he gave his full energy and talent every business day from that time until his death. His one-third interest in 316 River Street came to him under his father's will upon the termination of a trust for his mother, May 29, 1946. This property was a substantial one in the business section of Troy. Like two others he similarly acquired by inheritance, it was subject to net lease of the entire property to chain stores. The lease on 316 River Street was dated March 15, 1930 and executed by his father for twenty years, to expire April 30, 1952, the lessee being F. W. Woolworth Company. The lease was a net lease, and there was no obligation at all on Gross and his family to maintain or repair. Taxes, water rents, ordinary assessments, were all the obligations of the lessee. It is undisputed in the record that Gross did not to any extent, directly or indirectly through agents, have anything at all to do with the management and operation of the property. His passive contact was to receive his share of the rents as paid. The extension of the lease was arranged by his cousin through a broker, and I am content to find that the taxpayer played no active part in the arrangement of such extension. A most significant factor in the record is that the income of Gross for all rented properties in 1953 was $7,887.49; in 1954 $3,594.06, as compared to his declared net income for those years of $80,213.92 and $81,264.06. It would crush reason to conclude in view of these facts that the rental of property was his trade or business. The government concedes in its brief that the taxpayer was not heavily involved in real estate in Troy outside of the inherited properties.

[2209] *Grier v. U.S.*, 120 F.Supp. 395 (D. Conn. 1954), *aff'd* per curiam, 218 F2d 603 (2d Cir. 1955), in which the trial court held:

Court have found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[2210] The article that made these comments offers excellent planning tips.[2211]

> In this case the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair.
>
> Lacking the broader activity stressed in *Rogers v. U. S.*, D.C. Conn. 1946, 69 F.Supp. 8, and *Pinchot v. C.I. R.*, *Gilford v. C. I. R.* and *Fackler v. C. I. R.*, *supra*, the real estate in this case appears to partake more of the nature of property held for investment than property used in a trade or business. The property in this case, although used for the production of income should not be considered as used in the taxpayer's trade or business.

[2210] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq.*, 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
>
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issue*, 776 F.2d 1428, 1433 (9th Cir. 1985).

[2211] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional

Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[2212]

The Fall 2018 meeting of the Real Estate Committee of the American Bar Association's Section of Taxation included a panel, "Real Estate Trade or Business –When Does it Matter under Tax Reform?"[2213] Here are some categories of cases cited in the slides:

- *Deductions under section 162*. *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 4.

- *Section 1231 property*. *Fackler*, 133 F.2d 509 (6th Cir. 1943); *Hazard*, 7 T.C. 372 (1946), *acq.* 1946-2 C.B. 3; *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 3; *Grier*, 120 F.Supp. 395 (D.C. Conn. 1954), *aff'd*, 218 F.2d 603 (2nd Cir. 1955); *Bauer*, 144 Ct.Cl. 308 (1958); *Balsamo*, 54 T.C.M. (CCH) 608 (1987); G.C.M. 38779 (July 27, 1981); P.L.R. 8350008 (Aug. 23, 1983).

- *Inclusion of loss within net operating loss*. *Lagreide*, 23 T.C. 508 (1954).

- *Effectively connected income for non-U.S. taxpayers*. *Pinchot*, 113 F.2d 718 (2nd Cir. 1940); *Neill*, 46 B.T.A. 197 (1942); *Barbour*, 3 T.C.M. (CCH) 216 (1944); *The Investors' Mtge. Sec. Co.*, 4 T.C.M. (CCH) 45 (1945); *Gilford*, 201 F.2d 735 (2nd Cir. 1953); *Lewenhaupt*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); *Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Amodio*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3rd Cir. 1962); Rev. Rul. 73-522, 1973-2 C.B. 226.

- *Qualified real property business indebtedness under section 108(c)*. P.L.R. 9426006 (Mar. 25, 1994).

- *Disqualified income under refundable earned income credit*. F.S.A. 200120036 (Mar. 28, 2001).

- *Property eligible for section 38 credit*. *Fegan*, 71 T.C. 791 (1979), *aff'd*, 81-1 U.S.T.C. ¶ 9436 (10th Cir. 1981).

- *Home office expense under section 280A*. *Curphey*, 73 T.C. 766 (1980).

- *Extension of time for payment of estate tax under section 6166*. Rev. Rul. 2006-34, 2006-1 C.B. 1172.

- *GO Zone bonus depreciation*. Notice 2006-77, 2006-2 C.B. 590.

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cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

[2212] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[2213] Slides had the name of panelists Peter Genz of King & Spalding, LLP, David Leavitt of PwC, Jim Sowell of KPMG LLP, and Tom West of the U.S. Treasury Dept. Who drafted the slides is unclear, but government officials never draft slides for bar association presentations. The slides used KPMG's logo. Peter Genz wrote a separate paper to support the slides.

Although the authorities arise in a number of different contexts, courts and the IRS seem to cite the cases interchangeably in determining whether a rental real estate activity rises to the level of a trade or business for purposes of the specific context

— All seem to agree that the activities of a taxpayer's agent will be taken into account in determining whether a taxpayer is engaged in a trade or business. *See, e.g., Gilford*, 201 F.2d 735 (2nd Cir. 1953); Rev. Rul. 2006-34, 2006-1 C.B. 1172.

A helpful excerpt from Rev. Rul. 2006-34 accompanies fns 6591-6592 in part III.B.5.d.ii.(a) What is a Business?, which construes "trade or business" in the context of an automatic extension of time to pay estate tax on qualifying business interests.

Equipment rental appears to have much easier standards in qualifying as a trade or business.[2214]

Combining all of the ideas above:

- The IRS considers:
  - The type of property (commercial real property versus a residential condominium versus personal property),
  - The number of properties rented, the day-to-day involvement of the owner or its agent, and
  - The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).
- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person. The fairest view is that, for a single property, it depends.[2215]

[2214] See fns. 3150-3151 in part II.L.2.a.ii Rental Exception to SE Tax, discussing cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

[2215] In analyzing the existence of a trade or business under Code § 108, Letter Ruling 9840026 reasoned:

> The rental of even a single property may constitute a trade or business under various provisions of the Code. See, *e.g.*, *Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq.*, 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-2 C.B. 7 (same); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) (same); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), *acq.*, 1956-1 C.B. 5 (section 122 of the 1939 Code); *Elek v. Commissioner*, 30 T.C. 731 (1958), *acq.*, 1958-2 C.B. 5 (same); *Fegan v. Commissioner*, 71 T.C. 791 (1979), *aff'd*, 81-1 USTC ¶ 9436 (10th Cir. 1981) (section 482); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (section 302 of 1926 Act); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911) (Corporation Tax). However, the ownership and rental of property does not always constitute a trade or business. See *Neill v. Commissioner*, 46 B.T.A. 197 (1942); Rev.

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from leases in which the landlord does nothing and moving towards leases in which the landlord provides significant services, such as inside and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply. Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[2216]

See also part II.G.27 Real Estate Special Issues.

Rul. 73-522, 1973-2 C.B. 226. The issue of whether the rental of property is a trade or business of a taxpayer is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. *Bauer v. United States*, 168 F.Supp. 539, 541 (Ct. C1. 1958); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955); See *Higgins v. Commissioner*, 312 U.S. 212 (1941) (management of taxpayer's own investment portfolio not a business).

In Rev. Rul. 73-522, 1973-2 C.B. 226, the Service held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of section 871 of the Code. Section 871 provides special rules for taxation of a nonresident alien engaged in a trade or business in the United States. Under the facts of the ruling, the taxpayer owned rental property situated in the United States that was subject to long-term leases providing for monthly payments by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the leased property. See also *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

For more on Rev. Rul. 73-522 and related cases regarding whether nonresident aliens holding U.S. real estate are engaging in a trade or business, see part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.

[2216] See part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[2217]

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[2218]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[2217] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3895, the latter for rates.

[2218] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[2219]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[2220]

[2219] REG-130843-13.

[2220] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 2225 clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

For the self-employment consequences of guaranteed payments for services, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[2221] the preamble to the 2013 proposed regulations explains certain general ideas:[2222]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").
>
> Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.
>
> Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 2167.

[2221] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[2222] REG-130843-13.

> Section 1.469-2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[2223]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[2224]

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[2225] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

[2223] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

> In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[2224] REG-130843-13.

[2225] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

Thus, Code § 736(b) payments are treated as sales of partnership interests,[2226] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[2227] even though for income tax purposes each year's payment stands alone.[2228]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[2229]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.
>
> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[2230]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that

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[2226] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[2227] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[2228] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 5058 and 5085 and the accompanying text.

[2229] REG-130843-13.

[2230] REG-130843-13.

> income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.
>
> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[2231] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive share is not NII.[2232] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[2233] note that a retired partner generally would not be materially participating, although it is possible that the retired partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[2234] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[2235]

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[2236]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411

[2231] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 2225 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

[2232] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.

[2233] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).

[2234] See part II.K.1.a.ii Material Participation.

[2235] See part II.K.1.a.ii Material Participation, including fn. 2793, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

[2236] REG-130843-13.

> treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[2237]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.
>
> The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).
>
> If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[2238] and goodwill,[2239] for NII purposes it is treated as gain from the disposition of a partnership interest.[2240] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and

[2237] REG-130843-13.
[2238] Within the meaning of Code § 751(c).
[2239] As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 2912.
[2240] Prop. Reg. § 1.1411-4(g)(11)(iii)(A).

goodwill, for NII purposes it is treated as payment for services[2241] or the payment of interest consistent with its characterization under the passive loss rules.[2242]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[2243]

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

> In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.

[2241] Because this characterization is only for NII purposes (see fn. 2082), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

[2242] Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 2167.

[2243] For the favorable rules regarding prior participation, see text accompanying fns. 2234-2235.

For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest….

Getting into the details, Reg. § 1.1411-4(a)(1)(iii) taxes as net investment income:

Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(A) provides:

Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

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Reg. § 1.1411-4(d)(4)(i)(B)(1) provides:

> A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

Reg. § 1.1411-5(a) provides:

> *In general*. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--
>
> (1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or
>
> (2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

For whether assets are used in a business, see part II.I.8.a.v Working Capital Is NII (as describing Reg. § 1.1411-6). However, ultimately part II.I.8.a.v.(b) What Is Working Capital provides an additional exclusion under Reg. § 1.1411-7, which needs to be addressed anyway, as described in Reg. § 1.1411-4(d)(4)(i)(B)(1) above.

Note that qualified self-created intangible assets used in a business are never passive; see part II.K.1.g Not Passive If Gain from Sale of Self-Created Intangible. (Goodwill is within the definition but is not specifically mentioned. For taxation of the sale of goodwill, see part II.Q.1.c Personal Goodwill and Covenants Not to Compete.[2244] Arguably, personal goodwill in connection with an individual's work in a C corporation is also excluded from NII.[2245]) Thus, such assets are not described in Reg. § 1.1411-5(a) and do qualify for the exception from NII under Reg. § 1.1411-4(a)(1)(iii). I do not view this as the exclusive way to protect gain from the sale of intangible assets from NII tax; I just wanted to point out this provision.

The preamble to the final regulations explains:[2246]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

[2244] Self-created goodwill is taxed differently than purchased goodwill. See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[2245] See Hesse, "Personal Goodwill and the Net Investment Income Tax," *The Tax Adviser* 5/1/2016.
[2246] T.D. 9655.

The preamble to the 2013 proposed regulations summarized these rules:[2247]

> 9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S corporations
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.
>
> The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the Passthrough Entity's passive assets.
>
> The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.
>
> Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.
>
> Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments

[2247] REG-130843-13.

required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[2248] held in a nonpassive trade or business.[2249]

Thus, to determine whether net gain is from property held in a trade or business:[2250]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[2251] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2252]

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:[2253]

    - from a passive trade or business activity is determined at the owner level; and

    - derived in trade or business of a trader trading in financial instruments or commodities[2254] is determined at the entity level.

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[2248] As described in Reg. § 1.1411-6.
[2249] Reg. § 1.1411-4(d)(4)(i)(A).
[2250] Reg. § 1.1411-4(d)(4)(i)(B).
[2251] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.
[2252] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2253] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2254] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

The preamble to the final regulations explains how Code § 469(g) (the rule governing the disposition of a passive activity, which is described in part II.K.1.j Complete Disposition of Passive Activity) interacts with the 3.8% tax:[2255]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.
>
> Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).
>
> The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the

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[2255] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:

> *Treatment of section 469(g)(1) losses.* Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.

Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[2256]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[2257]

- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[2258] or

[2256] Reg. § 1.1411-4(f)(9).

[2257] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.

- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[2259]

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[2260]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[2261]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[2262]

- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 2260 above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).

- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

Also, a 250-hour safe harbor applies to allow rental real estate to qualify as a business for the Code § 199A deduction for pass-through business entities. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business within part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[2263]

[2258] See part II.K.1.a.ii Material Participation, including fn. 2793, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[2259] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.
[2260] See fns. 2790-2791 and accompanying text, found in part II.K.1.a.ii Material Participation.
[2261] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[2262] See part II.K.1.a Counting Work as Participation.
[2263] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[2264]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[2265]

See also part II.G.27 Real Estate Special Issues.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker and II.L.6 SE Tax N/A to Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[2266] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 2294-2298.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the landlord to materially participate in the tenant's business.[2267] Material participation in the tenant's business includes owning an interest in the tenant's business.[2268] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary,

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[2264] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.

[2265] For details and nuances, see fn. 2963 in part II.K.1.e Rental Activities.

[2266] Code § 164(f)(1).

[2267] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 2172, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 2921-2922.

[2268] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[2269] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last), perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[2270]

- Regrouping passive activities.[2271]
- Pre-2013 installment sales that might generate net investment income in 2013 and later years.
- Controlled foreign corporation and qualified electing fund stock.
- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[2272]

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring

[2269] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2270] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.
[2271] See parts II.K.1.b.ii Grouping Activities – General Rules and II.K.1.b.iv Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.
[2272] Code § 1411(e)(1).

minimum distributions to be taken.[2273] Even though retirement plan distributions are not NII, income from distributions increases MAGI.

- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[2274]

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[2275]

> an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

A life estate might create a relationship that rises to the level of a trust.[2276]

However, a mere agency agreement does not constitute a trust.[2277] Nor does a court-supervised guardianship or conservatorship for a minor or other incapacitated person.[2278]

[2273] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).

[2274] Code § 453, which is subject to Code §§ 453A and 453B.

[2275] Reg. § 301.7701-4(a), which further provides:

> Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

That a beneficiary provided consideration for the trust's establishment does not prevent the trust from being classified as such. *Hanover Bank v. Commissioner*, 40 T.C. 532 (1963), *acq.* 1964-2 C.B. 5, which further held:

> There does not appear to be any ambiguity in the agreement concerning the creation of the trust and, in fact, all the parties to that agreement, including Frances, have long treated the agreement as creating a valid trust. Petitioners Strong reported as trust income in 1953 and 1954 most of the amounts paid to them by the trustee. Long-standing interpretations should be given consideration and will not lightly be set aside even when there is ambiguity in the instrument, *Babette B. Israel*, 11 T.C. 1064 (1948). Furthermore, the Supreme Court of New York previously construed the agreement as creating a valid trust and the material parts of that judgment are set forth in our Findings of Fact. Judicial constructions by State courts are conclusive as to the legal extent and character of the interests created under such an agreement, *Louise Savage Knapp Trust A*, 46 B.T.A. 846 (1942).
>
> The situation here is distinguishable from cases such as *Lyeth v. Hoey*, 305 U.S. 188, and *Chase National Bank et al., Executors*, 40 B.T.A. 44 (1939). In each of those cases the taxpayer threatened to take contrary to a will and in each case compromised his claims. The Courts determined that the property received in compromise was the substitute for an inheritance. In the instant case, Frances did not contest the disposition and the amounts she received were not in compromise of any claim she may have had.

[2276] Taxpayers sought that conclusion in fn. 5585 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

See also part II.D Special Purpose Trusts.

This part II.J tends to focus on estates and nongrantor trusts and often refers to such entities when referring to trust. In many ways, estates are taxed as nongrantor trusts that are not required to distributed all of their income, so a reference to such a trust tends to apply to an estate as well; however, as with anything in these materials, a tax professional should apply independent judgment to any such inference.

For a focus on grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and III.B.2.h How to Make a Trust a Grantor Trust.

II.J.1. Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries

Our fiduciary income tax system, generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[2279]

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[2280] It also deducts any other amounts of DNI that are "properly paid or credited or required to be distributed" for the taxable year.[2281] Thus, a mandatory income

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[2277] Rev. Rul. 76-265 held:

> In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.
>
> Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

Letter Ruling 200227012 followed Rev. Rul. 76-265.

[2278] Reg. § 1.6012-3(b)(3).

[2279] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

[2280] Code § 651 and Code § 661(a)(1), (c). Code § 643(a) defines DNI, and Code § 643(b) defines accounting income. For more on accounting income, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which generally covers the area of accounting income, with extra attention paid to capital gains.

[2281] Code § 661(a)(2), (c). A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a US person. For the latter rule, see Code § 643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); TAM 8341005 (following *Plant* - real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3rd Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust. I have not read but have seen cited *Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd* 171 F.2d 704 (3rd Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961).

feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[2282] The beneficiary includes in income the amount of the trust's deduction for DNI.[2283]

The above is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[2284] and charitable deductions.[2285]

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended

Code § 663(b) allows distributions in the first 65 days of the taxable year to count as distributions in the current or prior year's tax return.

Thus, the trustee can count distributions from January 1, 2020 through and including March 5, 2020 as 2019 or 2020 distributions or a combination thereof.[2286]

When in doubt, distribute more rather than less (if distributions are appropriate).[2287] The tax return, including extensions, will determine how much of the distribution counts as a distribution for the year just ended or for the year in which the distribution is made, but the distribution needs to be made within the 65-day period.

[2282] Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

[2283] Code §§ 651, 652.

[2284] See part II.J.9.a.ii Separate Share Rule.

[2285] As described in part II.J.4.c Charitable Distributions, Code § 642(c) generally governs charitable deductions. Among other issues, see part II.Q.7.c S corporations Owned by a Trust Benefitting Charity, which also covers how a trust's income from business or certain other activities affects the charitable deduction.

[2286] Reg. § 1.663(b)-2(a), "Manner and time of election; irrevocability," provides:

> (1) *When return is required to be filed.* If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.
>
> (2) *When no return is required to be filed.* If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

In granting an extension of time to make a Code § 663(b) election, Letter Ruling 9215033 held:

> The time for filing an election under section 663(b) of the Code is fixed by section 1.663(b)-2(a)(1) of the regulations. Accordingly, the Commissioner has discretionary authority pursuant to section 301.9100-1(a) of the regulations to grant an extension of time for making the section 663(b) election provided good cause is shown and the other requirements of section 301.9100-1(a) are met.

[2287] See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[2288]

II.J.3. Strategic Fiduciary Income Tax Planning

Planning for fiduciary income tax is a matter of comparing taxation at the trust level, beneficiary level, or deemed owner level, including the following issues:

- Who is best taxed on gross income?[2289]
- Who benefits most from deductions?[2290]
- Consider not only the effect of federal tax but also state and local income tax.[2291]
- Does the method of shifting the incidence of taxation undermine any material purpose of the trust?
- Do decisions made for the current taxable year affect taxation in future years?
- How much flexibility does a trustee have for currently irrevocable trusts, and can this flexibility be enhanced?
- How should one draft to provide more flexibility?

For distributing capital gain, see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

Also note that beneficiaries who are trustees can reduce income subject to the net investment income tax by taking reasonable trustee fees; however, this strategy is not a good idea if the trust has any significant tax-exempt income (because the deduction would be disallowed to the extent allocable to tax-exempt income,[2292] but the entire fee income would still be recognized) or if and to the extent the deduction would offset income (such as qualified dividends or long-term capital gain) taxable at a lower rate. For other aspects of the NII tax, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and II.I.9 Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII.

II.J.3.a. Who Is Best Taxed on Gross Income

Increased adjusted gross income (AGI) might cause a beneficiary to lose tax benefits, effectively increasing the beneficiary's marginal income tax rate. Therefore, even if the trust and beneficiary have the same nominal rate, the beneficiary might have a higher effective tax rate. Increased beneficiary AGI can cause the following tax detriments:

[2288] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[2289] See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
[2290] See part II.J.3.d Who Benefits Most from Deductions.
[2291] See part II.J.3.e State and Local Income Tax.
[2292] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2579.

- Reduction in Particular Itemized Deductions. Itemized deductions such as medical expenses and casualty losses are reduced as AGI increases.

- Phase Out of AMT Exemption. The alternative minimum tax exemption is phased out and eventually eliminated once income exceeds certain limits.

- Net Investment Income (NII) Tax.

  - Once an individual's income exceeds certain thresholds, NII tax applies.[2293] Although a trust's income quickly becomes subject to the NII tax, the threshold for an individual is much higher.

  - NII tax applies to passive income.[2294] The trustee of a nongrantor trust might not be a suitable person to participate sufficiently to avoid the income being characterized as passive, and the rules governing whether a trustee's work constitutes participation are challenging to apply.[2295] If the trust is a grantor trust, the deemed owner's work is what counts while that person is the deemed owner,[2296] although the trustee's work might be important to set the stage for future nonpassive treatment.[2297] For a nongrantor trust, beneficiary's participation should count for depreciation but does not count for other items of business income.[2298]

  - If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[2299]

If the trust has business income, consider planning opportunities described in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

Also, consider whether the trust or the beneficiary has capital loss (or, less likely but still possible, net operating loss) carryovers against which to offset trust income.

[2293] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[2294] See part II.I.8 Application of 3.8% Tax to Business Income.
[2295] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2296] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 2124.
[2297] The trust will cease to be a grantor trust when the deemed owner dies, if the grantor trust powers are not turned off before then. If a QSST sells its S corporation stock, the sale is taxed to the trust rather than to the beneficiary. Consider having the trustee work in the business to try to establish participation, looking toward those events. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax), II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[2298] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.
[2299] Individuals cannot deduct charitable contributions against NII (the charitable deduction is not listed in part II.I.6 Deductions Against NII), but trusts can. See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 2130.

II.J.3.b. Effect of Kiddie Tax on Rates

Code § 1(g) requires the tax of certain children, including certain students who have not attained age 24 as of the close of such calendar year, to compute their income tax based on their parents' rates.

However, no comparable rule applies to computing children's 3.8% net investment income tax.[2300]

Thus, shifting income to children subject to the kiddie tax can still result in tax savings.

Code § 1(j)(4) provides special rules relating to the kiddie tax for any taxable year beginning after December 31, 2017, and before January 1, 2026. Unearned income is taxable based on trust tax brackets.

II.J.3.c. Who Is Benefits the Most from Losses

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

II.J.3.d. Who Benefits Most from Deductions

Consider that generally the fiduciary income tax system allows nongrantor trusts[2301] to net deductions against income before allocating income to beneficiaries. Thus, incurring expenses at the trust level provides benefits similar to trapping income inside trusts described in part II.J.3.a Who Is Best Taxed on Gross Income. However, depreciation deductions may pass through directly to beneficiaries, and trusts cannot use Code § 179 to expense assets but instead need to rely on bonus depreciation.[2302]

Note that miscellaneous itemized deductions are disallowed for any taxable year beginning after December 31, 2017 and before January 1, 2026.[2303] However, favorable treatment is provided deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.[2304] Unfortunately, this favorable treatment does not apply to grantor trusts.[2305]

[2300] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.

[2301] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.

[2302] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.

[2303] See part II.G.4.l.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

[2304] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought. Some people have suggested that Code § 67(g) limitations may apply to Code § 67(e). However, Code § 67(e)(1) provides that its deductions "shall be treated as allowable in arriving at adjusted gross income," and Code § 63(d)(1) provides:

> For purposes of this subtitle, the term "itemized deductions" means the deductions allowable under this chapter other than … the deductions allowable in arriving at adjusted gross income ….

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's (and a trust's, which are the same as an individual's except as provided otherwise) deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to a Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[2306] Suppose an individual is the beneficiary of a nongrantor trust that pays $10,000 in state taxes, and the individual pays $10,000 in state taxes. The individual and trust would deduct a total of $20,000 of state taxes. However, if the trust were a grantor trust, then only one $10,000 amount – the individual's – would apply. Splitting income among multiple trusts may generate more entities with up to $10,000 state income tax deductions, but beware part II.J.9.c Multiple Trusts Created for Tax Avoidance.

Charitable deductions often produce more benefit to a trust than to an individual.[2307]

Certain losses from the sale of small business stock[2308] are not available to nongrantor trusts,[2309] so grantor trust planning might be considered for that asset. Similarly, depreciation deductions allocated to the remaindermen of a nongrantor trust that is included in the grantor's or beneficiary's estate reduce the basis step-up; presumably this rule would not apply to a grantor trust.[2310]

II.J.3.e. State and Local Income Tax

II.J.3.e.i. Strategic State & Local Tax Issues re: Residence

Consider whether income trapped inside a trust might be taxed at a lower state and local income tax rate (or entirely exempt from such tax) than income reported on a beneficiary's income tax return.

Generally, states do not tax nonbusiness income earned by a nonresident trust. Some high income-tax states fail to tax income earned by trusts set up by their residents that are administered in other jurisdictions, which has led to the creation of incomplete gift nongrantor (ING) trusts to cause capital gain from investments to avoid state income tax.[2311] An ING trust

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Thus, Code § 67(e)(1) deductions are not itemized deductions and cannot be characterized under Code § 67(b) as miscellaneous itemized deduction that would have been allowed under Code § 67(a) but for Code § 67(g).

[2305] Code § 67(c)(1), which Reg. § 1.67-2T(e)(3) applies to grantor trusts.

[2306] Income taxes attributable to a trade or business remain subject to the $10,000 limit. For more details about my comment on real estate as a trade or business, see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

[2307] See part II.J.4.c Charitable Distributions, text accompanying fns 2357-2365.

[2308] See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

[2309] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[2310] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[2311] "Incomplete nongrantor" is abbreviated ING, so one often hears of DING (Delaware ING) or NING (Nevada ING) trusts, even though the strategy is available for trusts established in other states (including Missouri). Private letter rulings approving such trusts treat certain trustees as adverse for income tax but not gift tax purposes without explaining how those conditions can coexist.

Now I have some silly comments to add spice to your day:

- Suppose your DING also has some asset protection features. It might be a bankruptcy avoidance trust (BAT). Being a DING-BAT, it was referred to frequently in the TV series, "All in the Family."

typically uses a distribution committee that is an "adverse party" for income tax purposes, avoiding application of the Code § 674 grantor trust rules,[2312] yet for transfer tax purposes is not "adverse," causing the gift to be incomplete.[2313] Rev. Proc. 2020-3 imposes requirements on the distribution committee before the IRS will issue a private letter ruling.[2314] If a married couple transfers community property to an ING and that property retains its character as community property, then that community property will receive a new basis for both halves.[2315]

Consider whether:

- The trustee could have minimized tax by moving the trust.

- By changing residence, the trustee has subjected the trust to income tax. Sometimes a trustee moves, doesn't realize that the move subjects the trust to fiduciary income tax, fails to file, then makes the trust liable for not only tax but also interest and penalties.

Consider preparing and updating a contacts list for the trust to see what contacts the trust has with which states and whether that can generate state income tax liability or whether contacts can be changed to reduce or eliminate state income tax.

- Suppose you have a Missouri ING, and to the extent the grantor allocates GST exemption at death it terminates in favor of a perpetual trust. This MING Dynasty Trust might be appropriate to hold 13th century Chinese artifacts.

[2312] See part III.B.2.h.vi.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment.

[2313] *Income Taxation of Fiduciaries & Beneficiaries by Abbin*, CCH, § 1407.1.7 No Grantor Trust Status Even Though Transfer Was Incomplete Gift, citing Letter Rulings 201310002-201310006, 201410001-201410010, 201430003-201430007, 201550005-201550012, 201636027, 201650005, 201653001-201653009, 201718003-201718010, 201729009, 201742006, 201744006-201744008, and 201751001-201751003, as well as earlier rulings.

[2314] Rev. Proc. 2020-3, § 3.01(93), "Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners," says that the IRS will not rule on the following:

> Whether any portion of the items of income, deduction, and credit against tax of the trust will be included in computing under § 671 the taxable income, deductions and credits of grantors when distributions of income or corpus are made – (A) at the direction of a committee, with or without the participation of the grantor, and (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse; or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee or (B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A) of this section).

[2315] Letter Ruling 201850001 concluded:

> Grantors are married and reside in State 2, a community property state. Trust provides that all transferred property to Trust is community property. Moreover, any and all property transferred to Trust prior to the death of the Predeceased Grantor is and shall retain its character as community property. As concluded above, upon the death of each of Grantor, his or her respective interest in Trust as either the Predeceased Grantor or the Surviving Grantor will be includible in his or her respective gross estate for federal estate tax purposes.
>
> Accordingly, based upon the facts submitted and representations made, we conclude that the basis of all community property in Trust on the date of death of the Predeceased Grantor will receive an adjustment in basis to the fair market value of such property at the date of death of the Predeceased Grantor.

Companion rulings concluding to the same effect are Letter Rulings 201850002-201850006.

Before making a Code § 645 election to treat a revocable trust as an estate, consider whether that will subject the trust (and trusts created upon its funding) to state income tax.[2316]

If a state that imposes income tax follows the federal rules, exercising a general power of appointment might shift the grantor.[2317] If such a shift is undesirable, see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

II.J.3.e.ii. When a State Can or Does Tax a Trust's Income

I do not maintain a chart of when a state asserts the right to tax a trust's income. I suggest the reader check the research service of his or her choice.

If and to the extent a trust's income is carried out to a beneficiary on a K-1, that beneficiary's home state taxes the income at the beneficiary level and generally the issue of the trust's residency is moot.

For income a trust retains, in a unanimous opinion, *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. __ (2019), held that North Carolina could not tax a trust whose only ties consisted of a beneficiary who may at some point receive distributions in the trustee's "absolute discretion." The Syllabus prepared by the court reporter, which has no precedential value, summarized:

> Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York and appointed a fellow New York resident as the trustee. The trust agreement granted the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. In 1997, Rice's daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee later divided Rice's initial trust into three separate subtrusts, and North Carolina sought to tax the Kimberley Rice Kaestner 1992 Family Trust (Trust) - formed for the benefit of Kaestner and her three children - under a law authorizing the State to tax any trust income that "is for the benefit of" a state resident, N.C. Gen. Stat. Ann. § 105–160.2. The State assessed a tax of more than $1.3 million for tax years 2005 through 2008. During that period, Kaestner had no right to, and did not receive, any distributions. Nor did the Trust have a physical presence, make any direct investments, or hold any real property in the State. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, holding that the Kaestners' in-state residence was too tenuous a link between the State and the Trust to support the tax.
>
> *Held*: The presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it. Pp. 5–16.

[2316] See fn. 2494, found in part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[2317] Reg. § 1.671-2(e)(5). For Connecticut income tax purposes, Connecticut Legal Ruling 2005-2 held:

> The residency status of an appointive trust created by the exercise of a power of appointment that is not a general power of appointment is to be determined by the residency of the donor of the power of appointment. The residency status of an appointive trust created by the exercise of a general power of appointment is to be determined by the residency of the donee of the power of appointment.

By "donor," the ruling was referring to the settlor. The ruling is my doc. no. 6517233.

(a) The Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state." *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 444. Compliance with the Clause's demands "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that "the 'income attributed to the State for tax purposes . . . be rationally related to "values connected with the taxing State," ' " *Quill Corp. v. North Dakota*, 504 U. S. 298, 306. That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. *Id.*, at 307. Pp. 5–6.

(b) In the trust beneficiary context, the Court's due process analysis of state trust taxes focuses on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets. Cases such as *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83; *Brooke v. Norfolk*, 277 U.S. 27; and *Maguire v. Trefry*, 253 U. S. 12, reflect a common principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax. *Safe Deposit*, 280 U. S., at 91. Similar analysis also appears in the context of taxes premised on the in-state residency of settlors and trustees. See, *e.g.*, *Curry v. McCanless*, 307 U.S. 357. Pp. 6–10.

(c) Applying these principles here, the residence of the Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax. First, the beneficiaries did not receive any income from the Trust during the years in question. Second, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets in the tax years at issue. Third, they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Pp. 10–13.

(d) The State's counterarguments are unconvincing. First the State argues that "a trust and its constituents" are always "inextricably intertwined," and thus, because trustee residence supports state taxation, so too must beneficiary residence. The State emphasizes that beneficiaries are essential to a trust and have an equitable interest in its assets. Although a beneficiary is central to the trust relationship, the wide variation in beneficiaries' interests counsels against adopting such a categorical rule. Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. But only a small handful of States rely on beneficiary residency as a sole basis for trust taxation, and an even smaller number rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets. Finally, the State urges that adopting the Trust's position will lead to opportunistic gaming of state tax systems. There is no certainty, however, that such behavior will regularly come to pass, and in any event, mere speculation about negative consequences cannot conjure the "minimum connection" missing between the State and the object of its tax. Pp. 13–16.

371 N.C. 133, 814 S.E.2d 43, affirmed.

SOTOMAYOR, J., delivered the opinion for a unanimous Court. ALITO, J., filed a concurring opinion, in which ROBERTS, C. J., and GORSUCH, J., joined.

After reviewing case law on Due Process, the Court held:

> Applying these principles here, we conclude that the residence of the Kaestner Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax.
>
> First, the beneficiaries did not receive any income from the trust during the years in question. If they had, such income would have been taxable. See *Maguire*, 253 U.S., at 17; *Guaranty Trust Co.*, 305 U. S., at 23.
>
> Second, the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue. The decision of when, whether, and to whom the trustee would distribute the trust's assets was left to the trustee's "absolute discretion." Art. I, § 1.2(a), App 46–47. In fact, the Trust agreement explicitly authorized the trustee to distribute funds to one beneficiary to "the exclusion of other[s]," with the effect of cutting one or more beneficiaries out of the Trust. Art. I, § 1.4, *id.*, at 50. The agreement also authorized the trustee, not the beneficiaries, to make investment decisions regarding Trust property. Art. V, § 5.2, *id.*, at 55–60. The Trust agreement prohibited the beneficiaries from assigning to another person any right they might have to the Trust property, Art. XII, *id.*, at 70–71, thus making the beneficiaries' interest less like "a potential source of wealth [that] was property in [their] hands." *Curry*, 307 U.S., at\ 370–371.[9]
>
> > [9] We do not address whether a beneficiary's ability to assign a potential interest in income from a trust would afford that beneficiary sufficient control or possession over, or enjoyment of, the property to justify taxation based solely on his or her in-state residence.
>
> To be sure, the Kaestner Trust agreement also instructed the trustee to view the trust "as a family asset and to be liberal in the exercise of the discretion conferred," suggesting that the trustee was to make distributions generously with the goal of "meet[ing] the needs of the Beneficiaries" in various respects. Art. I, § 1.4(c), App. 51. And the trustee of a discretionary trust has a fiduciary duty not to "act in bad faith or for some purpose or motive other than to accomplish the purposes of the discretionary power." 2 Restatement (Third) of Trusts §50, Comment c, p. 262 (2003). But by reserving sole discretion to the trustee, the Trust agreement still deprived Kaestner and her children of any entitlement to demand distributions or to direct the use of the Trust assets in their favor in the years in question.
>
> Third, not only were Kaestner and her children unable to demand distributions in the tax years at issue, but they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Although the Trust agreement provided for the Trust to terminate in 2009 (on Kaestner's 40th birthday) and to distribute assets to Kaestner, Art. I, § 1.2(c)(1), App. 47, New York law allowed the trustee to roll over the trust assets into a new trust rather than terminating it. N.Y. Est., Powers & Trusts § 10–6.6(b). Here, the trustee did just that. 371 N. C., at 135, 814 S.E.2d, at 45.[10]
>
> > [10] In light of these features, one might characterize the interests of the beneficiaries as "contingent" on the exercise of the trustee's discretion. See *Fondren v. Commissioner*, 324 U.S. 18, 21 (1945) (describing "the exercise of the trustee's discretion" as an example of a contingency); see also *United States v. O'Malley*, 383 U.S. 627, 631

(1966) (describing a grantor's power to add income to the trust principal instead of distributing it and "thereby den[y] to the beneficiaries the privilege of immediate enjoyment and conditio[n] their eventual enjoyment upon surviving the termination of the trust"); *Commissioner v. Estate of Holmes*, 326 U.S. 480, 487 (1946) (the termination of a contingency changes "the mere prospect or possibility, even the probability, that one may have [enjoyment of property] at some uncertain future time or perhaps not at all" into a "present substantial benefit"). We have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future. See, *e.g.*, Cal. Rev. & Tax. Code Ann. § 17742(a) (West 2019); *Commonwealth v. Stewart*, 338 Pa. 9, 16–19, 12 A.2d 444, 448–449 (1940) (upholding a tax on the equitable interest of a beneficiary who had "a right to the income from [a] trust for life"), *aff'd*, 312 U.S. 649 (1941).

Like the beneficiaries in *Safe Deposit*, then, Kaestner and her children had no right to "control or posses[s]" the trust assets "or to receive income therefrom." 280 U.S., at 91. The beneficiaries received no income from the Trust, had no right to demand income from the Trust, and had no assurance that they would eventually receive a specific share of Trust income. Given these features of the Trust, the beneficiaries' residence cannot, consistent with due process, serve as the sole basis for North Carolina's tax on trust income.[11]

[11] Because the reasoning above resolves this case in the Trust's favor, it is unnecessary to reach the Trust's broader argument that the trustee's contacts alone determine the State's power over the Trust. Brief for Respondent 23–30. The Trust relies for this proposition on *Hanson v. Denckla*, 357 U.S. 235 (1958), which held that a Florida court lacked jurisdiction to adjudicate the validity of a trust agreement even though the trust settlor and most of the trust beneficiaries were domiciled in Florida. *Id.*, at 254. The problem was that Florida law made the trustee "an indispensable party over whom the court [had to] acquire jurisdiction" before resolving a trust's validity, and the trustee was a nonresident. *Ibid.* In deciding that the Florida courts lacked jurisdiction over the proceeding, the Court rejected the relevance of the trust beneficiaries' residence and focused instead on the "acts of the trustee" himself, which the Court found insufficient to support jurisdiction. *Ibid.* The State counters that Hanson is inapposite because the State's tax applies to the trust rather than to the trustee and because Hanson arose in the context of adjudicative jurisdiction rather than tax jurisdiction. Brief for Petitioner 21, n. 9; Reply Brief 16–17. There is no need to resolve the parties' dueling interpretations of *Hanson*. Even if beneficiary contacts - such as residence - could be sufficient in some circumstances to support North Carolina's power to impose this tax, the residence alone of the Kaestner Trust beneficiaries cannot do so for the reasons given above.

When rebuffing North Carolina's arguments, the Court discussed other states' laws:

Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. Tr. of Oral Arg. 8, 68; Brief for Petitioner 6, and n. 1. Today's ruling will have no such sweeping effect. North Carolina is one of a small handful of States that rely on beneficiary residency as a sole basis for trust taxation, and one of an even smaller number that will rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets.[12] 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).[13] We express no opinion on the validity of such taxes.

> [12] The State directs the Court's attention to 10 other state trust taxation statutes that also look to trust beneficiaries' in-state residency, see Brief for Petitioner 6, and n. 1, but 5 are unlike North Carolina's because they consider beneficiary residence only in combination with other factors, see Ala. Code § 40–18–1(33) (2011); Conn. Gen. Stat. § 12–701(a)(4) (2019 Cum. Supp.); Mo. Rev. Stat. §§ 143.331(2), (3) (2016); Ohio Rev. Code Ann. §5747.01(I)(3) (Lexis Supp. 2019); R.I. Gen. Laws § 44–30–5(c) (2010). 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. See Mont. Admin. Rule 42.30.101(16) (2016); N.D. Admin. Code § 81–03–02.1–04(2) (2018). Similarly, Georgia's imposition of a tax on the sole basis of beneficiary residency is disputed. See Ga. Code Ann. § 48–7–22(a)(1)(C) (2017); Brief for Respondent 52, n. 20. Tennessee will be phasing out its income tax entirely by 2021. H.B. 534, 110th Gen. Assem., Reg. Sess. (2017) (enacted); see Tenn. Code Ann. § 67–2–110(a) (2013). That leaves California, which (unlike North Carolina) applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent. Cal. Rev. & Tax. Code Ann. § 17742(a); see also n. 10, *supra*.

> [13] 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. See, *e.g.*, Cal. Rev. & Tax. Code Ann. §17745(b).

The Court rebuffed North Carolina's concern that "adopting the Trust's position will lead to opportunistic gaming of state tax systems" (highlighting is mine):

> Though this possibility is understandably troubling to the State, it is by no means certain that it will regularly come to pass. First, the power to make distributions to Kaestner or her children resides with the trustee. When and whether to make distributions is not for Kaestner to decide, and in fact the trustee may distribute funds to Kaestner while she resides in North Carolina (or deny her distributions entirely). Second, we address only 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. Settlors who create trusts in the future will have to weigh the potential tax benefits of such an arrangement against the costs to the trust beneficiaries of lesser control over trust assets. In any event, mere speculation about negative consequences cannot conjure the "minimum connection" missing between North Carolina and the object of its tax.

The highlighted text above suggests that the case protects only trusts where any future distribution to any beneficiary in the state is speculative. The Court noted in passing that 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.[2318]

At a meeting of fiduciary income tax experts at the end of June 2019, I heard the following:

[2318] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

- 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 have been filed.

- *Kaestner* has no bearing on most other states. North Carolina, Georgia, and Tennessee are the only directly affected states, and Tennessee will get rid of its income tax.

- Counsel for the state struggled to explain how state and federal income taxation are connected. He later publicly admitted that he got raked over the coals by the Supreme Court justices.

- Attendees were disappointed that the case did not grant guidance that applies to other states and that this case did not even rule on NC law outside of a purely discretionary trust where the beneficiary has not received a distribution. They speculated that the court had hoped to issue useful guidance but then found that fiduciary income tax was more complex than they realized. They speculated that, rather than admitting poor judgment in tackling an issue on which it didn't have sufficient depth of understanding to set forth helpful rules, the Court decided the case narrowly then shortly thereafter declined to review *Fielding* below.

None of this discussion is concerned with business income. When a business operates in a state, the state taxes that business income. Generally, a trust that owns 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. See part II.G.3 State Income Taxation.

On June 28, 2019, the U.S. Supreme Court 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. The Minnesota Supreme Court held that taxing the trust on that other income on that basis alone violated the Due Process Clauses of the U.S. and Minnesota Constitutions, which it view as identical to each other.

Again, I am omitting other cases and just trying to provide a flavor for the U.S. Supreme Court. Attendees at the June 2019 meeting I attended speculated that, after *Kaestner*, the Court would have no appetite to hear other state fiduciary income tax cases.

Another important case limits Illinois' income taxation of trusts, *Linn v. Department of Revenue*.[2319] In *Linn*, the trustees of an Illinois trust exercised their limited power of appointment to create a trust that eventually came to be governed purely by Texas law and administered in Texas by Texas trustee, holding no assets in Illinois, but with concededly an Illinois grantor. The court summarized the parties' arguments:

> Plaintiff asserts the Autonomy Trust 3 has no connections to Illinois. He notes the Autonomy Trust 3 is a Texas trust that is governed by the laws of and administered in

[2319] 2 N.E.3d 1203 (App. Ct. Ill. 4th D. 2013).

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> Texas. Moreover, in 2006, the Autonomy Trust 3's trustee, beneficiary, and protector were all not residents of Illinois. Without any connections to Illinois, the imposition of Illinois income tax on the Autonomy Trust 3 would be unconstitutional under the due process clause. Plaintiffs have shown no connections appear to exist with the trust in this case. However, defendants contend connections do exist because (1) the Autonomy Trust 3 owes its existence to Illinois, and (2) Illinois provides the Autonomy Trust 3's trustee and beneficiary with a panoply of legal benefits and opportunities. We note that, on appeal, defendants do not argue that, in 2006, the Autonomy Trust 3 still contained terms to be interpreted under Illinois law and that the Illinois choice of law provision in the March 1961 agreement applies to the Autonomy Trust 3.

Focusing on contacts during the tax year in question, the court dismissed Illinois' arguments that the trust "exists only because of Illinois law"[2320] and that Illinois continues to provide the trustee

[2320] Citing *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (1999), the court reasoned (highlighting added):

> Defendants further argue the Autonomy Trust 3 exists only because of Illinois law. However, Autonomy Trust 3 resulted from a January 2002 exercise of the limited power of appointment by the trustee of the P.G. Linda Trust, which was provided for in the March 1961 trust agreement. Assuming arguendo, an Illinois court ruling validated a provision of the March 1961 agreement that allowed for the limited power of appointment that was later invoked to create the Autonomy Trust 3, the Autonomy Trust 3 was created by the provisions of the March 1961 agreement allowing for powers of appointment and not Illinois law. Further, with income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case. See *Gavin*, 733 A.2d at 802 (noting the connection for the inter vivos trust was the fact a noncontingent beneficiary was an in-state resident during the tax year in question); see also *In re Swift*, 727 S.W.2d 880, 882 (Mo.1987) (addressing income taxation on a testamentary trust and stating, "An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period"). Thus, what happened historically with the trust in Illinois courts and under Illinois law has no bearing on the 2006 tax year.

and beneficiary with benefits.[2321] Instead, "in 2006, the Autonomy Trust 3 had nothing in and sought nothing from Illinois."[2322] The court held:[2323]

> Accordingly, we find insufficient contacts exist between Illinois and the to satisfy the due process clause, and thus the income tax imposed on the Autonomy Trust 3 for the tax year 2006 was unconstitutional.

Thus, decanting[2324] to another jurisdiction may allow an Illinois trust to flee Illinois income taxation.

II.J.3.e.iii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence

A state might ignore a trust's existence while the trust is a grantor trust.[2325] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[2326]

[2321] Citing *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 547 n. 11 (D.C. 1997), the court reasoned:

> Additionally, defendants argue the State of Illinois provides the trustee and beneficiary of the Autonomy Trust 3 with a panoply of legal benefits and opportunities. In support of its assertion, it again cites case law addressing testamentary trusts. See *Gavin*, 733 A.2d at 799; District of Columbia, 689 A.2d at 544. As we have stated, this case involves an inter vivos trust, not a testamentary trust. The Autonomy Trust 3 was not in existence when A.N. Pritzker died and thus was not part of his probate case. Accordingly, no Illinois probate court has jurisdiction over the Autonomy Trust 3, unlike in the testamentary trust cases.
>
> Defendants also cite several Illinois statutory provisions and claim the Autonomy Trust 3, plaintiff, Linda, or a contingent beneficiary can seek those statutory provisions at any time. However, the parties agree that, after the November 2005 Texas reformation order, the Autonomy Trust 3 choice of law provision provided for only the application of Texas law. Further, as stated earlier, the 1977 Cook County case has no application at all to the Autonomy Trust 3 because it dealt with beneficiary powers of appointment, not trustee powers of appointment in the March 1961 trust agreement. Accordingly, we find the Autonomy Trust 3 receives the benefits and protections of Texas law, not Illinois law.

[2322] The court elaborated:

> As plaintiff notes, all of the trust's business was conducted in Texas; the trustee, protector, and the noncontingent beneficiary resided outside Illinois; and none of the trust's property was in Illinois. Moreover, the Autonomy Trust 3 meets none of the following factors that would give Illinois personal jurisdiction over the trust in a litigation: "the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted." *Sullivan v. Kodsi*, 359 Ill.App.3d 1005, 1011, 296 Ill.Dec. 710, 836 N.E.2d 125, 131 (2005) (citing *People v. First National Bank of Chicago*, 364 Ill. 262, 268, 4 N.E.2d 378, 380 (1936)).

[2323] The court continued:

> Since we have found the income taxation of the Autonomy Trust 3 in 2006 violates the due process clause, we do not address plaintiff's commerce clause argument.

[2324] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

[2325] For example, in defining what is a trust, Illinois disregards the existence of a grantor trust. 35 ILCS 5/1501(a)(20)(D) and 86 Ill. Admin. Code § 100.3020(a)(4) refer to grantor trusts under Code §§ 671-678.

[2326] Nenno, 869 T.M. II.A. states:

> As noted above, if a trust is treated as a grantor trust for federal and for state income-tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the

Given that clients often retire to jurisdictions that are not subject to income tax, keeping the trusts as grantor trusts until the clients move to those jurisdiction might mean that the state in which the trust was created will not treat the trust as a resident trust, because for income tax purposes the trust was deemed not to exist until the grantor was not a resident.

See also part II.J.15.b QSSTs and State Income Tax Issues.

II.J.3.f. Consider Trust Purposes

If shifting the incidence of taxation requires making distributions, consider whether distributions are appropriate. Consider whether distributions undermine the following nonexclusive list of concerns:

- Supplemental needs trusts designed to protect the flow of governmental benefits
- Protection from tort creditors
- Protection from business creditors
- Protection from spouses or ex-spouses
- Otherwise keeping funds inside the family
- Poor spending habits
- Inability to handle money
- Discouraging undue influence
- Funding addictive behavior
- Protecting from estate tax
- Other spendthrift concerns

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trustor, making planning difficult if not impossible while that status continues. Nevertheless, where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. For instance, Pennsylvania and Tennessee don't have grantor-trust rules for irrevocable trusts; Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in limited circumstances;[21] and Massachusetts classifies a trust as a grantor trust based on §§ 671–678 only, so that a trust that falls under § 679 will be a grantor trust for federal but not for state purposes. Unfortunately, a number of those states tax individuals based on federal taxable income,[22] which captures all federal grantor-trust income,[23] making the foregoing planning option unavailable.

[21] Ark. Inc. Tax Reg. § 4.26-51-102; D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187; Mont. Code Ann. § 15-30-2151(5).

[22] § 63.

[23] § 671.

Instructions to Pennsylvania's fiduciary income tax returns explain that they respect the grantor trust rules only for revocable trusts.

II.J.3.g. Effect on Future Years

The first time a distribution of principal is made from principal without referring to or actually distributing capital gain proceeds, the trustee is essentially electing for that year and all future years whether such distributions will carry out capital gains.[2327]

Causing a trust to be taxed to the grantor can be turned on or off by the presence or absence of a swap power or other powers.[2328]

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[2329] If one wants flexibility in turning on or off beneficiary grantor trust treatment, consider using QSST strategies (which can cause difficulty splitting up trust assets if more than one person is a remainderman).[2330]

II.J.3.h. Drafting for Flexibility in Trust Income Taxation

When drafting using an ascertainable standard for distributions ("support" in my documents),[2331] one can give the trustee the flexibility to consider or ignore the beneficiary's other resources. If the trustee has a legal duty to support one or more beneficiaries, consider using "reasonable support and comfort"[2332] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[2333]

[2327] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[2328] See part III.B.2.h How to Make a Trust a Grantor Trust.

[2329] See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

[2330] See parts III.A.3.e.vi QSST (including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts) and III.A.3.e.iv Flexible Trust Design.

[2331] See Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules), 20.2041-1(c)(2) (exception to estate tax general power of appointment) and 25.2511-1(g)(2) (gift tax ascertainable standard – reproduced in fn. 2535).

Some documents include a statement that the trustee's determination is conclusive and binding on all parties. Reg. §§ 1.674(b)-1(b)(5)(i) and 25.2511-1(g)(2) take the position that such language undermines the ascertainable standard exception, but Reg. § 20.2041-1(c)(2) is silent on the issue. Those regulations were promulgated before the Uniform Trust Code ("UTC"), section 814(s) of which provides:

> Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

UTC §§ 1002(b), 1008(a)(1) (see also the sections to which the Comments to Section 103(8) refer) provide similar references to good faith and the beneficiaries' interests in determining whether a trustee is liable. Thus, the assumption that "conclusive and binding" language makes the trustee's discretion unreviewable might be incorrect. I would not use such language in connection with trying to establish an ascertainable standard, but generally I would not urge reformation of an irrevocable trust merely for using that language. *Jennings v. Smith*, 161 F2d 74 (2nd Cir. 1947), upheld as not causing estate inclusion an ascertainable standard that included some language about the trustee's "absolution discretion."

[2332] As defined in Reg. §§ 25.2511-1(g)(2) and 1.674(b)-1(b)(5)(i).

[2333] Generally, a legal support obligation encompasses a much more narrow view of support than does what is permitted for an ascertainable standard, but one would want to check state law to verify. Also, if a trust makes distributions for items encompassed by a support obligation, query whether the trust has a claim against the person who has the support obligation. Finally, state laws prohibiting trustees from discharging their legal obligations, as well as any such prohibitions in the trust instrument itself, should

I also like to include standards that are not ascertainable ("welfare" in my documents). To avoid the IRS alleging adverse estate/gift tax consequences, the trustee either cannot have been appointed by the beneficiary or was appointed by the beneficiary but is not a related or subordinate party (as defined in Code § 672(c))[2334] with respect to the beneficiary.[2335]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[2336] one twist on the power would be giving the trustee or a trust protector the power to turn off the power for a year (or range of years) before the year starts, allowing the power to be turned off if creditors are hovering. Absent such a provision, one might convert a trust to a partial beneficiary grantor trust by exercising one of the standards described above with respect to the lesser of $5,000 or 5% of the trust's assets and giving the beneficiary the power to withdraw the declared amount or portion.[2337] In either case, such treatment generally has a permanent effect.[2338]

If locking in the beneficiary as the deemed owner is unattractive, the trust can dump its assets in an S corporation, make a QSST election when taxing the beneficiary is attractive,[2339] and convert to an ESBT when trapping income in the trust (primarily when the trust is not subject to state income tax but the beneficiary is) is more attractive.[2340] However, planning using S corporations involves additional long-term planning.[2341]

Also, to promote flexibility in including capital gains in distributable net income that the trustee can elect to carry out to the beneficiaries, consider using flexible language regarding allocating receipts between income and principal.[2342]

II.J.3.i. Planning for Excess Losses

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[2343] to beneficiaries except in the year of termination. Also consider the points made in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good in light of planning a trust's and its beneficiaries' income and losses.

If the trust is not terminating by the end of the calendar year, consider accelerating income (perhaps selling appreciated assets, among other items) or deferring deductions if and to the extent that the trust's deductions otherwise would exceed its income.

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reinforce the idea of the trust having a claim against the beneficiary. Nevertheless, many estate planners prefer to have other mechanisms for getting distributions to dependent children.

[2334] See Rev. Rul. 66-160 (director of a corporation is not an "employee" under Code § 672(c)); Letter Rulings 9842007 and 9841014.

[2335] For the latter, see fn. 6257.

[2336] See part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[2337] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

[2338] For flexibility regarding beneficiary grantor trust status, see fn. 2330.

[2339] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, which is part of the larger part III.A.3.e QSSTs and ESBTs.

[2340] See parts III.A.3.e.ii.(c) When ESBT Income Taxation Might Help and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

[2341] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

[2342] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2532.

[2343] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

On the final termination of an estate or a nongrantor trust, it can pass to its beneficiaries a net operating loss carryover under Code § 172, a capital loss carryover under Code § 1212, or for the last taxable year of the estate or trust deductions (other than the exemption and charitable deduction) in excess of gross income for such year, all to the extent provided in regulations:[2344]

- These carryovers and excess deductions are allocated among the beneficiaries succeeding to the property proportionately according to the share of each in the burden of the loss or deductions, which can include those receiving specific bequests that are abated.[2345] A person who qualified as a beneficiary succeeding to the property with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property as to the amount with respect to which the beneficiary qualifies.[2346]

- However, other than the NOL and capital loss carryover, excess deductions on termination are miscellaneous itemized deductions in the hands of the beneficiaries, which means they will not receive any tax benefit for them until 2026. See parts II.G.4.I.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax and II.J.3.d Who Benefits Most from Deductions. Consider recognizing gain that can be offset by these deductions before distributing assets (essentially obtaining a free basis step-up) or retaining taxable income-producing assets, the income from which can be offset by those deductions instead of being taxable to the beneficiaries (if they had been distributed to the beneficiaries). Related party sales or an election to recognize gain on distribution[2347] are ways to recognize gain while keeping assets within the family.

A trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[2348]

II.J.4. Tips for Fiduciary Income Tax Preparers

The IRS' web page for fiduciary income tax returns is https://www.irs.gov/uac/about-form-1041.

Income tax preparers might consider the following:

[2344] Code § 642(h); Reg. § 1.642(h)-2.

[2345] Reg. § 1.642(h)-4, which concludes with an example:

> A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

[2346] Reg. § 1.642(h)-4.

[2347] See part II.J.8.d.i Distribution in Kind - Generally. The election to recognize gain on distribution may have unexpected results, so read that part carefully.

[2348] Reg. § 1.641(b)-3(b), incorporated by reference by Reg. § 1.642(h)-1(a).

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

Prepare a rough draft of the income tax return in February and compare it to the beneficiaries' income tax rates.

If distributions are appropriate, make them by March 5 or 6.

For details, see part II.J.2 Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended.

II.J.4.b. Capital Gain Elections

Tax return preparation software automatically treats capital gains as trapped in the trust.

Consider whether current or future capital gains should be shifted to the beneficiaries.[2349]

Although a prior year return might have constituted an election not to distribute capital gains under one particular option, the tax laws are much more flexible than might appear at first. See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

II.J.4.c. Charitable Distributions

Even more generous than the 65-day rule mentioned in part II.J.4.a, a charitable contribution made any time in the current year can count for the current or immediately preceding year.[2350] For example, a contribution made December 31, 2017 can count as a 2016 contribution for a calendar year fiduciary taxpayer.

A nongrantor trust or estate's charitable deduction reduces adjusted gross income distributed to the beneficiaries and is the only way a charitable deduction can reduce net investment income subject to the 3.8% tax.[2351] However, the Code § 642(c) charitable deduction does not reduce the amount of the DNI allocated to a mandatory income beneficiary.[2352] If the trust is mandatory

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[2349] See part II.J.3 Strategic Fiduciary Income Tax Planning.

[2350] Code § 642(c)(1); Reg. § 1.642(c)-1(b)(1). Although an estate can deduct any amounts set aside and paid any time before termination, that election can be fraught with danger. See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate, with the caution described in fn. 2491.

[2351] See fn. 2130.

[2352] Code § 651(b), as explained by Reg. § 1.651(a)-4(a), prevents trusts that make charitable distributions from being treated as simple trusts. Code § 662(a)(1), which applies to trusts other than simple trusts, provides:

> *Amounts required to be distributed currently*. The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

income as to a portion and discretionary as to a portion, the beneficiary receiving discretionary distributions may benefit from the charitable deduction and may receive a windfall,[2353] but these rules may also cause more K-1 income for the mandatory income beneficiary than the trust would have had if the trust had been able to accumulate the income.[2354] I have not explored the

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F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), explains:

> ... trust-accounting income (required to be distributed currently) may exceed DNI. In effect, charitable distributions of income are in a middle category: available income is first treated as going to first-tier beneficiaries; then, to the extent that income is distributed to charity, there is a charitable deduction. As a result, only the residue of income is taxed to the second-tier beneficiaries.

[2353] See Code § 662(a)(1), reproduced in fn. 2352. In applying this rule, Reg. § 1.662(b)-2 provides that:

> for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently.

Reg. § 1.662(b)-2, Example (1), illustrates this rule, with paragraph (e) of the example providing the discretionary beneficiary with the windfall of receiving:

> (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.
>
> (b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).
>
> (c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.
>
> (d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.
>
> (e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.
>
> (f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

[2354] F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), suggests:

> **Example**: A complex trust has $65,000 of taxable dividend income. Annually, the trust is required to distribute the first $10,000 of income to a qualified charity, C, and the balance of its accounting income to an individual, A. In addition, the trustee is authorized to invade principal for the benefit of a second individual, B, and distributes $10,000 to B. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000 (one-half of the trustee's fee)). Thus, the amount distributable to A is $50,000 ($60,000 less $10,000 due the charity).
>
> The trust's taxable income [ignoring the distribution deduction and exemption] is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to A and B exceed DNI, the trust's distribution deduction is limited to $45,000.

interaction of this rule with the fact that unrelated business income generally moves the charitable deduction from Code § 642(c) to Code § 170.[2355]

For the requirement that the contribution be paid from gross income and complexity that applies when the trust has S corporation, business, or debt-financed income, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Special rules apply to electing small business trusts owning S corporations that make charitable contributions, which disallow the charitable contribution regarding any donations that the ESBT portion of the trust makes and essentially apply the individual Code § 170 contribution rules rather than Code § 642(c) to any contributions flowing through the K-1 that the ESBT receives.[2356]

But for these limitations, generally a nongrantor trust's charitable deduction is not subject to the limitations that would apply to a beneficiary. Nongrantor trusts and estates may deduct charitable contributions made during the taxable year or in the next taxable year,[2357] whereas generally individuals may deduct contributions made during the taxable year. Also note that 2017 tax reform eliminates the benefit of the charitable deduction for individuals who take the standard deduction, whereas nongrantor trusts and estates may deduct them in full, subject to various limitations.[2358] Furthermore, charitable gifts from nongrantor trusts and estates do not appear to be subject to the strict substantiation[2359] and appraisal[2360] rules that apply to

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> When the amount of income A must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose and A has $50,000 of taxable income under section 662. Note that the amount of income A must report is less than the recomputed DNI by $5,000.
>
> Nevertheless, B has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000 and that amount is not in excess of the tier 1 distribution to A.

B's windfall comes at the expense of A paying tax on more income ($50,000) than the net of the trust's taxable items ($45,000).

[2355] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[2356] Under 2017 tax reform, Code § 642(c) does not apply to an ESBT; see fn 5664 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 5663 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation

[2357] See fn. 2350.

[2358] In addition to any limits imposed by Code § 642(c), charitable contributions by nongrantor trusts and estates may be reduced if they result in state tax credits, in a manner similar to that imposed on individuals. Reg. § 1.642(c)-3(g), "Payments resulting in state or local tax benefits," provides:

> (1) *In general*. If the trust or decedent's estate makes a payment of gross income for a purpose specified in section 170(c), and the trust or decedent's estate receives or expects to receive a state or local tax benefit in consideration for such payment, § 1.170A-1(h)(3) applies in determining the charitable contribution deduction under section 642(c).
>
> (2) *Effective/applicability date*. Paragraph (g)(1) of this section applies to payments of gross income after August 27, 2018.

Reg. § 1.170A-1(h)(3) is reproduced in fn 1324 in part II.G.4.l.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax; fn 1325 in part II.G.4.l.ii discusses the related state income effect.

[2359] Code § 170(f)(8) disallows contributions under Code § 170(a) if certain substantiation requirements are not met but does so without referring to Code § 642(c). Also, Code § 642(c) says that the deduction is "in lieu of the deduction allowed by section 170(a)," further disconnecting Code § 642(c) for Code § 170(f)(8). Note also that Reg. § 1.170A-13(f)(13) provides:

> Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a

individuals, partnerships, and corporations and appear to be more liberal as to who the donee is.[2361] As to the latter, note that Code § 170(c) describes who qualifies as a charitable donee, whereas Code § 642(c) refers to a contribution "paid for a purpose specified in Section 170(c) (determined without regard to section 170(c)(2)(A))."[2362] The substantiation rules can knock out

> charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or § 1.664-3(a)(1)(i)(b)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

[2360] Code § 170(f)(11) imposes requirements for various noncash contributions, depending on the nature and size of the gift. Reg. § 1.170A-13(c)(3) and Notice 2006-96 govern qualified appraisals; Prop. Reg. § 1.170-17 would apply only to contributions made after it is finalized (see subsection (c)) and therefore is not a consideration until then. Reg. § 1.170A-13(c)(3)(ii)(E), which is cross-referenced by Reg. § 1.170A-13(c)(4)(ii)(I), requires that the appraiser supply an EIN if required by Code § 6109 and the regulations thereunder; however, no formal guidance of which I am aware says whether this is required. However, the preamble to Prop. Reg. § 1.170-17, [REG-140029-07] (8/7/2008), expresses the IRS view:

> Expressing concerns about identity theft, some commenters requested elimination of the requirements of supplying the appraiser's taxpayer identification number on Form 8283 and in the appraisal, as currently required under §§ 1.170A-13(c)(3)(ii)(E) and 1.170A-13(c)(4)(ii)(I). The concern arises from appraisers who do not have a taxpayer identification number other than a social security number. The proposed regulations continue to require this information because, pursuant to § 301.6109-1(a)(1)(ii)(D) of the Procedure and Administration Regulations, an appraiser may obtain an employer identification number even if the appraiser does not have employees. This number may be obtained by completing Form SS-4, "Application for Employer Identification Number." See Pub. 1635, "Understanding Your Employer Identification Number." If an appraiser is employed by a firm, the firm's employer identification number should be used.

Relaxing the appraisal rules a bit, *Cave Buttes L.L.C. vs. Commissioner*, 147 T.C. No. 10 (2016), included in its official syllabus:

> *Held*: C's appraisal report substantially complied with the requirements of sec. 1.170A-13(c)(5)(iii), Income Tax Regs., by including one of the two appraisers' signatures on Form 8283, Noncash Charitable Contributions.
>
> *Held, further*, a description of the appraised property by address and characteristics is sufficient to strictly comply with sec. 1.170A-13(c)(3)(ii)(A), Income Tax Regs.
>
> *Held, further*, the wording in the appraisal report that it was conducted to value the property for "filing with the IRS" at least substantially, if not strictly, complied with sec. 1.170A-13(c)(3)(ii)(G), Income Tax Regs.
>
> *Held, further*, a difference between the date of valuation and the date of contribution of at least 11 days and at most 21 days, without any significant events' affecting the land during that time, substantially complies with sec. 1.170A-13(c)(3)(ii)(I), Income Tax Regs.
>
> *Held, further*, R conceded that the appraisal report's definition of fair market value, while not in strict conformity with the one in sec. 1.170A-1(c)(2), Income Tax Regs., substantially complied with it.

[2361] Code § 170(c) provides that "the term 'charitable contribution' means a contribution or gift to or for the purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A))."

[2362] Code § 170(c)(2)(A) refers to a donation to a corporation, trust, or community chest, fund, or foundation "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States."

contributions that qualify but for having timely documentation,[2363] and lack of a good appraisal may add valuation penalties[2364] even if the deduction is knocked out.[2365]

[2363] A reviewed decision, *15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (2016), disallowed a $64 million charitable deduction. The charity's acknowledgement of the gift failed to recite, as required by Code § 170(f)(8)(B)(ii), whether the charity provided any goods or services to the donor. The taxpayer lost even though the charity later filed an amended Form 990 stating the gift's value. Because no regulations implement Code § 170(f)(8)(D), taxpayers cannot rely on a charity's filing with the IRS as an exception to Code § 170(f)(8)(B)(ii).

However, *Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166, held:

> LP did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of section 170(f)(8)(B).… We have previously held that a deed of easement may constitute a CWA. See *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164; *RP Golf, LLC v. Commissioner,* T.C. Memo. 2012-282, 104 T.C.M. (CCH) 413; *Averyt v. Commissioner*, T.C. Memo. 2012-198, 104 T.C.M. (CCH) 65. We conclude that the deed of easement in this case qualifies as a CWA under the logic of these cases.

See fn. 2365 for a case that knocked out the charitable deduction for omitting its cost or other adjusted basis from its Form 8283.

[2364] See Code § 6664(c) and *Kaufman v. Commissioner*, 784 F.3d 56 (1st Cir. 2015), *aff'g* T.C. Memo. 2014-52. In affirming the imposition of penalties, the First Circuit reasoned:

> The Tax Court did not purport to equate "good faith investigation" with "exhaustive investigation." It merely required that the Kaufmans do some basic inquiry into the validity of an appraisal whose result was squarely contradicted by other available evidence glaringly in front of them.

[2365] *Partita Partners LLC v. U.S.*, 120 A.F.T.R.2d 2017-XXXX (D.C. NY 7/10/2017), which is consistent with another decision issued just a week before that one, *Reri Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (2017), the Official Tax Court Syllabus to which states:

> PS, a partnership, paid $2.95 million in March 2002 to acquire a remainder interest in property. The agreement that created the remainder interest provided covenants intended to preserve the value of the subject property but also limited the remedy available to the holder of the remainder interest for a breach of those covenants to immediate possession of the property; in no event would the holder of the corresponding term interest be liable for damages to the holder of the remainder interest. On Aug. 27, 2003, PS assigned the remainder interest to U, a university. On its 2003 Form 1065, U.S. Return of Partnership Income, PS claimed a deduction under sec. 170(a)(1) of $33,019,000. The Form 8283, Noncash Charitable Contributions, that PS attached to its return provides the date and manner of its acquisition of the contributed remainder interest but left blank the space for the "Donor's cost or other adjusted basis".
>
> *Held*: PS' omission from its Form 8283 of its cost or other adjusted basis in the contributed remainder interest violated the substantiation requirement of sec. 1.170A-13(c)(4)(ii)(E), Income Tax Regs.
>
> *Held*, *further*, because PS' disclosure of its cost or other basis in the contributed property would have alerted R to a potential overvaluation of that property, omission of that information prevented the Form 8283 from achieving its intended purpose; the omission thus cannot be excused on the grounds of substantial compliance.
>
> *Held*, *further*, PS' failure to comply, either strictly or substantially, with the requirements of sec. 1.170A-13(c)(2), Income Tax Regs., requires denial in full of its claimed charitable contribution deduction.
>
> *Held*, *further*, because of the limitation on remedies available to the holder of the remainder interest for breaches of protective covenants, the agreement that created that interest did not provide adequate protection to its holder, for purposes of sec. 1.7520-3(b)(2)(iii), Income Tax Regs.; the standard actuarial factors provided under sec. 7520 thus do not apply in valuing the remainder interest; instead, the value of that interest is its "actual fair market value", determined

However, rules requiring nongrantor trusts and estates to use gross income to make contributions can be tricky,[2366] especially when a nongrantor trust has unrelated business income.[2367]

A trust claiming a charitable deduction must identify the "governing instrument," show that the charitable contributions were paid "pursuant to" the terms of that instrument as required by Code § 642(c)(1), and demonstrate that each contribution was paid for a charitable purpose under Code § 170(c).[2368] Trustee discretion to distribute to charity satisfies the "pursuant to" standard;[2369] however, the trustee relevant documents must authorize the distributions.[2370]

> without regard to sec. 7520, on the basis of all of the facts and circumstances. Sec. 1.7520-3(b)(1)(iii), Income Tax Regs.
>
> *Held*, *further*, on the basis of all of the facts and circumstances, the remainder interest that PS assigned to U on Aug. 27, 2003, had a fair market value on that date of $3,462,886.
>
> *Held*, *further*, because the $33,019,000 value that PS assigned to the remainder interest it transferred to U is more than 400% of that interest's actual fair market value, PS' claimed charitable contribution deduction resulted in a gross valuation misstatement. sec. 6662(e)(1)(A), (h)(2).
>
> *Held*, further, any underpayment resulting from the disallowance of PS' claimed charitable contribution deduction would be "attributable to" a gross valuation misstatement to the extent the underpayment relates to the disallowance of that portion of the deduction that exceeds $3,462,886. *AHG Invs., LLC v. Commissioner*, 140 T.C. 73 (2013). *885 Inv. Co. v. Commissioner*, 95 T.C. 156 (1990), overruled.
>
> *Held*, *further*, PS did not make a good-faith investigation of the value of the property subject to the remainder interest and thus did not have reasonable cause for, or act in good faith with respect to, its claim of a charitable contribution deduction that resulted in a gross valuation misstatement. sec. 6662(c)(2)(B).

As applied to each owner of the LLC (partner for income tax purposes):

> Although the liability of a particular partner for the gross valuation misstatement penalty will depend on the arithmetic threshold provided in section 6662(e)(2), no partner will be able to avoid the penalty on the basis of the reasonable cause exception provided in section 6664(c).

The Tax Court did not refer to an argument previously made about whether the donor should have listed the single-member LLC it contributed instead of the underlying assets, which argument was described in fn. 335 in part II.B Limited Liability Company (LLC).

Reri was affirmed under the name *Blau v. Commissioner*, 123 A.F.T.R.2d 2019-XXXX (D.C. Cir. 5/24/2019), which held that omission of basis on Form 8283 was fatal regardless of whether the appraisal substantially complied (declining to address the latter).

[2366] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4496-4498.

[2367] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4511-4517, which impose individual percentage limitations in lieu of Code § 642(c) and seem to undo the benefits described above in the text accompanying fns. 2357 2361. This rule does not apply to estates. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4523-4524.

[2368] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67, citing *Brownstone v. United States*, 465 F.3d 525, 529 (2nd Cir. 2006).

[2369] *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), construing the predecessor to Code § 642(c), rejecting the IRS' narrow construction and adopting a broad definition of "pursuant to":

> We are asked to hold that the words "pursuant to" mean directed or definitely enjoined. And this notwithstanding the admission that Congress intended to encourage charitable contributions by relieving them from taxation. *Lederer, Collector, v. Stockton*, 260 U.S. 3, 43 S.Ct. 5, 67 L.Ed. 99; *United States v. Provident Trust Co., Administrator*, 291 U.S. 272, 285, 54 S.Ct. 389, 392, 78 L.Ed. 793.
>
> "Pursuant to" is defined as "acting or done in consequence or in prosecution (of anything); hence, agreeable, conformable; following; according."[3]
>
> [3] *Webster's New International Dictionary, Unabridged* (2d Ed.) 1935.

Payments an estate made to charity out of estate income attributable to that part of the estate transferred to charity, under the terms of a settlement agreement resulting from a will contest, qualify for a Code § 642(c) deduction;[2371] absent an actual dispute, the IRS has questioned the deduction.[2372] When a charitable lead annuity trust distributed more to charity than its annuity amount and that distribution was not clearly authorized, the trust received neither a charitable nor an income distribution deduction for those excess distributions.[2373] When a surviving spouse who had a general power of appointment over the marital trust created for her, exercised that power in favor of her estate, and left her estate to charity, the marital trust was not entitled to a charitable income tax deduction.[2374] When a trust gave a beneficiary an inter

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[2370] In rejecting a Code § 642(c) deduction when a pour-over revocable trust distributed to a charity that was a beneficiary under the grantor-decedent's will, *Love Charitable Foundation v. Commissioner*, 710 F.2d 1316 (8th Cir. 1983), reasoned:

> *Old Colony* stands for the proposition that a trust is entitled to a deduction when a trustee who is authorized but not required to make charitable contributions under the trust instrument does in fact make charitable contributions. We do not believe, however, that the *Old Colony* case and the definition of "pursuant to" given in that case should be read so broadly as to entitle a trust to a charitable deduction when a trustee, acting without any authority under the trust instrument, distributes the Trust assets to charity. Rather, as stated earlier, we believe it is necessary that a trust instrument authorize the trustee to make charitable contributions if it is to be said that the charitable contributions were made "pursuant to the terms of" the Trust instrument.

[2371] Rev. Rul. 59-15, which was followed by Letter Ruling 9044047 regarding the settlement of a dispute among all interested parties, including the state attorney general.

[2372] CCA 200848020.

[2373] *Crown Income Charitable Fund v. Commissioner*, 98 T.C. 327 (1992), *aff'd* 8 F.3d 571, 573 (7th Cir. 1993). In denying the income distribution deduction as an alternative when the charitable deduction was disallowed, the Tax Court referred to Reg. § 1.663(a)-2, which provides:

> Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c).

[2374] *Brownstone v. U.S.*, 465 F.3d 525 (2nd Cir. 2006). Instead of claiming the charitable deduction, the trust should have taken an income distribution deduction and the estate then taken the charitable deduction. Thus, the court was correct to deny the charitable deduction. However, rather than saying the above, the court used the following reasoning:

> Appellant's arguments are equally unavailing. Appellant asks us to consider Ethel's power of appointment and Lucien's will together as the governing instrument, but as the district court noted on the record, the statute refers to "governing instrument" in the singular. To combine Ethel's power of appointment with Lucien's will and deem the resultant agglomeration the "governing instrument" strains the statute's text. We agree with appellant that ordinarily "governing" can imply a broader subject-object relationship than does "creating." Nevertheless, we find that the implication is neutralized by the statute's legislative history, which deems the current statute and its predecessor "comparable." We also agree with the district court that "the legislative history doesn't suggest that there is any attempt to broaden the prior law...."
>
> In construing the statute, however, we do not go so far as to equate "governing instrument" with "will or deed creating the trust." Instead, we note "[i]t is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'" *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Here, Congress has not made clear provision that an instrument subsequent to the creating instrument, such as Ethel's exercise of the power of appointment, in Article Third of her will, when combined with the "creating" deed or will, such as Lucien's will, could qualify as a "governing instrument." Under this rule of construction, because there is no such clear provision, Ethel's appointment, combined with Lucien's will, cannot qualify as a governing instrument under § 642(c)(1). Indeed, were the Tax Code to permit a trustee to agglomerate the separately

vivos power of appointment in favor of charity that the beneficiary exercised to direct charitable distributions, Letter Ruling 201225004 allowed the charitable deduction. However, CCA 201651013 asserted no charitable deduction and no income distribution deduction when a court order gave a beneficiary an inter vivos power to appoint to charity and the beneficiary exercised it.[2375] Furthermore, the "pursuant to" requirement was not met when a court modified

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> manifested intents of diverse testamentary instruments so as to create a single, chimerical "governing instrument," it would greatly enhance the ability of trusts to obtain income tax deductions. For this, Congress has not made clear provision. We hold, therefore, that the governing instrument in this case is not a combination of two separate instruments. It is Lucien's will alone.
>
> The second step in our inquiry leads us to determine whether Ethel's distribution was made "pursuant to" the governing instrument, Lucien's will. In *Old Colony*, the U.S. Supreme Court held: "'Pursuant to' is defined as 'acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according.'" 301 U.S. at 383-84. This standard is permissive, but it "still conveys more than 'not in violation of'." *Weir Foundation*, 362 F.Supp. at 939. Therefore, "the instrument must be shown to possess some positive charitable intent or purpose of the settlor–not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty." *Id.* Ethel's will, in exercising the power of appointment, did not make the charitable distribution "pursuant to" the terms of Lucien's will because Lucien's will does not express sufficient charitable intent with respect to the Trust principal. In Article Seventh of his will, Lucien established the Trust for the support and maintenance of his wife. Article Seventh also gave Ethel a power of appointment that allowed her to distribute the Trust principal in any manner she saw fit. Only if she did not validly exercise that power would the Trust principal pass to a charitable organization. By the terms of Lucien's will, Ethel could have distributed the Trust principal entirely to private individuals. Just as easily, she could have distributed the Trust principal entirely to charity. But the choice was Ethel's alone, and Lucien's will expressed no preference. Indeed, Lucien's will necessarily abandoned all charitable intent with respect to the Trust principal in creating the power of appointment; if it had not, the Trust could not have taken advantage of the marital deduction. See 26 U.S.C. § 2056(b)(5). Once Ethel received the power of appointment, Lucien's will could not bind her to any course of action, charitable or otherwise. We agree with the district court: "She was not compelled to give one penny to charity. The governing instrument did not govern her free exercise of her discretion in any way, shape or form." Thus, Ethel did not make her distribution "pursuant to" the terms of the governing instrument.

The above analysis went way beyond what was necessary to resolve the case.

[2375] The CCA, which was issued in the name of Brad Poston, a well-respected senior IRS official, reasoned:

> In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to *Old Colony*. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both *Crown* and *Brownstone* have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

In denying the income distribution deduction, the CCA looked at Reg. § 1.663(a)-2, reproduced in fn. 2373, but took a much closer look at the issues that it said that the regulation definitively resolved. However, the CCA failed to consider Rev. Rul. 73-142, which would seem to resolve the issue in favor of

a trust to add charities as income beneficiaries when only individuals were beneficiaries and the charities did not become beneficiaries until a later taxable year, even though the court action purported to be a construction and not a modification.[2376] To avoid controversy, consider expressly authorizing the trustee to make charitable distributions or a beneficiary to exercise an inter vivos power of appointment in favor of charity.[2377] Also, consider having the trust participate in a partnership that makes the donation, which may avoid needing to satisfy the "pursuant to" requirement.[2378]

A trust claiming Code § 642(c) charitable deduction may have additional filing requirements. Split-interest trusts described in Code § 4947(a)(2) have their own filing requirements.[2379] Other trusts claiming Code § 642(c) deductions have certain filing requirements (Form 1041-A)[2380] unless "all the net income for the year, determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries,"[2381] or the trust is described in Code § 4947(a)(1).[2382]

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the taxpayer; see fn. 5950, in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts, giving prospective effect to a court modification. Following up on this and other issues, CCA 201747005 discussed Rev. Rul. 73-142; however, the CCA's arguments focused on will/trust construction cases being retroactive under *Bosch* and did not distinguish that in its reasoning from the much lower hurdle of merely needing a final court decree required for respecting court action prospectively. For example, the CCA cited *Hubbell* (see fn. 2376) as favoring the CCA's position when *Hubbell* addressed only an attempt to apply a decree retroactively.

[2376] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67. The probate court order stated:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.

The Tax Court rejected the purposed construction, holding that the will did not provide for charitable contributions during that time period and that there was no ambiguity about that. Note that Rev. Rul. 73-142, referred to in fn. 2375, provides relief prospectively only.

[2377] I often give a beneficiary a broad inter vivos limited power of appointment at whatever age the settlor feels is appropriate. I include a clause saying that, whenever the trust refers to all persons (with or without excluding the beneficiary, the beneficiary's estate, and the creditors of either), that expressly includes the power to appoint to charity.

[2378] See fn. 4498, in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[2379] Code § 6034(a). Code § 4947(a)(2) describes:

> … a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 ….

[2380] Code § 6034(b)(1).

[2381] Code § 6034(b)(2)(A). Form 1041-A instructions refer to Code § 643(b) income. For more on Code § 643(b) income, see parts II.J.8.c.i.(a) Power to Adjust, II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[2382] Code § 6034(b)(2)(B). Code § 4947(a)(1) describes:

> … a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law)….

IRM § 7.26.15.2.1 (04-08-1999), "Estates and Certain Trusts Performing Administrative Functions," as found on the IRS website https://www.irs.gov/irm/part7/irm_07-026-015 on 8/12/2019, provides:

Charitable contributions are merely deductions and do not trigger issuing a K-1 to the charity.[2383]

If the charitable deduction is problematic, consider adding a Code § 501(c)(4) organization as a beneficiary. Adding the organization appears not to be subject to gift tax.[2384] The trust would get an income distribution deduction for distributions to the organization,[2385] and the organization pays no income tax.

II.J.4.d. Possible Change in Beneficiary's Residence

A beneficiary changing residence might change the beneficiary's income tax posture and possibly the trust's residence. See part II.J.3.e State and Local Income Tax.

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

The 3.8% tax on net investment income[2386] applies to passive activities a trust holds.[2387] However, if the business has enough potential for ups and downs in its taxable income that

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1. An estate is not considered to be an IRC 4947(a)(1) trust during any reasonable period for administration or winding up of its affairs. Once it is terminated for federal income tax purposes or if it is considered unduly prolonged, the provisions of IRC 4947(a)(1) will apply.
2. Similarly, in the winding up of an IRC 4947(a)(2) trust, there are transitional rules that apply before the trust is considered described in IRC 4947(a)(1).
3. Examples of trusts or estates not subject to IRC 4947(a)(1) during a period of administration or settlement include the following:
   a. A split-interest trust for which a final distribution of all assets is required because its private interests have expired would not be subject to the provisions of IRC 4947(a)(1) until expiration of any reasonable period for settlement. Regs. 53.4947-1(b)(2)(iii).
   b. Another variation of the preceding example is a split interest trust where all private interests have expired and where the charitable beneficiaries are not entitled to a distribution will continue to be treated as a split-interest trust during a period of settlement. This trust is unlike the preceding trust because some or all of the charitable remainder interests remain in the trust rather than being distributed. Regs. 53.4947-1(b)(2)(iv).
   c. A revocable trust that becomes irrevocable at the creator's death and is required to make a final distribution of all its assets is not subject to IRC 4947(a)(1) during any reasonable period of settlement. Regs. 53.4947-1(b)(2)(v).

What is a reasonable period of administration for a trust depends on the circumstances, but presumably it is not less than that described in part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate. For an estate, Reg. § 53.4947-1(b)(2)(ii)(A) provides:

> When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under § 1.641(b)-3(a), then the estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under § 1.641(b)-3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This (ii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the estates.

Reg. § 1.641(b)-3(a) is reproduced in fn 2500 in part II.J.7.

[2383] See fn 2629 in part II.J.9.a.ii Separate Share Rule.

[2384] See part II.Q.6.g Gift Tax Exclusion for Gifts to Certain Noncharitable Organizations.

[2385] See part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries, fns 2280-2282.

[2386] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

planning for a potential significant loss becomes important, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income.

Special rules apply to trusts when determining whether an activity is passive.[2388]

Consider how to document[2389] the trustee's participation as trustee in business activities,[2390] whether the trust should be converted to a beneficiary grantor trust to use the beneficiary's work rather than the trustee's work,[2391] and the effect of the beneficiary's participation on any depreciation deductions.[2392]

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

If the trustee believes that a permanent change to the trust's income tax posture shifting income to the beneficiary would be helpful,[2393] the trustee might try to convert a trust to a partial beneficiary grantor trust[2394] by exercising discretion to declare a distribution.

Distributions include amounts required to be distributed[2395] and any other amounts properly paid, credited, or required to be distributed to such beneficiary.[2396] Generally, an amount is considered credited if the trustee must pay it on the beneficiary's demand (without the trustee exercising any discretion when the beneficiary makes the demand) and there is no practical or legal impediment to making the payment.[2397] Instead of or in addition to exercising discretion by

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[2387] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.g Structuring Businesses in Response to 3.8% Tax.
[2388] See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.
[2389] See part II.K.1.a.vi Proving Participation.
[2390] The IRS argues that the trust does not get credit for work a trustee does as an individual. See part II.K.2.b.i Participation by a Nongrantor Trust: Authority. Although the IRS has lost in court, one might consider avoiding being a test case. Accordingly, for steps one might consider to comply with the IRS' position, see part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[2391] See parts II.K.2.c Participation When Grantor Trusts Are Involved; Effect of Toggling and III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
[2392] As described in part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses), depreciation deductions often pass through to the income beneficiaries, bypassing the usual fiduciary income tax filter. Therefore, the beneficiary's work is the only counted as participation in deciding whether the deductions are allowable.
[2393] See part II.J.3 Strategic Fiduciary Income Tax Planning.
[2394] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.
[2395] Code §§ 652(a), 662(a)(1).
[2396] Code § 662(a)(2). Reg. § 1.662(a)-3(a) provides:

> There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

[2397] See *Cecelia K. Frank Trust of 1931 v. Commissioner*, 8 T.C. 368 (1947), *aff'd* 165 F.2d 992 (3d Cir. 1948); *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir.), *cert. den.* 290 U.S. 670 (1933); *Weed's Estate v. United States*, 110 F.Supp. 149 (E.D. Tex. 1952); *Igoe v. Commissioner*, 19 T.C. 913 (1953); *Estate of Cohen v. Commissioner*, 8 T.C. 784 (1947); *Estate of Bruner v. Commissioner*, 3 T.C. 1051

making payments to or for a beneficiary, a trustee can inform a beneficiary that the trustee is crediting a percentage (up to 5%) of the trust's assets[2398] and that, upon demand, the beneficiary may withdraw that amount for a stated reasonable period of time. Although that looks somewhat like a Code § 678(a)(1) withdrawal right, the process of crediting counts as a distribution rather than as a withdrawal right, because it was subject to the trustee's discretion.[2399] However, once it is credited and vests in the beneficiary, so that the beneficiary has the unqualified right to withdraw, presumably looking forward from then one would look at the grantor trust rules as to income attributable to the beneficiary's withdrawal right and any lapses of it.[2400]

If the withdrawal right were included in the agreement instead of the crediting taking place, the beneficiary would be taxed on a portion of the trust instead of being treated as having been credited with a distribution.[2401] However, the process of crediting allows any allocable deductions to be determined at the trust level and offset directly against the trust's income,[2402] whereas any deductions allocable to the beneficiary grantor trust portion are separately deducted on the deemed owner's return.[2403] Using the trust's own tax attributes may avoid various restrictions on the Code § 199A deduction for pass-through business income, state income tax, and deductions relating to managing the trust,[2404] so the crediting mechanism may provide better short-term tax benefits than having included a withdrawal right to begin with.

If the right to withdraw the credited funds lapses, the beneficiary would make a gift if and to the extent that the lapse exceeds the greater of $5,000 or 5% of the funds out of which the

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(1944); *Estate of Johnson v. Commissioner*, 88 T.C. 225, *aff'd* 838 F.2d 1202 (2d Cir. 1987); *Estate of Hubbard v. Commissioner*, 41 B.T.A. 628 (1941); *cf. Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied* 414 U.S. 820 (1973); *Warburton v. Commissioner*, 193 F.2d 1008 (3d Cir. 1952). The author thanks Lad Boyle for providing the above citations from F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008). Additional authority includes *Bohan v. U.S.*, 326 F.Supp. 1356 (W.D. Mo. 1971), *aff'd* 456 F.2d 851 (8th Cir. 1972), *nonacq.* Rev. Rul. 82-396. Note also that Code § 643(g) provides circumstances under which a trustee may credit a beneficiary with the trust's estimated tax payments. A similar concept is found in Reg. § 1.451-2(a), the constructive receipt doctrine, which provides in part:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions…. In the case of interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank, … the following are not substantial limitations or restrictions on the taxpayer's control over the receipt of such earnings… (4) A requirement that a notice of intention to withdraw must be given in advance of the withdrawal.

[2398] It should be expressed as a portion of the trust's assets, rather than as a specific dollar amount. See fn 5736 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

[2399] See part III.B.2.i.ii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?

[2400] See part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[2401] Rev. Rul. 67-241; see parts III.B.2.i.i Trusts Intended to Be Beneficiary Grantor Trusts from Inception, especially fn. 6269, and III.B.2.i.ii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 6277.

[2402] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

[2403] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

[2404] See part II.J.3.d Who Benefits Most from Deductions.

withdrawal could have been satisfied.[2405] To avoid an IRS argument that the 5% refers to the income rather than referring to the whole trust,[2406] the withdrawal right should refer to the entire trust. For example, instead of granting a $20,000 right to withdraw, the trustee grants the right to withdraw a fractional share of the trust, the numerator of which is $20,000 and the denominator of which is the value of the trust's assets. The right to withdraw would continue, lapsing each year only to the extent provided in Code § 2514(e). Because the lapse does not constitute a gift for gift tax purposes, the lapse does not cause a portion of the trust to be included in the beneficiary's estate for estate tax purposes. (The latter might be important even for QTIP marital deduction trusts that are included in the beneficiary's estate anyway, because the inclusion of such a trust's assets might be valued at a lower rate as a QTIP asset than as an incomplete gift or Code § 2036 asset.[2407]) If it is desirable to isolate the grantor trust portion from the nongrantor trust portion, see part III.B.2.i.vii Funding the Trust with a Large Initial Gift or Bequest, which is within the larger discussion of part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

Over time, the portion deemed owned by the beneficiary increases. See part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust, found within the larger discussion of part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

II.J.4.g. Making the Trust a Complete Grantor Trust as to the Beneficiary

If the beneficiary being taxed on the trust's income is desirable, whether because of rates or a desire to accumulate funds in the trust, then consider converting the trust to a qualified subchapter S trust (QSST).[2408]

The trust forms an S corporation, the trust is modified as needed to be eligible for a QSST election, and the beneficiary makes a QSST election.

The beneficiary is taxed on the trust's distributive share of the S corporation's income.

[2405] Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."

[2406] Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied." *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970), held that Code § 2514(e) measures the lapse of a right to income by multiplying the income, rather than the trust's value, by 5%. *Fish* cited Senate Report No. 382, 82nd Cong., 1st Sess., pp. 6-7 (2 U.S. Code Congressional and Administrative News (1951) 1530, 1535). Here is an excerpt to which it may have been referring:

> The committee amendment provides an annual exemption with respect to lapsed powers equal to $5,000 or 5 percent of the trust or fund in which the lapsed power existed, whichever is the greater. Thus, for example, if a person has a noncumulative right to withdraw $10,000 a year from the principal of a $200,000 trust fund, failure to exercise this right will not result in either estate or gift tax with respect to the power over $10,000 which lapses each year prior to the year of death. At his death there will be included in his gross estate the $10,000 which he was entitled to draw for the year in which his death occurs, less any sums which he may have taken on account thereof while he was alive during the year. However, if, in the above example, the person had had a right to withdraw $15,000 annually, failure to exercise this right in any year prior to the year of death will be considered a release of a power to the extent of the excess over 5 percent of the trust fund.

[2407] For the potentially lower valuation of QTIP assets, see fn. 3500.

[2408] See parts III.A.3.e.i.(a) QSSTs Generally and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Although the trust must distribute all of its income, income generally means distributions from the S corporation, and the trustee as the sole shareholder can control how much the S corporation distributes.[2409] Note that the trust can continue to be a discretionary trust as to income if all of the income is actually distributed.[2410] Mandatory income is safer in that it prevents a misstep in not distributing enough income, but in some cases the flexibility is more important (in a mandatory income trust, the beneficiary might pressure the trustee to distribute more from the S corporation).

Unlike the partial grantor trust strategy mentioned above, this trust's beneficiary grantor status can be toggled off, with income being accumulated in the trust.[2411]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[2412]

II.J.4.h. Trapping Income in Trust Notwithstanding Distributions – ESBT

Just as in the above strategy, the trust forms an S corporation, only this time makes an electing small business trust (ESBT) election[2413] or creates another trust.

The trust's distributive share of S corporation income is taxed to the trust, even if distributed to the beneficiary.

To better control the effect of distributions, if the trust reinvests its distributions in taxable investments then it should divide and put those assets in a separate trust.[2414]

If circumstances change, the trust could toggle to being taxed to the beneficiaries.[2415]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[2416]

II.J.4.i. Modifying Trust to Make More Income Tax Efficient

In some states, the settlor and all beneficiaries may amend a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust.[2417]

Also, depending on the distribution standard and state law, the trustee might be able to change a trust using decanting.[2418] Decanting might be done by merely amending the trust rather than

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[2409] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries and III.A.4 Trust Accounting Income Regarding Business Interests.
[2410] See parts III.A.3.e.i.(a) QSSTs Generally (especially fn. 5587) and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[2411] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[2412] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.
[2413] See part III.A.3.e.ii ESBTs.
[2414] See part III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.
[2415] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.
[2416] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.
[2417] Uniform Trust Code § 401, found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.4A-411, found at http://www.moga.mo.gov/mostatutes/stathtml/45604A04111.html.
[2418] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting. Before considering decanting a QSST, see fn. 5582, found in part III.A.3.e.i.(a) QSSTs Generally.

by actually transferring assets to another trust.[2419] If the trust's situs has moved since inception, the trust's situs (not the substantive law of the original state) determines authority to decant through merger.[2420] If decanting is done using asset transfers to a new trust, see parts II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN) and II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

See also part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, especially fns 6476-6478.

II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure

II.J.4.j.i. Need to Provide Notices

In Missouri and many other states, a beneficiary can sue a trustee any time before five years after the first to occur of the trustee's removal, resignation, or death of the trustee, the termination of the beneficiary's interest in the trust, or the trust's termination.[2421]

However, a beneficiary may not sue a trustee more than one year after the last to occur of the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and the date the trustee informed the beneficiary of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.[2422]

A report adequately discloses the existence of a potential claim if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have

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[2419] For details on decanting by mere amendment, see fn. 2717, found in part II.J.18.c.i What Is Decanting.

[2420] Letter Ruling 201711002, described in detail in part II.J.18.c.ii Tax Consequences of Decanting.

[2421] Section 1005(c) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provides:

> (c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:
> (1) the removal, resignation, or death of the trustee;
> (2) the termination of the beneficiary's interest in the trust; or
> (3) the termination of the trust.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2422] Section 1005(a) and (b) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provide:

> (a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than one year after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.
> (b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

inquired into its existence.[2423] The trustee may choose to disclose less than complete information; in that case, the trustee is protected only with respect to the information that is disclosed.

The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it. Given that a beneficiary's failure to bring a claim might constitute a gift,[2424] allowing any disputes to settle annually might minimize gift tax issues.

Each year, after a tax return preparer's peak period ends, the preparer might consider suggesting that the trustee contact counsel and obtain help in putting together an annual notice. The tax return preparer can compile the information, especially given that many preparers keep records in PDFs and can easily burn them to a CD. Part II.J.4.j.ii provides an example of what that might look like.

Every trustee should consider following this procedure:

- Litigious Beneficiaries. Having as few years as possible open will help reduce the stakes and make it less worthwhile for them to spend money to take legal action. Annual notices require them to state their concerns now, rather the criticizing many years in the future – put up or shut up. And, if the trustee has made a mistake (nobody's perfect), the trustee is in a better position to rectify it now than after the mistake's effects have been compounded for many years.

- One Big Happy Family. Sure, everyone's happy now. But relationships can change overnight – a beneficiary gets divorced, has a business failure, becomes addicted to drugs, is struck by physical or mental illness that changes his or her outlook on life, undergoes other financial or emotional stress, or simply starts disliking the trustee. Provide notices now, while everyone is happy and unlikely to complain. Besides, the trustee generally should be keeping beneficiaries informed anyway. Notices now can prevent a big claim later if a blow-up occurs.

[2423] Uniform Trust Code § 1005(b), found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.10-1005.2, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2424] The failure to assert a claim is a gift when the right to assert the claim becomes foreclosed, Rev. Rul. 84-105, which is described in fn. 5952, which is found in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts. Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> … the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

If somehow the consent does somehow consist of any power or right to enlarge or shift a beneficial interest, note that a principal/income allocation generally is only a few percent, and a beneficiary's failure to object to an accounting – if somehow characterized as a lapse of a general power of appointment - might very well be less than the 5% lapse of a general power of appointment that, under Code § 2514(e), does not constitute a gift. Having an annual report may keep the grievances within the 5% range. For more details on calculating the 5% lapse, see fn 5736 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

Generally, a trustee may use the trust's resources to provide notices, respond to questions, provide distributions to some beneficiaries to adjust for perceived unfairness in distributions to other beneficiaries, and defend lawsuits (so long as the trustee did not engage in bad faith or reckless indifference to the beneficiaries' interests).

Countervailing this recommendation are concerns about the effect of notices on the beneficiaries themselves. The trustee might be concerned that knowing that a pool of funds is available for a beneficiary might change the beneficiary's behavior – make the beneficiary more interested in draining the trust than earning a living, generate a sense of entitlement, or encourage the beneficiary to ask the grantor or the grantor's surviving spouse for money. The trustee will need to weigh those concerns against the trustee's legal exposure and general duties to provide information and might even decide that serving as trustee is too thankless a task. Better to think about these issues now and with eyes opened than to encounter a surprise.

II.J.4.j.ii. Sample Notice

After this paragraph, the rest of this part II.J.4.j.ii is a shell of a notice I have used. The trustee should consult with the trustee's own legal counsel to determine the advisability and sufficiency of such a notice under the circumstances.

Re: Trustee's Notice re: [trust's name]

As you know, the [trust's name] (the "Trust") was created by the [name of trust agreement].

As a beneficiary of the Trust, and on behalf of any other current or future beneficiaries of the Trust, you have the right to request a copy of the [name of trust agreement] and to receive information about the Trust's investments and other activity.

[Disclose any related party transactions.]

The enclosed CD-ROM contains the following information for the Trust for the period of January 1, 20xx, through December 31, 20xx:

1. [any trust accounting regularly prepared]

2. [brokerage statements]: January 1, 20xx, through December 31, 20xx

3. 20xx Fiduciary Income Tax Return for the Trust

4. Investment policy for [brokerage account or for trust as a whole]

If you have any questions with respect to this letter and the information contained on the enclosed CD-ROM, or if you have any difficulty accessing the information, please contact me. If you want to make a claim that I, as trustee, have breached any duty with respect to the Trust, you have one (1) year from the last to occur of (i) the date on which you (or your representative) were sent a report that adequately disclosed the existence of potential claim for breach of trust, and (ii) the date you were informed of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.

Attached you will find an Acknowledgement confirming receipt of this information. Please sign and date the acknowledgement and return it via fax or email to my attention.

Thank you.

[closing]

[page break]

ACKNOWLEDGEMENT

On my behalf and on the behalf of any other current or future beneficiaries, I hereby acknowledge receipt of the Trustee's Notice to the beneficiaries of the [trust's name], which includes reports relating to the trust's activities for the period January 1, 20xx, through December 31, 20xx.

[signature line and date blank]

II.J.5. Mandatory Income Trusts

II.J.5.a. Issues Arising with Mandatory Income Trusts

For very important limitations on the use of the Code § 642(c) charitable deduction, see fns. 2352-2353 in part II.J.4.c Charitable Distributions.

Some of the interplay between entities and trusts is described in parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

Also consider what happens when a trust holds only illiquid business assets and the trust needs to pay the trustee fee. Generally, one-half of trustee fees and certain other administrative expenses is allocated to income and one-half to principal.[2425] Using the trust's income to pay trustee fees, etc. attributable to would be problematic. Consider:

- Draft into the trust agreement language flexible enough to opt out of this general rule.[2426]

- Consider exercising a power to adjust, reclassifying some of the entity's distributions from income to principal, if the income that the business generates after the adjustment fairly balances the interests of the income beneficiary and remaindermen.[2427]

- Consider that the trustee might not have any significant activities directly on behalf of the trust and might instead spend most of his or her time running the business entity. This would especially be true if the entity was formed to hold investment assets. Perhaps the business entity should pick up a large majority of the burden of compensating the trustee, so that the above two recommendations are more palatable?

- Have the entity make noncash distributions, which generally are treated as principal.[2428] The trust can then sell those assets and use the proceeds to pay trustee fees. Note that a

[2425] Section 501 of the Uniform Principal & Income Act.
[2426] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2532.
[2427] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2434.

distribution of property is a recognition event for corporations[2429] and might be a recognition event for partnerships,[2430] so consider distributing high basis assets (which the entity might need to purchase).

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[2431]

II.J.5.b. Uniform Fiduciary Income & Principal Act (UFIPA)

II.J.5.b.i. General Ideas in UFIPA

A fiduciary determines trust accounting income by analyzing the character of the trust's receipts and disbursements, which are not necessarily tied to the trust's taxable income. This part II.J.5.b refers to trusts and trustees as a shorthand for any type of fiduciary arrangement (including an estate) or fiduciary (including a personal representative/executor; UFIPA (see below) section 103 determines the scope and section 102 provides definitions of "fiduciary" and "terms of the trust" refer to other trust-like arrangements (including life estates) to which this discussion applies.

At its July 2018 annual meeting, the Uniform Law Commission approved the Uniform Fiduciary Income & Principal Act (UFIPA). The drafting committee chair was Turney Berry; the "reporter" who drafted the results of the committee's decisions was Ron Aucutt; and, as an ACTEC observer, I had significant input into the process.

UFIPA re-wrote the Uniform Principal & Income Act ("UPIA" in this part II.J.5.b), the 2008 limited changes to which I served as the reporter.

In those states that adopt UFIPA/UPIA (the "Act" in this part II.J.5.b), the Act serves as rules that apply if and to the extent that the governing instrument does not provide different results ("default rules in this part II.J.5.b). UFIPA § 201(a) provides:[2432]

> In making an allocation or determination exercising discretion under this [act], a fiduciary shall:
>
> (1) act in good faith, based on what is fair and reasonable to all the beneficiaries;
>
> (2) administer a trust or estate impartially, except to the extent terms of the trust manifest an intent that the fiduciary shall or may favor one more beneficiaries;
>
> (3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in this [act]; and

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[2428] Section 401(c)(1) of the Uniform Principal & Income Act.
[2429] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[2430] See part II.Q.8.b.i Distribution of Property by a Partnership.
[2431] See parts III.A.4.c.iv.(b) What the Trustee Must Do to Alter the Trust's Investments If the Trust Agreement Does Not Address the Issue and III.A.4.c.iv.(c) How to Minimize Disputes About What the Trustee Should Do.
[2432] For UPIA's counterpart, see fn 2529 in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

(4) administer the trust or estate in accordance with this [act], except to extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise.

Although the terms of a trust and UFIPA describe what happens under state law, the tax laws might not respect a provision that strays too far from traditional fiduciary accounting income (FAI) principles.[2433]

II.J.5.b.ii. Power to Adjust or Convert to/from a Unitrust

Mandatory income trusts can cause conflicts between the income beneficiary, who tends to want the trustee to invest to generate current income, and the remaindermen, who tend to want the trustee to invest to generate long-term growth in principal. However, investing for long-term growth may increase long-term income, so all parties may benefit from investing for growth – especially if the trustee can count some of this growth as income.

UFIPA recognizes this solution by providing a power to adjust (see part II.J.5.b.ii.(a)) or to convert to/from a unitrust (see part II.J.5.b.ii.(b) Unitrust).

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

The power to adjust authorizes the trustee to divide the trust's total realized return, meaning income and realized gains, between income and principal. For example, if a reasonable income distribution rate is 3% and the total realized return is 8%, but traditional income included in the total realized return is only 2%, then the trustee would exercise the power to adjust by allocating 3% of the total realized return, consisting of 2% traditional income distribution rate and 1% from the realized gains. In other words, capital gains comprising 1% of the total return would be reallocated from trust accounting principal to trust accounting income. If desirable, the trustee would then be able to include that reallocated 1% capital gain to distributable net income (DNI), so that the income beneficiary would pay tax at his or her rates, rather than the capital gain possibly being taxed to the trust at its perhaps higher rates. See parts II.J.8.c.i Capital Gain Allocated to Income Under State Law and II.J.3.a Who Is Best Taxed on Gross Income.

Under UPIA, a trustee may adjust between principal and income to the extent the trustee considers necessary if:[2434]

- 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.

The impartiality component recognizes that an income beneficiary would want the trustee to invest for income and the remaindermen want the trustee to invest for growth. A prudent investor would tend to invest for both income and growth and make fair distributions of total return to the income beneficiary. The power to adjust authorizes the trustee to invest for total

[2433] See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2434] UPIA § 104(a).

return and allocate part of the growth component to the income beneficiary. If the trustee is actually distributing the capital gain to the income beneficiary as part of a fair sharing of the trust's total return, then it would seem fair to tax the income beneficiary on the capital gain that the income beneficiary receives. Depending on the overall situation, it might also be fair to include in that adjustment compensation for the taxes the income beneficiary pays on those capital gains.[2435] Often, the trustee couches the power to adjust in terms of a target percentage of the trust's value; however, the trustee might vary the target percentage as the trustee deems appropriate.

UPIA prescribes a number of the factors the trustee should consider[2436] and circumstances that limit or prevent the exercise of this power.[2437] Illinois has a more concise power to adjust that is in some ways more flexible and in some ways less flexible than UPIA.[2438]

Under UPIA, because the adjustment must be necessary to fulfill the trustee's duty of impartiality between the beneficiaries, presumably the power to adjust would not apply when the same standards apply to the distribution of income and principal.

However, 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 also clarifies that the trustee is not liable for failing to exercise the power[2439] and provides that the trustee is not liable for any decision regarding the power made in good faith.[2440] The fiduciary has wide latitude regarding the periods to which any such adjustment applies[2441] but is subject to reporting requirements.[2442]

[2435] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

[2436] UPIA § 104(b).

[2437] UPIA § 104(c).

[2438] 760 ILCS 15/3(b)(2) authorizes the trustee to use discretion in allocating receipts to income or principal:

> if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.

[2439] UFIPA § 203(b) provides:

> This section does not create a duty to exercise or consider the power to adjust under subsection (a) or to inform a beneficiary about the applicability of this section.

[2440] UFIPA § 203(c) provides:

> (c) A fiduciary that in good faith exercises or fails to exercise the power to adjust under subsection (a) is not liable to a person affected by the exercise or failure to exercise.

[2441] UFIPA § 203(j) provides:

> (j) The exercise of the power to adjust under subsection (a) in any accounting period may apply to the current period, the immediately preceding period, and one or more subsequent periods.

[2442] UFIPA § 203(k) requires a description of the exercise of the power to adjust to be:

> (1) included in a report, if any, sent to beneficiaries under [Uniform Trust Code Section 813(c)]; or
>
> (2) communicated at least annually to [the qualified beneficiaries determined under [Uniform Trust Code Section 103(13)], other than [the Attorney General]][all beneficiaries that receive or are entitled to receive income from the trust or would be entitled to receive a distribution of

In deciding whether and to what extent to exercise the power to adjust, a fiduciary must consider all factors the fiduciary considers relevant, including relevant factors in UFIPA § 201(e) and the application of UFIPA § 401(i),[2443] 408,[2444] or 413 (the latter being a general marital deduction savings clause).[2445]

UFIPA 201(e) provides factors a fiduciary must consider in deciding whether to exercise the power to adjust under UFIPA § 203, convert an income trust to a unitrust under UFIPA § 303(a)(1), change the percentage or method used to calculate a unitrust amount under UFIPA § 303(a)(2), or convert a unitrust to an income trust under UFIPA § 303(a)(3), all of which are exercisable "if the fiduciary determines the exercise of the power will assist the fiduciary to administer the trust or estate impartially."[2446] UFIPA § 201(e) provides the following factors:

(1) the terms of the trust;

(2) the nature, distribution standards, and expected duration of the trust;

(3) the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7;

(4) the desirability of liquidity and regularity of income;

(5) the desirability of the preservation and appreciation of principal;

(6) the extent to which an asset is used or may be used by a beneficiary;

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principal if the trust were terminated at the time the notice is sent, assuming no power of appointment is exercised].

[2443] UFIPA § 401(i) provides:

> If a fiduciary receives additional information about the application of this section to an entity distribution after the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under Section 203.

[2444] UFIPA § 408 authorizes an independent fiduciary to ignore various insubstantial allocations to income (and allocate all to principal). Subsection (b) authorizes a fiduciary to presume an allocation is insubstantial if:

> (1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; and
> (2) the asset producing the receipt to be allocated has a fair market value less than 10 percent of the total fair market value of the assets owned or held by the fiduciary at the beginning of the accounting period.

In addition to restrictions on exercising this power found within UFIPA § 408, UFIPA § 203(e) restricts the exercise of the UFIPA § 408 power; see fn 2447 and accompanying text.

[2445] UFIPA § 413, "Marital Deduction Property Not Productive of Income," provides:

> If a trust received property for which a gift or estate tax marital deduction was allowed and the settlor's spouse holds a mandatory income interest in the trust, the spouse may require the trustee to make property productive of income, convert property to property productive of income within a reasonable time, or exercise the power to adjust under Section 203, to the extent the trust assets otherwise do not provide the spouse with sufficient income from or use of the trust assets to qualify for the deduction. The trustee may decide which action or combination of actions to take.

[2446] UFIPA § 201(d).

(7) the increase or decrease in the value of principal assets, reasonably determined by the fiduciary;

(8) 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;

(9) the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods;

(10) the effect of current and reasonably expected economic conditions; and

(11) the reasonably expected tax consequences of the exercise of the power.

A fiduciary may not exercise the power to adjust:[2447]

(1) if the adjustment or determination 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;

(2) if the adjustment or determination would 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;

(3) if the adjustment or determination would reduce an amount that is permanently set aside for a charitable purpose under the terms of the trust, unless both income and principal are set aside for the charitable purpose;

(4) if possessing or exercising the power would cause a person to be treated as the owner of all or part of the trust for federal income tax purposes;

(5) if possessing or exercising the power would 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;

(6) if possessing or exercising the power would cause an individual to be treated as making a gift for federal gift tax purposes;

(7) if the fiduciary is not an independent person;[2448]

[2447] UFIPA § 203(e), which also precludes determining that an allocation is insubstantial under UFIPA § 408.

[2448] [This footnote is not in UFIPA § 203(e)(7).] UFIPA § 102(10) defines an "independent person as a parson that is not:

(A) for a trust:

(i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the

(8) if the trust is irrevocable and provides for income to be paid to the settlor and possessing or exercising the power would cause the adjusted principal or income to be considered an available resource or available income under a public-benefit program; or

(9) if the trust is a unitrust under Article 3.

However, if (4), (5), (6), or (7) above applies to a fiduciary but do not limit a co-fiduciary, the co-fiduciary may exercise the power to adjust, unless the exercise of the power by the remaining co-fiduciary or co-fiduciaries is not permitted by the terms of a trust or applicable law.[2449] If there is no such co-fiduciary, the fiduciary may appoint such a co-fiduciary, which may be a special fiduciary with limited powers, and the appointed co-fiduciary may exercise the power to adjust, unless the appointment of a co-fiduciary or the exercise of the power by a co-fiduciary is not permitted by the terms of the trust or applicable law.[2450]

Furthermore, a fiduciary may release or delegate to a co-fiduciary[2451] the power to adjust if the fiduciary determines that possessing or exercising the power to adjust will or may cause a result described in (1) through (6) or (8) above; or deprive the trust of a tax benefit or impose a tax burden not described in (1) through (6) above.[2452]

For tax issues regarding the power to adjust, see part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

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trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];

(ii) a settlor of the trust; or

(iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;

(B) for an estate, a beneficiary;

(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);

(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or

(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

[2449] UFIPA § 203(f)(1).

[2450] UFIPA § 203(f)(2).

[2451] UFIPA § 203(h) provides that such a release or delegation to a co-fiduciary of the power to adjust:

(1) must be in a record;

(2) applies to the entire power to adjust under subsection (a), unless the release or delegation in the record provides a limitation, which may be a limitation to the power to adjust:

(A) from income to principal;

(B) from principal to income;

(C) for specified property; or

(D) in specified circumstances;

(3) for a delegation, may be modified by a re-delegation under this subsection by the co-fiduciary to which the delegation is made; and

(4) subject to paragraph (3), is permanent, unless the release or delegation in the record provides a specified period, including a period measured by the life of an individual or the lives of more than one individual.

[2452] UFIPA § 203(g).

Terms of a trust which deny or limit the power to adjust between income and principal do not affect the application of UFIPA § 203, unless the terms of the trust expressly deny or limit the power to adjust.[2453]

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

UFIPA Article 3 provides for unitrusts. Part II.J.8.c.i.(c) Unitrust describes various tax issues relating to using unitrusts.

A "unitrust" is a trust for which net income is a unitrust amount.[2454] A "unitrust amount" means an amount computed by multiplying the trust's value by a determined percentage,[2455] the percentage being referred to as the "unitrust rate."[2456] Some tax laws prevent

The terms of a trust may provide that income must or may be calculated as a unitrust amount, in which case the trust is an "express unitrust."[2457] Otherwise, a fiduciary may convert an income trust to a unitrust if the fiduciary adopts a unitrust policy.[2458] A fiduciary may modify a unitrust policy[2459] or even convert a unitrust back to a trust that is not unitrust.[2460] In changing to or from or modifying a unitrust, a fiduciary must follow certain procedures and determine "that the action will assist the fiduciary to administer a trust impartially."[2461]

A fiduciary has no duty to take or consider any of these actions or to inform a beneficiary about the possibility of taking any of these actions.[2462] Furthermore, a fiduciary that in good faith takes or fails to take an action described above is not liable to a person affected by the action or inaction.[2463]

Of course,[2464] the terms of the trust may regulate or prohibit any of the above actions.[2465]

[2453] UFIPA § 203(i).
[2454] UFIPA § 301(5).
[2455] UFIPA § 301(6).
[2456] UFIPA § 301(8).
[2457] UFIPA § 301(2).
[2458] UFIPA § 303(a)(1).
[2459] UFIPA § 303(a)(2).
[2460] UFIPA § 303(a)(3), which refers to an "income trust," which UFIPA § 301(3) defines as "a trust that is not a unitrust."
[2461] UFIPA § 303(b).
[2462] UFIPA § 302(e).
[2463] UFIPA § 302(f).
[2464] UFIPA § 201(a)(3) provides that a fiduciary shall "(3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in [UFIPA]." Furthermore, UFIPA § 201(a)(4) requires a fiduciary to "administer the trust or estate in accordance with [UFIPA], except to the extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise."
[2465] UFIPA § 302(a) provides that, except as provided in subsection (b), UFIPA Article 3 applies to:

(1) an income trust, unless the terms of the trust expressly prohibit use of this [article] by a specific reference to this [article] or an explicit expression of intent that net income not be calculated as a unitrust amount; and
(2) an express unitrust, except to the extent the terms of the trust explicitly:
    (A) prohibit use of this [article] by a specific reference to this [article];
    (B) prohibit conversion to an income trust; or
    (C) limit changes to the method of calculating the unitrust amount.

A unitrust policy must provide:

(1) the unitrust rate or the method for determining the unitrust rate,[2466]

(2) the method for determining the applicable value,[2467] and

(3) the application of certain mandatory or permissive rules.[2468]

A unitrust policy may:[2469]

(1) provide methods and standards for:

(A) determining the timing of distributions;

(B) making distributions in cash or in kind or partly in cash and partly in kind; or

(C) correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;

(2) 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

(3) provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

UFIPA Article 3 does not apply to a trust described in Code § 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3)(A)(ii) or (iii), or 2702(b).[2470] Also, if a trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%, as well as other requirements.[2471] A "special tax benefit" includes the gift tax annual exclusion because the trust's income interest qualifies as a present interest in property;[2472] the trust is or was a QSST;[2473] a marital deduction trust;[2474] or a trust grandfathered from GST or a trust with an inclusion ratio less than one, in either case if needed to avoid possible GST tax.[2475] Whether a fiduciary in independent generally is based on whether that person is a settlor or a beneficiary or is related to either.[2476]

[2466] UFIPA § 305(b)(1), referring to UFIPA § 306.
[2467] UFIPA § 305(b)(1), referring to UFIPA § 307.
[2468] UFIPA § 305(b)(3), referring to UFIPA §§ 306-309, including mandatory rules under UFIPA §§ 307(a) and 308(a) and optional rules to the extent the fiduciary adopts them, referring to UFIPA §§ 306, 307(b), 308(b), and 309(a).
[2469] UFIPA § 309(a).
[2470] UFIPA § 302(b).
[2471] UFIPA § 309(b).
[2472] UFIPA § 102(18)(A), referring to Code § 2503(b).
[2473] UFIPA § 102(18)(B). See part III.A.3.e.i QSSTs.
[2474] UFIPA § 102(18)(C), referring to an estate or gift tax marital deduction under Code § 2056 or 2523 for a transfer to a trust, which deduction depends or depended in whole or in part on the right of the settlor's spouse to receive the trust's net income.
[2475] UFIPA § 102(18)(D), (E).
[2476] UFIPA § 102(10) provides that an "independent person" is a person who is not:
(A) for a trust:

II.J.5.b.ii.(c). Comparing Power to Adjust to a Unitrust

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.

Computing this average adds to the trustee's recordkeeping burden, although the calculation itself might or might not be simple. For a trust holding marketable securities, the calculation might not take very long. On the other hand, for a trust with closely-held business interests or real estate, the calculation might impose additional costs on the trust; in such a case, one might draft a trust applying the unitrust only to easy-to-value assets and using either more traditional principal and income concepts or the power to adjust for difficult-to-value assets.

Providing a fixed unitrust percentage allows the trustee to avoid fights with the income beneficiary and remaindermen over what percentage to use. However, it also can cause the trust to sell assets in a down year. For example, if the trust provides a 3% unitrust and interest and dividends are 2%, the trustee needs to raise the 1% difference by selling assets. That's fine when asset values increase, but it can cause the trust to be depleted if trust values have not increased, especially if the trust has several down years. Using a power to adjust, the trustee might distribute only interest and dividends in down years and distribute capital gains in up years, perhaps making extra distributions in up years to make up for decreased distributions in down years. The problem is that the income beneficiary might rely on a particular level of distributions, and distributing less in a down year might not be acceptable. Using a unitrust based on an average of the past few years' value would help smooth fluctuations, giving the beneficiary time to adjust spending habits when notified that values are down but that the decrease will be spread over time. When assets appreciate, the trustee might consider taking some of those gains and reserving them for down years, so that a unitrust will not have to sell assets in a down market.

(i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];

(ii) a settlor of the trust; or

(iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;

(B) for an estate, a beneficiary;

(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);

(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or

(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

Satisfying a unitrust with appreciated assets appears to be a deemed sale of those assets.[2477]

The first time a unitrust payment includes amounts in excess of trust accounting income, whether or not satisfied with appreciated assets, the trustee must make an irrevocable election to treat that excess (to the extent required to satisfy the unitrust obligation) - in the current and all future years - as included in or excluded from DNI.[2478]

However, the trustee may each year separately elect to treat any distribution of capital gain pursuant to a power to adjust as included in or excluded from DNI.[2479]

Thus, to maximize income tax flexibility, I tend to prefer the power to adjust over a unitrust.

II.J.5.b.iii. Modifying a Mandatory Income Trust to Make It Discretionary Income

Modifying a mandatory income trust to allow the trustees to accumulate income and then require any accumulated income to be paid to the beneficiary's estate did not have any income, gift,[2480] or GST[2481] tax consequences.[2482] For further analysis of trust medications, see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting, which provides an overview and concludes with part II.J.18.f Commutation vs Mere Division.

[2477] See part II.J.8.d.i Distribution in Kind - Generally, especially fns 2555-2556.

[2478] See part II.J.8.c.i.(c) Unitrust, found in part II.J.8.c.i Capital Gain Allocated to Income Under State Law.

[2479] See part II.J.8.c.i.(a) Power to Adjust, found in part II.J.8.c.i Capital Gain Allocated to Income Under State Law.

[2480] Letter Ruling 201320004 reasoned:

> In this case, the income distribution provisions will be modified to give the trustees discretion to distribute income to the primary beneficiaries or to accumulate such income. However, the accumulated income will be included in each primary beneficiary's estate upon the death of the beneficiary. Accordingly, at the time of the modification, none of the income interest will be gratuitously transferred from the primary beneficiary to any other beneficiary of Trust. The beneficial interests in the modified Trust will be substantially similar to the interests prior to the modification. Accordingly, based upon the facts submitted and representations made, we conclude that the proposed modification to Trust will not cause any beneficiary of Trust to have made a gift that is subject to gift tax under § 2501.

[2481] Letter Ruling 201320004 reasoned:

> In this case, the proposed agreement to modify Trust provides that the trustees have no duty to distribute income annually to the primary beneficiary of each separate trust share but will have the discretion to pay or apply the income for the benefit of each beneficiary. In addition, the proposed agreement to modify Trust provides that any accumulated income not distributed prior to the death of the beneficiary will be paid and distributed to the estate of the deceased beneficiary. Accordingly, the accumulated income will be included in the beneficiary's gross estate for estate tax purposes and the beneficiary will be treated as the transferor of the accumulated income for GST tax purposes. The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, based upon the facts submitted and the representations made, we conclude that the proposed agreement to modify Trust pursuant to Court Order will not cause Trust, as modified, to lose its GST exempt status as a result of allocating Settlor's GST exemption to Trust.

[2482] Letter Ruling 201320004.

II.J.6. Income Allocation on Death of a Beneficiary

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for the beneficiary's last taxable year or in the gross income of the beneficiary's estate is determined by the computations under Code § 652 for the taxable year of the trust in which his last taxable year ends.[2483] Consider whether income should be expressly payable or not payable to the beneficiary's estate.

If an amount is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under Code § 662 for the taxable year of the estate or trust in which his last taxable year ends.[2484]

Both of these rules are subject to part II.J.9.a.ii Separate Share Rule.

II.J.7. Code § 645 Election to Treat a Revocable Trust as an Estate

An election under Code § 645, filing IRS Form 8855, causes a qualified revocable trust[2485] to be taxed as part of an estate. The form is due by the time of the first income tax return filed for the

[2483] Reg. § 1.652(c)-2, which further provides:

> Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

[2484] Reg. § 1.662(c)-2, which further provides:

> Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

[2485] "Qualified revocable trust" means any trust treated under Code § 676 as owned by the decedent by reason of a power in the grantor, determined without regard to Code § 672(e). Code § 645(b)(1).

grantor's estate (or grantor's revocable trust, if no probate estate exists);[2486] there appears to be no relief for failing to meet that deadline, because the deadline is statutory.[2487]

An estate may elect to use a fiscal year,[2488] which can help shift income to the most suitable year, if the additional work in reconciling calendar year Forms 1099 can be justified. It appears that an estate may elect a fiscal year on a late-filed return,[2489] an estate with a Code § 645 election requires a timely filing.[2490]

[2486] Code § 645(c) provides a deadline of "not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions)."

[2487] Letter Ruling 201314011 granted relief for late filing of Form 8939, which was due with the estate's first income tax return. The ruling noted:

> Estate did not make an effective election under § 645 to treat Trust as part of the estate However, Estate's first Form 1041, US Income Tax Return for Estates and Trusts, reported all of the income of Estate and Trust as if Estate had made an effective election under § 645, and set a fiscal tax year ending Date.

In granting the relief for late filing of Form 8939, the ruling held:

> This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645.

[2488] Code § 441 generally allows the taxpayer to choose its taxable year, subject to certain limitations. Code § 644 requires trusts to use the calendar year, but estates are not so required.

[2489] Reg. § 1.441-1(c)(1) provides:

> *In general*. Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (*e.g.*, Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return"), the filing of an application for an employer identification number (*i.e.*, Form SS-4, "Application for Employer Identification Number"), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

Although Reg. § 1.441-1(c)(2) provides exceptions, the only one of concern is that the taxpayer must keep books. Reg. § 1.441-1(c)(2)(ii) provides:

> *Taxpayers without books*. A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

[2490] Reg. § 1.645-1(c)(2)(i) provides:

> *Time and manner for filing the election*. If there is no executor for a related estate, an election to treat one or more QRTs of the decedent as an estate for purposes of subtitle A of the Internal Revenue Code is made by the trustees of each QRT joining in the election, by filing a properly completed election form, or in any other manner prescribed after December 24, 2002 by forms provided by the IRS, or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the trust, taking into account the trustee's election to treat the trust as an estate under section 645 (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time

Among benefits are an unlimited charitable set-aside (which is not always beneficial)[2491] and UBTI not reducing the charitable deduction,[2492] deducting losses on funding pecuniary bequests, more favorable time deadlines for holding or making elections with respect to stock in an S corporation, and being able to deduct losses from certain active real estate rental.[2493] However, beware state income results – it might be easier for a state to claim jurisdiction over an estate than a trust, so making the Code § 645 election might convert a nonresident trust to a resident estate;[2494] note that this result might be better if the trust would be taxed in a high-tax state and the estate taxed in a low-or-no-tax state. Also, if the trust owns stock in an S corporation that makes material charitable contributions, an ESBT election may facilitate deducting the charitable contribution deduction.[2495]

This treatment expires on the "applicable date." If no estate tax return is required to be filed, the "applicable date" is two years after the date of the decedent's death;[2496] otherwise, it is six months after the date of the final determination of estate tax liability.[2497] Final determination of estate tax liability is the earliest of the following:[2498]

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

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prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041.

[2491] Code § 642(c)(1) and the regulations thereunder allow trusts to deduct gross income paid to charity during the taxable year and the following taxable year. Code § 642(c)(2) and the regulations thereunder (as well as Reg. § 1.645-1(e)(2)(i) and(e)(3)(i)) authorize estates to deduct gross income permanently set aside; however, contingent claims, regardless of size, might disallow the entire set-aside deduction. *Belmont v. Commissioner*, 144 T.C. No. 6 (2015). Reg. § 1.642(c)-2(d) provides, "No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." *Estate of John D. DiMarco v. Commissioner*, T.C. Memo. 2015-184, citing *Belmont*, concerned with the uncertainty of administrative expenses in light of litigation, disallowed the charitable set-aside, holding, "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

[2492] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 4523.

[2493] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 2962.

[2494] See part II.J.3.e.i Strategic State & Local Tax Issues re: Residence. For example, RSMo § 143.331 (http://www.moga.mo.gov/mostatutes/stathtml/14300003311.html) treats an estate as a resident merely if the decedent was domiciled in Missouri, whereas a trust is not a resident unless not only was the settlor a resident but also the trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

[2495] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, fn 4503 and the text preceding it.

[2496] Code § 645(b)(2)(A).

[2497] Code § 645(b)(2)(B).

[2498] Reg. § 1.645-1(f)(2)(ii).

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

The IRS might not issue a closing letter until the estate requests one, thereby extending the time that a Code § 645 might continue to apply under (A) above.[2499]

After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the Code § 6166 election.[2500]

Reg. § 601.6109-1(a)(4), "Taxpayer identification number to be used by a trust upon termination of a section 645 election," provides:[2501]

[2499] See fn. 6671, found in part III.B.5.d.iv.(g).

[2500] Reg. § 1.645-1(f)(2)(ii). Jonathan Blattmachr suggested this idea. Note that Rev. Rul. 76-23 held that, "where the sole purpose for retaining stock of a small business corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under section 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged for purposes of section 641(a)(3), and thus the estate will continue to be an eligible shareholder within the meaning of section 1371(a) for the period during which the estate complies with the provisions of section 6166." Contrast this to an estate, for which Reg. § 1.641(b)-3(a) discusses whether administration is unduly prolonged:

> The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

[2501] Reg. § 301.6109-1(a)(5), "Persons treated as payors," provides:

> For purposes of paragraphs (a)(2), (3), and (4) of this section, a payor is a person described in § 1.671-4(b)(4) of this chapter.

(i) *If there is an executor*. Upon the termination of the section 645 election period, if there is an executor, the trustee of the former electing trust may need to obtain a taxpayer identification number. If § 1.645-1(g) of this chapter regarding the appointment of an executor after a section 645 election is made applies to the electing trust, the electing trust must obtain a new TIN upon termination of the election period. See the instructions to the Form 1041 for whether a new taxpayer identification number is required for other former electing trusts.

(ii) *If there is no executor*. Upon termination of the section 645 election period, if there is no executor, the trustee of the former electing trust must obtain a new taxpayer identification number.

(iii) *Requirement to provide taxpayer identification number to payors*. If the trustee is required to obtain a new taxpayer identification number for a former electing trust pursuant to this paragraph (a)(4), or pursuant to the instructions to the Form 1041, the trustee must furnish all payors of the trust with a completed Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury by the trustee providing each payor with the name of the trust, the new taxpayer identification number, and the address of the trustee.

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[2502]

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[2503]

Code § 643(a)(3) provides:[2504]

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust,[2505] the gains must:

Reg. § 1.671-4(b)(4) is found in part III.B.2.e.i Grantor Trust Treatment During the Grantor's Life.

[2502] Reg. § 1.643(a)-3(e), Example (14).

[2503] Code § 643(a) provides:

> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[2504] Code § 643(a)(3) further provides:

> Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[2506]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset.[2507] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[2508] Whether other real estate is a capital asset depends on various facts.[2509]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[2510] to the extent it does not constitute certain depreciation recapture.[2511] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[2512] Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

[2505] Code § 643(a)(6)(C) provides:

> Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

[2506] Code § 643(a)(3); Reg. § 1.643(a)-3(a).

[2507] Code § 1221(2).

[2508] Section 401(c)(1) of the Uniform Principal & Income Act.

[2509] See part II.G.14 Future Development of Real Estate, especially fn. 1475.

[2510] Code § 1231(a)(3)(A)(i). See part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.

[2511] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 1370. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 1371. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015). In October 2016, the IRS made major revisions to its Cost Segregation Audit Techniques Guide, found at https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents.

[2512] Letter Ruling 200243002. For more discussion of goodwill, see fns. 1847, 3803, and 3843 (especially the latter).

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.
- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal.[2513] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[2514]
- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.
- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

[2513] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.
[2514] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading would be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[2515] are excluded from distributable net income (DNI).[2516]

[2515] Reg. § 1.643(a)-3(d) provides:

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[2516] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note that (b)(1) relates to determining whether capital gain has been allocated to income for state law purposes, and (b)(2) and (b)(3) relate to distributing capital gains that have been allocated to corpus.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[2517]

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act,[2518] which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b

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Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

[2517] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:
>
> (1) Allocated to income under the terms of the governing instrument or local law by the generates fiduciary on its books or by notice to the beneficiary,
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
> (3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.
>
> However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2518] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[2519]

Generally, the Act allocates capital gains to principal.[2520] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[2521] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See part II.J.5.b.ii.(a) Power to Adjust.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[2522] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.[2523]

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amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.c.i Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[2519] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

[2520] Act § 401.

[2521] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).

[2522] See part III.A.4 Trust Accounting Income Regarding Business Interests.

[2523] See part II.J.8.c.i.(a) Power to Adjust.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.
- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.
- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets for important tactical issues in implementing these ideas.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[2524] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[2525] The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.c.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

[2524] Part II.J.8.c.i.(a) Power to Adjust.

[2525] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11).* The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12).* The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13).* The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[2526]

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[2527]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[2528] The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.[2529]

[2526] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

> State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

[2527] Act § 103(a).

[2528] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing

However, Reg. § 1.643(b)-1[2530] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

The regulation respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to

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> instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[2529] Section 103(a) of UPIA provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

For UFIPA's counterpart, UFIPA § 201(a), see text preceding the text accompanying fn 2433 in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

[2530] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

> administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[2531]

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[2532] That language comes from

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[2531] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

[2532] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 2696.

the marital deduction regulations.[2533] Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status,[2534] does not constitute a power of appointment,[2535] and does not have generation-skipping transfer tax implications.[2536] The

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[2533] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income.* The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

[2534] Code § 674(b)(8); Reg. § 1.674(a)-1(b)(1)(iv).

[2535] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

See fn. 2331 for additional authority on ascertainable standards.

Letter Ruling 8908032 recognized that Reg. §§ 20.2041-1(b)(1) generally prevents administrative powers from creating a general power of appointment:

> …. Although the amount of income that A may receive each year is generally limited, the trust provides that any income from real estate must be distributed first and that all the income from real estate be distributed to A even if such distribution exceeds the annual limitation. Thus, if the trust had substantial income from real estate, it is possible for A to receive distributions in excess of the annual limitation imposed by the trust.

trustee might want to consider providing accountings or other notices to the beneficiaries that

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Where the holder of a power is not completely free from legal control or restraint in the disposition of property, a power held by the holder would not be a general power of appointment. Such legal control or restraint exists when the holder is legally accountable for its exercise. fiduciary duties imposed by local law are always subject to the control of the courts and the holder is always under a legal duty to account. See *Security-Peoples Trust Company v. United States*, 238 F.Supp. 40 (W.D. Pa. 1965). The initial step in determining whether a decedent has a general power of appointment is to determine, in light of local law, the interest conveyed to the decedent under trust; *i.e.*, the extent to which consonant with testamentary trust provisions, the decedent could invade and consume the principal. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).

It is necessary to look to the law of State X to determine whether A has the power to alter the beneficial interest under the trust. If A appointed herself trustee, A, as the trustee, would have the authority under the trust to sell trust assets and to invest the proceeds in real estate. Thus, A could cause trust income from real estate to exceed the limitation set forth in the trust for income distributions from other sources and, consequently, increase the total income distributions to A. Such investment policy and actions by A as the trustee would result in a shift of the beneficial interest of the trust. However, A would not have complete freedom to set investment policy for the trust. The statutory law of State X requires that a trustee consider the relative interests of both income and remainder beneficiaries in determining the prudence of any investment and imposes a duty on the trustee to administer the trust with due regard to the respective interests of income beneficiaries and remainderpersons in accordance with the terms of the trust. In addition, the highest court in State X has addressed the responsibilities of the trustee and stated that:

> It is the duty of the trustees to preserve the corpus of the trust for the remaindermen and to secure the usual rate of income upon safe investments for the life tenant, and to use a sound discretion in reference to each of those objectives. They cannot postpone the yielding of income for the increase of capital, nor select a wasting or hazardous investment for the sake of greater present income.

Congdon v. Congdon, 160 Minn. 343, 200 N.W. 76 (1924).

Moreover, *In re Clarke's Will*, 204 Minn. 574, 284 N.W. 876 (1939), addressed a situation where the trustee, who was also the income beneficiary, treated trust property incorrectly as "income" rather than "capital" and made erroneous distributions to herself. The court held that the trustee-income beneficiary had a duty to distinguish between the rights of the life tenant and those of the remaindermen with meticulous care. The court found that, although there had been no intentional wrong, there was an invasion of the rights of the remaindermen by the trustee-income beneficiary that amounted to fraud, irrespective of intention.

The law of State X clearly imposes a strong fiduciary duty on a trustee to protect the interests of all beneficiaries of the trust. While A, as the trustee, may invest trust assets in real estate that may produce sufficient income resulting in an increase in distributions to A, A cannot adopt an investment policy that would be detrimental to the interests of the remaindermen. Neither Trust 1 nor Trust 2 gives A, as the income beneficiary, any control over investment policy or income withdrawal. Due to the restrictions imposed by both the law of State X and the trust instruments, A does not have an unfettered right to change the interests of the beneficiaries.

Accordingly, A's power to remove the current trustee and appoint anyone, including A, as the trustee is not a general power of appointment as described in section 2041 of the Code.

[2536] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

> … administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[2537]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[2538]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

II.J.8.c.ii. Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1).* Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year.

[2537] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.
[2538] See fn. 2570.

During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example (3). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. <u>The beneficiary's need for distributions in excess of income is sporadic</u>. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[2539] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6).* Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[2540] For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution.[2541] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under

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[2539] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

[2540] Code § 663(b).

[2541] In a leap year, the deadline is March 5; in other years, the deadline in March 6.

Reg. §§ 1.643(a)-1 through 1.643(a)-7.[2542] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[2543]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus.[2544] The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[2545]

[2542] Reg. § 1.663(b)-1(a)(2)(i).

[2543] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).

[2544] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 6257. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

[2545] Code § 643(e)(2).

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

II.J.8.c.iv. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.v. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.v. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind; Specific Bequests

II.J.8.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI[2546] or constitutes a bequest of income,[2547] a distribution is a nontaxable gift[2548] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[2549]

When a trust distributes property to satisfy a pecuniary distribution[2550] (even if the amount is expressly authorized to be satisfied in cash or in kind),[2551] the trust recognizes gain on the

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[2546] Reg. § 1.102-1(d).
[2547] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).
[2548] Reg. § 1.102-1(a), (d).
[2549] See part III.B.1.c Gifts with Consideration – Bargain Sales.
[2550] Similar logic applies to satisfying a debt. Citing Rev. Rul. 66-207 (fn 2553), Rev. Rul. 74-178 Rev. Rul. 74-178 held:

> In the instant case the fair market value of the shares of stock at the time such stock was transferred to the creditor is equal to the amount of the claim satisfied ($8,000). However, since the executor did not elect the alternate valuation date, the estate's basis in the shares transferred is the fair market value of the shares at the date of the decedent's death ($7,000). Accordingly, it is held that upon such transfer the estate realized a gain of $1,000, which is the excess of the amount of the claim satisfied by the transfer over the estate's basis in the shares. Had the estate's basis in the shares of stock transferred exceeded the amount of the claim satisfied, the estate would have sustained a loss deductible to the extent allowed in sections 1211 and 1212 of the Code.

[2551] Rev. Rul. 86-105 held:

> 1. A bequest of "assets, in cash or in kind or partly in each," with a fair market value at date of distribution equal to a specified amount is a bequest of a "specific sum of money" under section 663(a) of the Code.
> 2. The bequest of unspecified property with a specified value at the date of distribution creates a right to receive a "specific dollar amount" under section 1.661(a)-2(f)(1) of the regulations. Therefore, gain or loss is realized by the estate upon a distribution in kind.

deemed sale,[2552] even if the trust's residue is less than the pecuniary obligation.[2553] Such a pecuniary obligation includes an equalizing distribution[2554] (presumably unless expressed as a

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[2552] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Reg. § 1.651(a)-2(d) provides:

> If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

[2553] Rev. Rul. 66-207 included the following facts and conclusion:

> By the terms of the decedent's will he made a bequest of a specific sum of money in the amount of 250x dollars to be used to create a trust for the benefit of a designated beneficiary. After payment of all debts, costs of administration, claims, and specific bequests, other than the sum of 250x dollars, the executor finds that all he has left in the estate are assets now having a fair market value of 200x dollars and an aggregate basis to the estate of 150x dollars. Included among these assets is cash in the amount of 10x dollars. All of these assets will be transferred in trust to the designated trustee in accordance with the terms of the will….
>
> Section 1.661(a)-2(f) of the regulations provides, in part, that no gain or loss is realized by the trust or estate by reason of the distribution of property in kind unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount. Under this provision of the regulations whenever property other than money is distributed by an estate to any beneficiary, including a trust, in satisfaction of a cash bequest the estate realizes gain or loss measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property so distributed. See *William R. Kenan, Jr., et al. v. Commissioner*, 114 F.2d 217 (1940); and *Sarah P. Suisman v. Eaton*, 15 F.Supp. 113 (1935), *affirmed per curiam*, 83 F.2d 1019, *certiorari denied*, 299 U.S 573.
>
> When the executor of this estate distributes the property remaining in the estate to the designated trustee in creation of the trust the estate will realize a gain of 50x dollars. This is the difference between the amount of the bequest satisfied by distribution of property other than cash (200x dollars less 10x dollars cash, or 190x dollars) and the basis (150x dollars less 10x dollars cash or 140x dollars) to the estate of the assets other than cash distributed in satisfaction of the bequest of a specific sum of money. The effect of the distribution will be the same as if the executor sold the remaining assets of the estate and distributed the proceeds to the trustee in trust.
>
> No amount is deductible by the estate under section 661 of the Code or includible in gross income of the trust under section 662 of the Code since the distribution will be in satisfaction of a bequest of a specific sum of money, as defined by section 1.663(a)-1(b) of the regulations.
>
> Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest.

[2554] Rev. Rul. 82-4 held:

> In this case, as in Rev. Rul. 66-207, the residue equal to the value of 100,000 shares of X company stock as of date of death bequeathed to C is a "bequest of a specific sum of money," as that term is defined in section 1.663(a)-1(b)(1) of the regulations, because the amount is ascertainable under the terms of A's will as of the date of A's death. Thus, no amount is

fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary,[2555] and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied.[2556] If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income.[2557] However, when a charity that was the

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> deductible by the estate under section 661 of the Code or includible in the gross income of B under section 662. Also, under section 1.661(a)-2(f)(1), the estate realizes a gain on the distribution in kind of appreciated property in satisfaction of C's right to receive a distribution in a specific dollar amount.
>
> **Holding**
>
> The estate realizes gain of $60,000 (date of distribution value ($180,000) less the basis of the property in the estate ($120,000)) for federal income tax purposes when the executor distributes the entire residuary estate to C to equalize to the extent possible the respective shares of total transfers received from the decedent.
>
> If in this case the value of the residuary estate had been, for example, $250,000, the property remaining after satisfaction of the $200,000 bequest to C ($50,000) would pass to B and C in equal shares. The estate would realize no gain or loss under section 1.661(a)-2(f)(1) of the regulations upon distribution of this portion of the $50,000 residue because the distribution would not be in satisfaction of the right to receive a distribution in a specific dollar amount.

[2555] Rev. Rul. 83-75, citing *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940), reasoned:

> The trustee was obligated to pay a fixed annuity to qualified charitable organizations. Under the principles of section 1.661(a)-2(f)(1) of the regulations and the case law cited, the distribution of appreciated securities causes the trust to realize gain or loss if the distribution satisfies a right to receive a distribution in a specific dollar amount. Although the trustee has authority to pay the annuity to qualified charities of the trustee's choice, the distribution satisfies a right to receive a specified dollar amount. It is not necessary or practical to identify a particular qualified charity with the right to receive a specified dollar amount. In *Kenan*, the court stated that the word "exchange" does not necessarily have the connotation of a bilateral agreement which may be said to attach to the word "sale". Thus, the distribution in this case is an exchange even though the trustee consulted with no one before satisfying the obligation to pay the annuity by using the appreciated securities.

Rev. Rul. 83-75 held:

> The distribution by the trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable organization is a sale or exchange of the securities that results in taxable gain to the trust.

Rev. Proc. 2007-45, § 8.02(2) says:

> *Payment requirements*. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The annuity payments may be made in cash or in kind. If the trustee distributes appreciated property in satisfaction of the required annuity payment, the donor will realize capital gain on the assets distributed to satisfy part or all of the annuity payment.

[2556] Rev. Rul. 68-392, which went through the rules that existed at that time regarding including capital gain in DNI and concluded that they did not apply. However, since then, the regulations have changed, so a different result may occur; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[2557] Letter Ruling 9548020, citing Rev. Rul. 66-207, a relevant excerpt from which is reproduced in fn 2553.

annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event.[2558]

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries.[2559] Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; [2560] for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales,[2561] but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate)[2562] satisfying a pecuniary bequest.[2563] The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value,[2564] unless gain was recognized, in which case it is the property's value.[2565]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust

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[2558] Letter Ruling 201928005, holding that Rev. Rul. 83-75 (fn 2555) did not apply.

[2559] Rev. Rul. 69-486. See Zaritsky, Lane & Danforth, ¶2.19. Gain on the Division, Termination, or Reformation of a Trust, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2560] Rev. Rul. 69-486. Reg. § 1.1015-2(a) provides:

> (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.
>
> (2) The principles stated in paragraph (b) of § 1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

[2561] Code § 643(e)(3).

[2562] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[2563] Code § 267, especially subsections (a)(1), (b)(6) and (b)(13).

[2564] Code § 643(e)(2).

[2565] Code § 643(e)(3).

instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.[2566]

II.J.8.e. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time.[2567] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[2568]

[2566] Reg. § 1.663(a)-1(a), which provides further:

> Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

[2567] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[2568] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act,[2569] consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[2570]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[2571] Only the following distributions from an entity are not considered trust accounting income:[2572]

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- 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.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[2573] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust

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[2569] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.
[2570] In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.
[2571] Act § 401(b).
[2572] Act § 401(c).
[2573] See part II.M.3.b Exception: Diversification of Investment Risk.

assets on termination or any other trust division.[2574] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[2575]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[2576] Furthermore, interrelated calculations might be required for a mandatory income trust.[2577] Generally, we should look to see whether planning under part II.J.8.c.i Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[2578] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[2579]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[2580] Such indirect

[2574] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[2575] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 4953.
[2576] See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.
[2577] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.D.2 Trust Accounting and Taxation.
[2578] Reg. § 1.652(b)-3(a).
[2579] Reg. § 1.652(b)-3(d).
[2580] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116)

expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[2581] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income.[2582] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2113-2114).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[2583]

> pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

An expense allocated to tax-exempt income and therefore disallowed for income tax purposes may be deductible for estate tax purposes. Rev. Rul. 59-32, which Rev. Rul. 63-27 clarifies as showing just one among the acceptable methods of such a calculation.

[2581] Reg. § 1.652(b)-3(c).

[2582] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2583] Reg. § 1.642(c)-3(b)(2) provides:

> *Determination of the character of an amount deductible under section 642(c).* In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:
>
> Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income

- Special rules apply to depreciation deductions.[2584]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[2585]

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[2586] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[2587]

> tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.
>
> Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

Reg. § 1.643(a)-5(b) provides:

> If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of § 1.662(b)-2 and § 1.662(c)-4(e).

[2584] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2585] Code § 661(b).

[2586] Reg. § 1.661(b)-1.

[2587] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[2588] it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[2589]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands[2590] (which, among other things, is important for net investment income tax purposes).[2591]

> section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[2588] See fn. 2583.

[2589] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 2583, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

[2590] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[2592]

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the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[2591] See fn. 2133, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[2592] Reg. § 1.662(b)-1, which is quoted in fully in fn. 2590. Furthermore, Reg. § 1.652(b)-2(a) provides:

The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

When allocating among beneficiaries:[2593]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is

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[2593] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

II.J.9. Separate Share Rule; Trust Divisions; Multiple Trust Rules for Tax Avoidance

II.J.9.a. Specific Bequests; Separate Share Rule

The extent to which distributions carry out distributive net income is limited by parts II.J.9.a.i Specific Bequests and II.J.9.a.ii Separate Share Rule.

II.J.9.a.i. Specific Bequests under Code § 663(a)

Limiting what counts as distributions carrying out distributive net income ("DNI"), Code § 663(a), "Exclusions," provides:

> There shall not be included as amounts falling within section 661(a) or 662(a) —
>
> (1) *Gifts, bequests, etc.* Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.
>
> (2) *Charitable, etc., distributions*. Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to sections 508(d), 681, and 4948(c)(4)).
>
> (3) *Denial of double deduction*. Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

Reg. § 1.663(a)-1, "Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.," provides:

> (a) *In general*. A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing

instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property*.

(1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the

taxable year, the executor paid the legacy of $5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under section 663(a)(1).

Example (2). Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of $50,000 for the taxable year. The estate distributed to A stock with a basis of $40,000 and with a fair market value of $40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see § 1.661(a)-2(c)).

Example (3). Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During the eleventh year, the trustee is to distribute $10,000 to B, payable from income or corpus, and $10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments*.

(1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)-2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the

ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1).

(i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as

> an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.
>
> *Example (3)* A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

When an estate funds a pecuniary bequest to a trust before the estate terminates, the distribution receives Code § 663(a)(1) treatment.[2594]

Although Reg. § 1.663(a)-1 protects a gift or bequest of a specific sum of money or of specific property, it does not protect a combination of those. Rev. Rul. 72-295 had the following facts:

> The decedent in his will directed his executor to distribute to B, an heir, 8x dollars worth but no more than all of the Y stock owned by the decedent at his death, the valuation to be made on the date of distribution. At the time of his death the decedent owned 300 shares of Y stock. At the time of distribution 64 shares of Y stock were required to satisfy the bequest and the executor distributed that number of the shares to B.

Rev. Rul. 72-295 reasoned and held:

> Generally, in order to qualify as specific property, the property must be identifiable both as to its kind and as to its amount. In the instant case, the bequest to B consisted of property other than money. Since only the kind of property, not the amount thereof, was ascertainable under the terms of the decedent's will as of the date of his death, it did not qualify as a bequest of specific property.
>
> Accordingly, in the instant case, since the 8x dollars worth of Y stock received by B does not qualify as a bequest of specific property, it is not subject to the provisions of section 663(a) of the Code but is a distribution to B that comes within the meaning of the phrase "any other amounts properly paid or credited," set forth in section 661(a)(2) of the Code.
>
> … since the distribution in kind to B is not in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed, the estate does not realize gain or loss by reason of the distribution of the shares of stock.
>
> If the estate has distributable net income, then in determining the amount deductible by the estate under section 661(a) of the Code, and includible in the gross income of B

[2594] Rev. Rul. 57-214. Rev. Rul. 64-307 held that Rev. Rul. 57-214 applies only to a pecuniary bequest and not to a bequest of residue and that any distribution deduction relating to the residue applies only when the bequest is actually funded.

> under section 662(a) of the Code the shares of Y stock will be taken into account at their fair market value at the time of distribution.
>
> In addition, the basis of the shares of Y stock in the hands of B is their fair market value at the time of distribution, to the extent such value is included in his gross income. To the extent that the value of the Y shares are not includible in B's gross income, they will retain the same basis they had to the estate.

Satisfying a bequest of specific property with other property does not affect the bequest's qualification under Code § 663(a)(1).[2595]

Apparently focusing on Reg. § 1.663(a)-1(b)(1), Letter Ruling 9218076 addressed specific bequests provided to settle a contest of the exercise of a testamentary power of appointment, holding:

> Based on the information submitted, we conclude that the amount of money and the identity of the specific property contained in the 1990 payments were not ascertainable under the terms of Trust as of the date of the inception of Trust. Therefore, the 1990 payments do not qualify as bequests of specific sums of money or property under section 663(a)(1) of the Code. Accordingly, the 1990 payments are included as amounts falling within sections 661(a) and 662(a).

However, if settlement reforms the trust as of the trust's inception as a separate taxpayer, as did Letter Ruling 9218076, I believe that the settlement payments should be eligible for Code § 663(a)(1) treatment. It has been suggested that Code § 663(a)(1) merely overlays Code § 102 principles[2596] over the fiduciary income tax system. Keeping that mind, consider *Vincent v. Commissioner*, T.C. Memo. 1992-21, which discussed Code § 102:[2597]

[2595] TAM 8220062.

> In the instant case the bequest by A of his shares in M clearly constituted a bequest of specific property. On the death of A there was no doubt as to the kind of property given. A's will made a bequest of M stock and A was possessed of M stock at the time of his death. On the death of A the amount of M stock which each of A's sons was to get was ascertainable. B was to get b shares and C was to get c shares. Unlike the case presented in Rev. Rul. 72-295 the number of shares in M which B and C were to receive was not tied into the value of the M shares on the date of their distribution. Instead, the amount of M shares which both B and C were to get was known with certainty on the day that A died. The bequest of M stock was identifiable as to its kind and amount under the terms of A's will as of the date of his death. Therefore, the bequest of M stock was a bequest of specific property. See Rev. Rul. 72-295.
>
> Although the bequest of M stock was a bequest of specific property it was satisfied, in part, with shares of N stock and not with shares of M stock. Nevertheless, the character of the property used to satisfy a bequest does not alter the nature of the bequest so satisfied. The use of money and property to satisfy a bequest of a specific sum of money is nevertheless considered a distribution in satisfaction of a bequest of a specific sum of money. Rev. Rul. 66-207. Therefore, the use of one type of property to satisfy a specific bequest of another type of property should be considered a distribution in satisfaction of a bequest of specific property.

Although the TAM did not rule on the issue, presumably the distribution of N stock was a sale or exchange.

[2596] Code § 102, "Gifts and inheritances," starts with:

> (a) *General rule*. Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

Petitioners did not acquire the $390,000 payment by gift, bequest, devise, or inheritance, but instead by the settlement of a lawsuit. Whether a dispute is resolved through litigation or settlement, the nature of the underlying action determines the proper tax consequences. *Getty v. Commissioner*, *supra*; *Tribune Publishing Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988). The taxability of a settlement is controlled by the nature of the litigation. *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 114 (1st Cir. 1944), *affg*. 1 T.C. 952 (1943); *Victor E. Gidwitz Family Trust v. Commissioner*, 61 T.C. 664, 673 (1974). The nature of the litigation is, in turn, controlled by the origin and character of the claim which gave rise to the litigation. *United States v. Gilmore*, 372 U.S. 39 (1963); *Victor E. Gidwitz Family Trust v. Commissioner*, *supra*.

(b) *Income*. Subsection (a) shall not exclude from gross income—
 (1) the income from any property referred to in subsection (a); or
 (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

 Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

Reg. § 1.102-1, "Gifts and inheritances," provides:

(a) *General rule*. Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances*. The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income*. If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J*. Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor*. Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

[2597] *Vincent* dealt with tax years 1980 and 1983. A cite shortcutted below referred to earlier in the case include *Getty v. Commissioner*, 913 F.2d 1486, 1490 (9th Cir. 1990), *revg*. 91 T.C. 160 (1988).

> In characterizing the settlement payment for tax purposes, the test to be applied is stated most simply as "In lieu of what were the damages awarded?" *Getty v. Commissioner*, *supra*; *Tribune Publishing Co. v. Commissioner*, *supra* at 1178. In the instant case, petitioner's stepmother filed a complaint to set aside the 1978 Deed to the Modoc property. Petitioner filed a cross-complaint requesting a determination of his interests in the Modoc property. Petitioner also requested that the Santa Barbara Superior Court order a partition of the property or, in the alternative, order the property be sold with the proceeds to be divided according to the parties' respective interests in the Modoc property. After 3 years of legal posturing in the property dispute, and having twice had petitioner's general demurrers sustained against her, petitioner's stepmother agreed to a settlement in the amount of $390,000….
>
> In the instant case, the origin and character of the dispute involved the validity of a gratuitous transfer of real property to petitioner by his father pursuant to the 1978 Deed. The pleadings concerning the Modoc property transfer clearly indicate that the parties disputed the validity of the 1978 Deed. Petitioner's stepmother requested the court to declare the 1978 Deed null and void. Petitioner, in his cross-complaint, requested a judicial determination of his interest in the Modoc property. The Compromise Settlement and Mutual Release stated that the covenants therein and the $390,000 payment was in lieu and instead of any inherited interest in the Modoc property. We therefore reject respondent's contention that the $390,000 payment represented a nuisance settlement based on an unrecognized claim to property. We conclude that the underlying claim arose out of a dispute as to the validity of the gratuitous transfer of the Modoc property to petitioner.
>
> Accordingly, we conclude that the settlement proceeds represented a payment for any interest that petitioner may have acquired from the purported gratuitous transfer by his father pursuant to the 1978 Deed. Therefore, we hold that the settlement payment was properly excludable from petitioners' 1983 gross income under section 102(a).

Although *Vincent* does discuss Code § 663(a)(1), the principle that Code § 102 may protect settlements from taxation undercuts Letter Ruling 9218076's idea that a settlement of rights as of the trust's inception would not be eligible for the Code § 663(a)(1) exclusion of a distribution from carrying out DNI. On the other hand, Reg. § 1.663(a)-1(b)(1), reproduced above, does require that "the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust," so uncertainty such as that provided by a formula marital bequest (as pointed out later in the regulation)[2598] can prevent Code § 663(a)(1) protection (even though satisfying with property a formula bequest of a

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[2598] *Lemle v. United States*, 419 F.Supp. 68 (S.D.N.Y. 1976), commented:

> The design of Section 662 is clear enough: the section as presently framed effectively eliminates the problem of tracing distributions to their source, a problem that had inevitably attended the former statutory schema. See 1954 Oscoda Cong. & Admin. News at pp. 4086-87, 4621, 4714-15, 4990 (83d Cong., 2d Sess.). It is equally clear that distributions representing an elective share in the corpus of a deceased spouse's estate may be subject to the conclusive presumption raised by Section 662. See 26 U.S.C. 663 and 26 C.F.R. 1.663(a)-1(b).[5]
>
> [5] A dower interest, in contradistinction to a surviving spouse's elective share, is excepted from Section 662 coverage. The rationale behind this difference in tax treatment is indirectly revealed in 26 C.F.R. 1.663(a)-1(b).

pecuniary amount is treated as a sale of that property).[2599] Ultimately, the limits of Code § 663(a)(1) override Code § 102, which is required so that a bequest of a series of payments will carry out income.[2600] Furthermore, if a beneficiary receives a series of payments that under state law constitute income at the time but in a later taxable year settles with the estate, applying the payments towards the estate's lump-sum obligation (an elective share), that application of payments under the settlement agreement does not prevent the series of payments from being distributions that carry out DNI.[2601]

Using property to satisfy a pecuniary bequest, although not a Code § 663(a)(1) distribution, is a deemed sale from the trust to the beneficiary.[2602] If an estate that is about to distribute specially

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[2599] Rev. Rul. 60-87 provides:

> Revenue Ruling 56-270, C. B. 1956-1, 325, stands for the proposition that, if a marital deduction trust comprises a fraction or percentage of the "adjusted gross estate" of a decedent, the marital trust fund is considered to have been provided for in a fixed and definite "dollar amount." Therefore, capital gain or loss is recognized upon the distribution of property to a trust…
>
> Unlike section 1.663(a)-1(b)(1) of the regulations, Revenue Ruling 56-270, *supra*, is not concerned with the ascertainability of a specific amount at the date of death but rather whether the marital trust fund is provided for in a fixed and definite amount at the time of the distribution. Thus, to qualify for the exclusion provided for in section 663(a) of the Code, the above-quoted regulation prescribes an entirely different test from that prescribed in Revenue Ruling 56-270, which has application only for capital gain purposes. Further, the last sentence of the above-quoted regulations recognizes the fact that a different rule applies for capital gain purposes and clearly implies that the regulations are not to be considered inconsistent with that rule.
>
> In the instant case, the marital deduction trust comprises a portion of the residue of the decedent's estate. However, instead of using a residuary formula clause, which leaves a percentage or fraction of the value of the residuary estate to the surviving spouse or trust, the will uses a pecuniary formula clause, as a Revenue Ruling 56-270, *supra*, which leaves a percentage of the "adjusted gross estate" to the surviving spouse or trust. There is a significant distinction between a marital deduction trust of the pecuniary formula type and one of the residuary formula type.
>
> The rationale of Revenue Ruling 56-270, *supra*, is that a marital deduction trust of the pecuniary formula type provides for a trust fund in a fixed and definite amount, once the value of the adjusted gross estate is finally determined, which amount is unaffected by any appreciation or depreciation in value of the assets comprising the estate.
>
> The difference is that under a pecuniary formula clause the trust will receive assets of a fixed and definite amount at the time of distribution, whereas under the residuary formula clause the percentage or fraction will be applied for the purpose of making distribution of the residuary estate as constituted at the time of distribution. Therefore, under a residuary formula clause, the trust will share in appreciation and depreciation of the value of the estate, which is not the case under a pecuniary formula clause. Thus, Revenue Ruling 56-270, *supra*, is not inconsistent with section 1.663(a)-1(b)(1) of the regulations.
>
> The facts in the instant case show that the marital deduction trust comprising a portion of the residue of the estate is measured by a percentage of the value of the adjusted gross estate. Under such circumstances, the marital trust fund is considered as being provided for in a fixed and definite "dollar amount." Accordingly, gain or loss is realized by the estate measured by the difference between the fair market value of the property at the date of distribution and the value of the property determined for Federal estate tax purposes.

[2600] *Mahler v. Commissioner*, T.C. Memo. 1987-64.

[2601] *Lemle v. United States*, 579 F.2d 185 (2nd Cir. 1978).

[2602] Consistent with *Kenan v. Commissioner*, 40 B.T.A. 824 (1939) (taxing gain on deemed sale), *aff'd* 114 F.2d 217 (2nd Cir. 1940) (gain received capital gain treatment), Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific

bequeathed assets sells them at the beneficiaries' request, the executor's compliance with this request is the equivalent of a distribution of the securities to the beneficiaries, accompanied by an immediate return of the securities by the beneficiaries with instructions to the executor to sell on their behalf and is taxed directly to them.[2603] However, if an estate has legal title to property whose income is dedicated to charity, the estate reports the income and then takes a charitable deduction for the charitable set-aside.[2604] However, where the beneficiaries have only equitable rights and no legal rights to property, the income is received in trust and then distributed to the beneficiaries.[2605] On the other hand, if under applicable law a decedent's real estate passes

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> dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

[2603] Rev. Rul. 68-666 reads in its entirety:

> A decedent by will made a specific bequest of securities to three charitable organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954. After all of the debts of the decedent's estate had been satisfied, and when the executor of the estate was preparing to make distribution of the specific bequest, the beneficiaries thereof requested the executor to sell the securities and to distribute the proceeds in satisfaction of the specific bequest. Held, the executor's compliance with this request is the equivalent of a distribution of the securities to the beneficiaries, accompanied by an immediate return of the securities by the beneficiaries with instructions to the executor to sell on their behalf.
>
> Accordingly, gain realized on the sale of the securities is not includible in the gross income of the decedent's estate. Such gain was not realized and received by the estate. It was realized and received by the beneficiaries as a result of sales made by the executor while acting on their behalf.

This agency argument does not apply to qualified retirement plans that sell stock before distributing it. *Clayton v. U.S.*, 33 Fed. Cl 628 (1995) (distributees argued that they received low basis stock from an ESOP and then sold it for capital gain instead of an ordinary income distribution), *aff'd* 91 F.3d 170 *Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996).

[2604] Rev. Rul. 57-133.

[2605] Rev. Rul. 75-61 involved the following facts:

> A died testate in 1963. His will provided that after the payment of his just debts and funeral expenses one-third of the estate be "alloted and assigned" to his wife, B, as satisfaction of her dower interest. Real property was transferred by the executor of A's estate to B in 1964 to carry out this provision in the will. Under local law, real property and income therefrom is subject to administration.
>
> A's will further provided that the income from certain property, comprising one-third of the estate, was to be paid to his son, C, for life and at C's death, such property was to be distributed to those of C's children living at the time of his death. In the event any portion of such property should vest in any person before such person attained his or her majority, then such portion would be retained by a trustee under a power in trust to invest and reinvest the principal, to collect the income and apply the net income, or as much thereof as the trustee should in his sole discretion determine, to the support and maintenance of such person during his or her minority.
>
> C died in the year 1971 leaving only a minor child, D. Under the laws of the appropriate jurisdiction legal title to property held under a power in trust is in the beneficiaries, in this case D.
>
> The final third of the estate consisted of real estate and under the will was to be held by A's daughter, E, in fee simple, with the limitation that she would have no right to sell, convey, mortgage, incumber or dispose of, in any way, the real estate or rights therein before January 1, 1971, or to control, receive, or collect income from such real estate before January 1, 1967, unless permitted to do so at an earlier date by the action of the trustee. On and after January 1, 1967, however, she could lease the real property and receive the income from it.

directly to the beneficiaries, the estate does not include income from the real estate, except if and to the extent that the executor takes charge of the property and uses it to pay expenses rather than distributing it to the beneficiaries.[2606]

> The specific issues are whether the income derived from the property held by the executor and ultimately distributed to B is income to B or to the executor; whether the income derived from the property held subject to the power in trust is income of a trust or of C's child; and whether income derived from the property conveyed to A's daughter is her income or income of a trust.

Rev. Rul. 75-61 held:

> The will, in the instant case, passed legal title to one-third of the estate to B, one-third to D, and one-third to E. However, it is manifest that complete control over the realty conveyed to D and E was given to the trustee. D and E could not collect the rental income themselves regardless of where the bare legal title to the real estate might vest. It was A's intent that the income from the real estate held by D should be received by C, until C's death, then controlled by the trustee for the benefit of D until such time as D reached his majority, then to D. Furthermore, it was A's intent that the income from the real estate held by E should be controlled by the trustee until January 1, 1967, and the power to convey the real estate was to be withheld until January 1, 1971.
>
> Thus, the trustee of the properties of D and E is vested with the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of the responsibility.
>
> Accordingly, it is held that the trustee must file U.S. Fiduciary Income Tax Returns (Form 1041) reporting therein the income from the property held under the power in trust for the benefit of D, for the taxable years in which he, as trustee, received such income. It is further held that the trustee must also report the income received from the real property left by A for the benefit of E for the taxable years in which such income was received by the trustee. Furthermore, it is noted that the dower interest of B has been satisfied by the transfer to her of real property of the estate by the executor, since under local law the property and income therefrom was subject to administration during that period. Rev. Rul. 57-133, 1957-1 C.B. 200. The income from such property that was received prior to the transfer to B is held to be income to the estate and reportable by the executor. After the transfer of the real estate to B, the income is held to be the personal income of B.

[2606] Rev. Rul. 59-375 reasoned and held:

> Under North Carolina law, when a person dies intestate, his real property descends directly to his heirs and is not subject to the control of the administrator. See *Alexander v. Galloway, et al.*, 80 S.E.(2d) 369; *Parker, et al., v. Porter, et al.*, 179 S.E. 28. However, under section 28-81 of the General Statutes of North Carolina, if the personal estate of the decedent should prove insufficient to pay the debts and costs of administration, the administrator may apply to the courts to sell the real property. Under section 28-57 of the General Statutes of North Carolina, all proceeds arising from such a sale are deemed personal assets in the hands of the administrator. Section 28-58 of the General Statutes of North Carolina provides, further as follows:
>
>> Surplus of proceeds of realty sold for debts is real asset.—All proceeds from the sale of real estate, as hereinafter provided, which may not be necessary to pay the debts and charges of administration, shall, notwithstanding, be considered real assets and as such shall be paid by the executor, administrator or collector to such persons as would have been entitled to the land had it not been sold.
>
> In the present case the income was realized from sales of property made on behalf of both the administrator and the heirs. There was a joint sale of their respective interests in the lands. Such partition of real property by sale, where it appears that the actual partition cannot be made without injury to some or all of the interested parties, is provided for under Chapter 46, Article 2 to the General Statutes of North Carolina. The sales involved here were made according to section 1-339.4 of such General Statutes which authorizes the appointment of a commissioner to hold a sale in any proceeding. In such cases, the commissioner is acting as an agent of the court

II.J.9.a.ii. Separate Share Rule

In addition to its significance for fiduciary income tax purposes, the separate share rule can be critically important for determining a trust's eligibility for QSST treatment[2607] and for certain nonqualified deferred compensation plans.[2608]

"A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists,"[2609] which really means that "distributions of the trust are to be made in substantially the

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> on behalf of the petitioning parties. See *Ex parte Wilson*, 22 S.E.(2d) 262; and *Harrell v. Blythe*, 53 S.E. 232. Under the orders of the court, the commissioner holds the proceeds for the heirs, subject only to the actual requirements of the administrator. Thus, to the extent that the property was sold for the purpose of providing funds for the administration of the estate, the proceeds are to be considered personalty and are subject to administration. It was only to that extent that the administrator had any interest in the property. See *Linker v. Linker, et al.*, 196 S.E. 329. As only a portion of the lands was sold on behalf of the administrator, only an allocable portion of the gains from the sale is includible in the gross income of the estate.
>
> Accordingly, it is held that only that part of the gain from the sales of an intestate decedent's real estate, which is proportionate to the portion of the proceeds payable to the administrator under state law for the discharge of the debts of the estate, is required to be included in the gross income of the estate. The remainder of the gain, which arises from the partition at the suit of the heirs, does not constitute an amount "received by" the estate within the purview of section 641(a)(3) of the Code.

[2607] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 5597-5599.

[2608] Reg. § 1.404(a)-12(b)(3).

[2609] Reg. § 1.663(c)-2(a), which applies to trusts other than qualified revocable trusts within the meaning of Code § 645(b)(1). For estates and such qualified trusts:

> The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.

Reg. §§ 1.663(c)-3(c) and 1.663(c)-4(c) discuss this economic interest:

> 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 separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Reg. § 1.663(c)-3(b) explains how rights to distributions need to be separated:

> Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:
>
> (1) Distribute, apportion, or accumulate income, or
>
> (2) Distribute corpus
>
> to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

Reg. § 1.663(c)-3(d) explains that remote possibilities of distributions outside the separate share's targeted beneficiaries will not ruin separate share treatment:

> Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the

same manner as if separate trusts had been created."[2610] If a trust (or estate) has separate and independent shares, that treatment "must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment."[2611] This rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[2612] Special rules apply to specific bequests,[2613] trusts with Code § 645 elections, and elective shares;[2614] also see

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> corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

However, such remoteness is not permitted for a QSST. See part III.A.3.e.i.(a) QSSTs Generally, fn. 5597.

[2610] Reg. § 1.663(c)-3(a), which explains:

> Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

[2611] Reg. § 1.663(c)-1(d).

[2612] Reg. § 1.663(c)-1(c).

[2613] See part II.J.9.a.i Specific Bequests under Code § 663(a). T.D. 8849 (12/28/1999) explained:

> The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.

[2614] Reg. § 1.663(c)-4(a) provides:

> Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

Reg. § 1.663(c)-4(b) provides:

> Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

If different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income (DNI) allocable to the respective beneficiaries under Code §§ 661 and 662.[2615] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[2616]

- Gross income includible in DNI that is fiduciary accounting income "is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law."[2617]

- Gross income includible in DNI that is income in respect of a decedent under Code § 691(a) and is not fiduciary accounting income "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."[2618]

- Gross income includible in DNI "that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the

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[2615] Reg. § 1.663(c)-1(a). Rev. Rul. 74-299 (amplified by Rev. Rul. 2007-48) applied Reg. § 1.663(c)-1(a) to a Code § 402(b) nonexempt employees' trust.
Reg. § 1.663(c)-1(b) elaborates on Reg. § 1.663(c)-1(a):

> The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:
> (1) The filing of returns and payment of tax,
> (2) The deduction of personal exemption under section 642(b), and
> (3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

[2616] Reg. § 1.663(c)-2(b)(1), which further provides:

> Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

[2617] Reg. § 1.663(c)-2(b)(2).

[2618] Reg. § 1.663(c)-2(b)(3). Reg. § 1.663(c)-5, Example (9), provides:

> The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is $9,000,000. During 2000, the $900,000 balance in Testator's individual retirement account is distributed to the estate. The entire $900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of income in respect of a decedent must be allocated to A's share.

The Example is troubling, in that the allocation of the IRA does not have economic effect under the actual facts. However, if the residue is less than $1.8 million, then A gets $900,000 and B gets the balance, which would be less than what A received. The fact that the estate was more than that does not change the possible economic effect, because one never knew how large the IRA or the estate would be.

pro rata share of an S corporation's tax items) … is allocated among the separate shares in the same proportion as [fiduciary accounting] income from the same source would be allocated under the terms of the governing instrument or applicable local law."[2619]

- "Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."[2620] It is unclear whether (a) this merely keeps the deduction within its share to offset its share's income but allows a net loss from a separate share might lower the trust's and therefore the other shares' tax liability, or (b) it completely prevents the loss generated by one share from reducing the amount included in the income of the other shares' beneficiaries.[2621] I believe that the former is the better view,[2622] although when taking that position one might attach

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[2619] Reg. § 1.663(c)-2(b)(4).

[2620] Reg. § 1.663(c)-2(b)(5).

[2621] Although the above allocations govern the allocation of DNI, Code §§ 661 and 662 govern how much income the trust can deduct and consequently include in a beneficiary's income. That amount is the lesser of DNI or the sum of income required to be distributed for a taxable year and any other amounts properly paid or credited or required to be distributed for such taxable year. Code § 661(a). These amounts are allocated to the beneficiaries and included in their income. Code § 662(a).
However, because the only mechanism for a beneficiary to deduct a loss is either depreciation deductions (see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss) or loss on termination (Code § 642(h)), a beneficiary cannot deduct a loss and the trust cannot carry over a loss other than one generated by a business (Code § 642(d)) or a capital loss (Code § 1212). Thus, if a separate share has a net loss, the beneficiary(ies) will not deduct that loss. See part II.J.3.i Planning for Excess Losses.
Consider the following scenario: Trust has $10,000 of taxable interest income, allocated to share A, and $10,000 of state income tax liability, attributable to taxes on the prior year's municipal bond interest earned by share B earned before the bonds were sold at no gain or loss. The trust distributes $10,000 to A and $10,000 to B, each out of her own share. The trust's taxable income, ignoring exemptions, is zero. Applying Reg. § 1.663(c)-2(b)(5) to disallow the state income tax deduction would result in A including $10,000 in income and the trust having a $10,000 loss ($10,000 interest income minus the $20,000 sum of the $10,000 income distribution deduction and the $10,000 state income tax liability). Which is correct: zero taxable income for everyone, or $10,000 taxable income to A and the trust has a $10,000 loss that benefits nobody? In other words, does the trust's overall DNI of zero control, or do A's DNI of $10,000 and B's DNI of negative $10,000 control?
Consider another scenario: share A has $10,000 of dividends and $10,000 of capital gain through a partnership that distributes $20,000 as a distribution of operating income (and not a distribution in partial liquidation), and share B has no dividends and $10,000 of capital loss through a partnership that distributes $20,000 of cash as a distribution of the prior year's operating income. On Form 1041, Schedule D, the capital gain and loss offset. We know that the separate share rule prevents B from reporting any of A's income. However, does the separate share rule tax $20,000 ($10,000 of dividends and $10,000 of capital gain) or $10,000 (dividends only, because capital gains were offset by capital loss) to A? If the former, what mechanism is there for preserving the $10,000 capital loss allocated to B? Nowhere do the Instructions for Schedule D (Form 1041) address this issue; even if one allocated share B's capital loss to the trust instead of to the beneficiaries, neither the tax return nor the Capital Loss Carryover Worksheet in the Instructions provides a mechanism that prevents netting the beneficiaries' capital gain against the trust's capital loss in a manner that would generate a capital loss carryover for share B.

[2622] Yu, "Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate," 5 Pitt. Tax Rev. 123 (2008) (saved as my document no. 6167169), reviews the two approaches to resolve the issue raised in fn. 2621 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's article cited F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008), as saying on pages 3-104 to 3-105 the following about Reg. § 1.663(c)-2(b)(5):

IRS Form 8275-R because on its face that position appears to contradict Reg. § 1.663(c)-2(b)(5).[2623] If one or more separate shares benefit from the overall ceiling of tax liability, then the trustee should consider making an equitable adjustment to compensate the share that generated the loss for the benefit that the other share(s) received – especially because that loss is probably reflected in lower tax basis of assets held by the share that generated the loss. If one is doing an interim division of a trust, holding some back in the general residue but opening up a separate account within a trust to represent a separate share for each beneficiary or group of beneficiaries, one might consider raising this issue and clarifying the approach to be taken if one share generates a loss.

A specialized application of the above is in part III.A.3.d.i Various Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

In making the above allocations to separate shares, "the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations…."[2624] For example, a principal distribution from one share that is disproportionately larger than a principal distribution from another share should affect the relative allocation of income between those shares.[2625]

However, the amount the trust deducts[2626] and the amount each separate share includes in income[2627] is the lesser of the DNI allocated to[2628] or the amount actually distributed to that separate share.

> Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

Informal email conversations with Lad and Jonathan in April 2015 confirmed that they had not changed their view on this issue.

Reg. § 1.663(c)-1(a) explains the philosophy of the separate share rules, applying them to an example, and concludes, "In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B." Yu's preferred approach that I adopted does not cause any income to be shifted from one beneficiary to another; it merely limits the estate's deduction consistent with the overall DNI limitation of Code § 661(a).

[2623] Such an explanation is saved as my document no. 6149985.

[2624] Reg. § 1.663(c)-2(c).

[2625] Reg. § 1.663(c)-5, Example (3) provides:

> The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

T.D. 8849 added this example December 27, 1999, presumably superseding the approach taken in Letter Ruling 9644057, which ruling approved disproportionate distributions of principal without changing the distribution of income.

[2626] Code § 661(a).

The charitable deduction may reduce the amount allocable to DNI (and the charity does not receive a K-1);[2629] however, a distribution to a charitable remainder trust (CRT) generates a Code § 661 deduction and K-1 rather than a charitable income tax deduction,[2630] and be sure to use discretion to allocate various types of taxable income[2631] to try to avoid allocating unrelated business income to the CRT.[2632] After separate shares are determined, the charitable deduction reduces the amount of DNI allocated to each separate share.[2633] Furthermore,

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2627 Code § 662(a).

2628 Code § 663(c) allocates DNI and therefore is a factor the determining, rather than the sole determinant of, the amount deducted by the trust or estate and included in the beneficiary's income.

2629 Code § 663(a)(2) and Reg. § 1.663(a)-2 (reproduced in fn 4527 in part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, as is Notice 2004-35), the former which is incorporated by reference into Reg. § 1.661(a)-1. Additional authority for no K-1 to charity includes Rev. Rul. 2003-123; Rev. Rul. 68-667; *U.S. Trust Company v. Internal Revenue Service*, 803 F.2d 1363 (5th Cir. 1986) (upholding the regulation as valid); *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972) (*en banc*), *cert. denied*, 409 U.S. 1108 (1973) (same); *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977) (same result) (reviewed); *Pullen v. United States*, 45 A.F.T.R.2d 80-381 (D. Nev. 11/30/1979), *aff'd* No. 80-1034 (8th Cir. 1980) (memo) (same result); CCAs 201651013 (thoroughly reviewing the above authorities and GCMs 33410 (1/10/67) and 33696 (11/29/67), which the CCA said resulted in TAM 6802210560A specifically and Rev. Rul. 68-667 generally, and agreeing with the result) and 201747005 (I believe that the CCAs are greatly flawed on their Code § 642(c) analysis but agree with their analysis of Code § 663(a)(2) and Reg. § 1.663(a)-2). For the charitable fiduciary income tax deduction, see part II.J.4.c Charitable Distributions.

2630 GCM 39707 (3/14/1988) first ruled that Code § 642(c) does not apply to a distribution to a CRT, citing Reg. §§ 1.664-1(a)(5)(iii) and 1.664- 1(a)(6), Example (5), the latter providing:

> In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.
>
> For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

The GCM concluded:

> Since we have concluded in our discussion of Issue (1) that no amounts distributed to the charitable remainder trust in this case are considered as set aside for charitable purposes within the meaning of section 642(c)(2) of the Code, the prohibition of Treas. Reg. 1.663(a)-2 on section 661 deductions for amounts paid or set aside for charitable purposes has no application in this case. Thus the estate is entitled to a deduction under section 661 of the Code for its distributions to the trust, up to the amount of the estate's distributable net income.

2631 See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

2632 See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially the text accompanying fns 4270-4271.

2633 Reg. § 1.663(c)-5, Example (11) provides:

> The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable

generally the charitable deduction proportionately reduces the other deductions allocable to each share.[2634]

For the interaction of this part II.J.9.a.ii to the Code § 199A deduction described in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, see part II.E.1.f.i.(d) Separate Shares.

If a beneficiary dies, to the extent that this part II.J.9.a.ii does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

II.J.9.b. Trust Divisions

See parts II.J.18 Trust Divisions, Mergers, and Commutations; Decanting and II.D.5 Severing Trusts with Multiple Grantors.

II.J.9.c. Multiple Trusts Created for Tax Avoidance

For purposes of the fiduciary income tax rules under Code §§ 641-692, under Treasury regulations, two or more trusts are treated as one trust if:[2635]

> (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
>
> (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.
>
> For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

1984 Committee Reports for HR 98-432, P.L.98-369, provide:

> For example, the committee expects that the Treasury regulations would treat the trusts in the following example as one trust: A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.
>
> Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existence of separate trusts, the trusts will not be aggregated. The following is an example where separate trusts will not be aggregated under the committee bill: X establishes two irrevocable trusts for the benefit of X's son and

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organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[2634] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2583.

[2635] Code § 643(f).

daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

However, no relevant Treasury regulations existed before 2018, so one wondered whether the provision is effective. Nevertheless, at least one taxpayer was concerned enough to include it in a private letter ruling request that focused on a trust division and received a favorable ruling (which is not surprising, considering that the trusts has different primary beneficiaries).[2636]

Proposed regulations regarding the multiple trust rule were issued in conjunction with proposed regulations interpreting Code § 199A, which has its own multiple trust rule.[2637] The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), explained:

VII. Proposed § 1.643(f)-1: Anti-avoidance Rules for Multiple Trusts

As described in section VI.B of the Explanation of Provisions, under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Therefore, taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A and general trust principles.

To address this and other concerns regarding the abusive use of multiple trusts, proposed § 1.643(f)-1 confirms the applicability of section 643(f). As noted in part II of the Background, section 643(f) permits the Secretary to prescribe regulations to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid Federal income tax. Proposed § 1.643(f)-1 provides that, in the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. For purposes of applying this rule, spouses are treated as only one person and, accordingly, multiple trusts established for a principal purpose of avoiding Federal income tax may be treated as a single trust even in cases where separate trusts are established or funded independently by each spouse. Proposed § 1.643(f)-1 further provides examples to illustrate specific situations in which multiple trusts will or will not be treated as a single trust under this rule, including a situation where multiple trusts are created with a principal purpose of avoiding the limitations of Section 199A. The application of proposed § 1.643(f)-1, however, is not limited to avoidance of the limitations under Section 199A and proposed §§ 1.199A-1 through 1.199A-6.

[2636] Letter Ruling 199912034.

[2637] Reg. § 1.199A-6(d)(3)(vii), which is reproduced in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

> The rule in proposed § 1.643(f)-1 would apply to any arrangement involving multiple trusts entered into or modified on or after August 16, 2018. In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed § 1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VIII, "Treatment of Multiple Trusts," retreated from this overbroad provision:

> Two commenters requested clarification regarding whether multiple trusts will be aggregated if section 643(f) requirements are met. Specifically, the commenters asked for clarification on what it means to form or fund a trust with a significant purpose of receiving a Section 199A deduction. These commenters state that trusts should not be combined simply because the Section 199A deduction is increased if a legitimate non-tax reason led to the creation of the trusts.
>
> Other commenters objected to the presumption of a tax-avoidance purpose, arguing that it will shift the focus to a requirement that there be a non-tax purpose for creating multiple trusts. The commenters also asked whether the reference to income tax includes state income tax, as the proposed rule refers to the avoidance of more than Federal income tax.
>
> Another commenter agreed with the need for the rule but asked for clarification on the definitions of primary beneficiary, significant tax benefit, principal purpose, and arrangement involving multiple trusts; the application of the substantially the same beneficiary rule; and whether trusts for different children, with other children as default beneficiaries, are the same. Another commenter noted that the use of substantial purpose rather than principal purpose is inconsistent with the statutory language.
>
> Another commenter asked for clarification of the effective date regarding modifications or contributions to pre-effective date trusts, and of the identification of trusts to which the regulation applies. Another commenter requested that final regulations address the applicability of the rule to the conversion of grantor trusts to non-grantor trusts post enactment of the TCJA.
>
> One commenter requested that examples be given for each of the three requirements under section 643(f) and requested that § 1.643(f)-1, Example 2, be clarified to describe the trusts as non-grantor trusts.
>
> Based on the comments received, the Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms.

Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

The retreat from the overbroad proposed regulations is encouraging. However, the statute and especially the legislative history create many unanswered questions. And "taking under advisement whether and how these questions should be addressed in future guidance" indicates to me that the Treasury Department and the IRS are not working on providing clarification anytime in the near future.

Reg. § 1.643(f)-1(a), "Treatment of Multiple Trusts," provides:

(a) *General rule*. For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, 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. For purposes of applying this rule, spouses will be treated as one person.

(b) *Effective/ applicability date*. The provisions of this section apply to taxable years ending after August 16, 2018.

The regulation merely mirrors the statute, removing the overreaching language that was in the proposed regulations and leaving uncertain many issues. The statute uses undefined terms, and the Committee Reports introduce uncertainty to how to apply its undefined terms. ACTEC's official comments to the proposed regulations criticized some overreaching terms in the proposed regulations that were removed, but its concern over undefined terms and confusing Committee Reports remains.[2638]

What is the effect of violating the rule? Suppose parents create a separate trust for each of their five children, where each child is the sole beneficiary who may or must receive distributions. Code § 643(f) would not try to combine them. Suppose they create a sixth trust that sprinkles among all five children and that the avoidance of Federal income tax was a principal purpose for establishing the sixth trust. Are all six trusts combined? Are the tax attributes of the sixth trust allocated to the five other trusts? We need better guidance.

Rev. Proc. 2019-3 added section 3.01(85), which continues identically in Rev. Proc. 2020-3, § 3.01(89), among the list of issues on which private letter rulings will not be issued:

> Section 643(f).—Treatment of multiple trusts.—Whether two or more trusts shall be treated as one trust for purposes of subchapter J of chapter 1.

That addition is not surprising, in that Code § 643(f) is based on a taxpayer's motivation, and the IRS ordinarily does not issue rulings in such areas. On the other hand, having "substantially the

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[2638] ACTEC comments on proposed regulations under Sections 199A and 643(f) (September 27, 2018).

same primary beneficiary or beneficiaries" is not based on a taxpayer's motivation, and it would be nice to know when trusts are sufficiently different to avoid needing to look into the taxpayer's motivation.

Notwithstanding this prohibition, Letter Ruling 201928004, which was issued 3/21/2019 and released to the public 7/12/2019, provided a favorable Code § 643(f) ruling with respect to a trust that was grandfathered from GST tax. The trust agreement required income to be accumulated for an undisclosed period, then:[2639]

> Upon the conclusion of the x-month period, the trustee divided the principal of the trust into equal shares among the Trustors' living children, including a share to be held for the benefit of Son and his issue ("Trust"). Son has five children, Child 1, Child 2, Child 3, Child 4 and Child 5 (collectively, "Son's Children"). Bank is currently serving as trustee of Trust ("Trustee"). Trust is the subject of this ruling request.
>
> Pursuant to § 3(b)(i) of Trust Agreement, Trustee is to pay so much of the income or principal of Trust to or for the benefit of Son or his issue as Trustee deems advisable for their care, comfort, support and education, or in the case of sickness or other emergency. Upon Son's death, Trust is held in continuing trust for Son's Children until the youngest of Son's Children is age 21, at which point Trust terminates and is distributed to Son's issue, per stirpes. All of Son's Children have reached age 21.
>
> If upon Son's death, Son has no issue living, then distribution will be made to Son's brothers or sisters, per stirpes. Because Son's Children have different investment goals and distribution needs, Trustee proposes to divide Trust into five subtrusts ("Subtrust"; collectively, the "Subtrusts") for the benefit of Son and each of Son's Children and their respective issue ("Proposed Division"). Each Subtrust will be funded with one-fifth of the assets of Trust. The terms of each Subtrust will be identical and unchanged from the terms of Trust Agreement, except that each Subtrust will be held for the benefit of Son and his respective child for whom the Subtrust was created and such child's issue. Any distribution to Son from a Subtrust will be pro rata from each Subtrust.
>
> In accordance with the terms of the Trust Agreement, each Subtrust will terminate on Son's death and remaining Subtrust assets will be distributed to the then living child for whom the Subtrust was created, or, if such child is deceased, to the then living issue of the deceased child, per stirpes. If the child dies without living issue, then the Subtrust will be distributed to Son's other living issue, per stirpes.

Letter Ruling 201928004 cited Code § 643(f), then held:

> Accordingly, based on the facts submitted and representations made, the Proposed Division of Trust will result in each Subtrust having different primary beneficiaries. We conclude that as long as each Subtrust created by the Proposed Division is separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

[2639] The ruling also addressed the lack of income tax consequences on the trust division itself. See text accompanying fn 2715 in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Code § 643(f) has been the subject of various private letter rulings before 2017 tax reform, when the tax laws did not motivate multiple trusts as strongly as they do after 2017 tax reform. The most recent ruling, Letter Ruling 201722007, held:

> Taxpayer represents that each Successor Trust will have different beneficiaries. Based on the facts submitted and the representations made, we conclude that as long as the Successor Trusts are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

What an unhelpful ruling! The ruling stated the trusts' terms, so the IRS knew who the beneficiaries would be and did not need a representation that the beneficiaries would be different.

Letter Ruling 201709020 was more helpful. It actually took a position:

> The Article THIRD Trusts will each have different primary beneficiaries. We conclude that as long the Article THIRD Trusts created by the pro-rata transfer of assets from Trust are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

In the ruling, one trust for the benefit of all of the grantor's descendants was divided into separate trusts for each of the grantor's seven children before the grantor's death instead of after the grantor's death.[2640] Each new trust followed the trust's terms that would have applied after the grantor's death anyway:

[2640] The proposed transaction was described as:

> Trust, through its trustee, proposes to create eight separate trusts governed under Article THIRD of the trust agreement for the Family Trust and each of Grantor's seven children and their descendants ("Article THIRD Trusts") and to transfer the Article ONE trust estate, other than the X stock, in equal shares to each of the Article THIRD Trusts. The trustee will allocate a pro rata portion of each and every asset transferred from Trust to the Article THIRD Trusts. Trust will retain the X stock that will continue to be governed by Article ONE of the trust agreement.
>
> The trustee and beneficiaries filed a petition with Court to: (i) interpret and construe the terms of the trust agreement to provide for the establishment of the Article THIRD Trusts by the trustee pursuant to the powers given under Paragraph 4.1(P) of the trust agreement, (ii) approve the creation of the Article THIRD Trusts for the Family Trust and each of Grantor's seven children and their descendants pursuant the terms of paragraph 4.1(P) of the trust agreement, and (iii) approve the transfer of the Article ONE trust estate other than the X stock in equal shares to the eight Article THIRD Trusts.
>
> Court granted such petition in a Declaratory Judgment on Date 3.

As to Paragraph 4.1(P):

> Paragraph 4.1(P) of Article FOURTH of the trust agreement gives the trustee the power to: (i) divide any trust created under Article FIRST or Article THIRD of the trust agreement into one or more separate trusts for the benefit of one or more of the beneficiaries of the trust (to the exclusion of the other beneficiaries) so divided, as the trustee, in the exercise of her absolute discretion, shall determine, but in all other respects under the same terms as set forth in Article THIRD; (ii) divide any trust created under Article SECOND hereof into one or more separate trusts for the benefit of the beneficiary but in all respects under the same terms as set forth in Article SECOND hereof; and (iii) to allocate to such divided trust some or all of the assets of the trust estate for any reason including, but not limited to, enabling any such trust or trusts to qualify as an eligible shareholder of an S corporation as described in the Code, or for any other purpose.

> Paragraph 3.1 of Article THIRD of the trust agreement provides that any share or part of a share which is directed to be held in accordance with the terms and conditions of Article THIRD, the trustee shall pay over or apply the net income and principal to such extent and at such time or times as the trustee, in the exercise of absolute discretion, shall determine. Any net income not so paid over or applied shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed as a part thereof.
>
> Paragraph 3.2 of Article THIRD provides that upon the death of the primary beneficiary, the principal of the trust shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for each child of the deceased primary beneficiary who is then living and one such share for the collective descendants who are then living of any child of the deceased primary beneficiary who is not then living.

Presumably each trust had only one beneficiary to whom distributions could be made during the beneficiary's life.

One resource on Code § 199A pointed to Letter Ruling 200209008. However, it actually did not rule on whether Code § 643(f) applied:

> A primary purpose of establishing Trust A and Trust B is the need to eliminate the dispute that has arisen among the beneficiaries concerning investment strategies. It is represented that avoidance of income tax is not a primary purpose of Trust A and Trust B within the meaning of section 643(f)(2). Determining whether avoidance of income tax is a primary purpose of Trust A and Trust B is a question of fact, the determination of which must be deferred until the federal income returns of the parties involved have been examined by the office having examination jurisdiction over the income tax returns.
>
> Therefore, provided that Trust A and Trust B are separately managed and administered and it is determined that tax avoidance is not a primary purpose of Trust A and Trust B, each will be treated as a separate trust for federal income tax purposes.

That same author also cited Letter Ruling 199923004. However, Field Service Advice 199923004 did not address Code § 643(f); it involved a change in accounting method. The closest ruling in time to that was Letter Ruling 199929021, which was also unhelpful:

> A, B, and C represent that the primary purpose of establishing the New Trusts is the need to eliminate the impasse that has arisen among the trustees in choosing the charitable beneficiaries of Trust 1. By dividing Trust 1 into three separate trusts, A, B, and C will act independently of each other, thereby allowing each to act independently of the other in choosing the charitable beneficiaries. They further represent that avoidance of income tax is not a primary purpose of the New Trusts within the meaning of section 643(f)(2). Determining whether avoidance of income tax is a primary purpose of the New Trusts is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director having examination jurisdiction over the tax returns. Therefore,

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Article SECOND provided a QSST whenever S corporation stock was owned. See part III.A.3.e.i.(a) QSSTs Generally.

> provided that each of the Trusts is separately managed and administered and it is not determined that tax avoidance is a primary purpose of the New Trusts, each of the Trusts will be treated as a separate trust for federal income tax purposes.

I have not reviewed the more than 140 other private rulings that cited Code § 643(f).

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter

If an estate tax audit results in higher values and therefore higher basis, the related fiduciary income tax return might need to be amended to take advantage of higher basis to reduce gain on sale of assets or increase depreciation deduction.

II.J.11. Trust Business Income Tax Nuances

II.J.11.a. Depreciation Advantages and Disadvantages

II.J.11.a.i. Code § 179 Disallowance for Estate or Nongrantor Trust

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[2641] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[2642] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed.[2643] Presumably, this complexity would be avoided by using a grantor trust.[2644]

However, don't overlook the possibility of bonus depreciation, which under the 2017 tax reform law allows 100% deduction for most tangible personal property placed in service after September 27, 2017 and before January 1, 2023. See part II.G.5.b Bonus Depreciation.

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses)

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary

When a depreciation deduction of a trust is allocable to its beneficiaries, and where such deductions if separately taken into account by the trust would result in an income tax liability for the trust different from that which would result if the trust did not take such deductions into account separately, then the partnership's depreciation must be separately reported on the K-1

[2641] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).

[2642] Code § 179(d)(4).

[2643] Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense (including bonus depreciation – see part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation) to the trust or estate. Presumably, an S corporation or partnership would allocate the asset's inside basis, depreciation expense, and other tax attributes to the trust, including not reducing the basis of the trust's interest in the business until depreciation expense is incurred.

[2644] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially fn. 6097, for the proposition that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

that the trust receives; a similar rule applies to depreciation allocated between a life tenant and the remaindermen or between an estate and its beneficiaries.[2645]

The allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;[2646] however, if the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve is apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each,[2647] and the trust agreement may not override this rule.[2648] No effect is given to any allocation of the depreciation deduction which gives any beneficiary a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument.[2649] I am unaware of any guidance how to allocate in a sprinkle trust; presumably, those beneficiaries who tend to receive distributions would be the ones entitled to the depreciation deductions. Regarding the trustee's authority to set aside income to maintain a reserve for depreciation, note that depreciable property tends to be held in a business entity, and the entity itself would be maintaining any necessary depreciation reserves rather than the trustee maintaining such reserves.

If a trust holds mortgaged property and the trustee charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, depreciation must be allocated to the trust, by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated and the denominator of which is the total trust income computed under Code § 643(b).[2650]

[2645] Rev. Rul. 74-71. See 2017 Form 1041, Schedule K-1, line 9, "directly apportioned deductions." Code § 167(d) provides:

> *Life tenants and beneficiaries of trusts and estates*. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

For an elaboration on rules governing estates, see *Estate of Nissen v. Commissioner*, 345 F2d 230 (4th Cir. 1965), *rev'g* 41 T.C. 522 (1964); *Lamkin v. U.S.*, 533 F.2d 303 (5th Cir. 1976).

[2646] Code § 642(e) provides:

> An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(d) and 611(b) .

[2647] Reg. § 1.167(h)-1(b), incorporated by reference by Reg. § 1.642(e)-1, the latter of which (not yet amended to reflect changes made by P.L. 101-508, P.L. 97-34, P.L. 94-455) provides:

> An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

[2648] *Dusek v. Commissioner*, 376 F.2d 410 (10th Cir. 1967).

[2649] Reg. § 1.167(h)-1(b).

[2650] Rev. Rul. 90-82.

Rev. Rul. 74-530 clarifies that the trust calculates deductions and then apportions them [note, however, that Code § 167(h) then is now Code § 167(d)]:

> For purposes of section 167(h) and section 611(b) of the Code the allowable deductions described therein are the depreciation and depletion deductions attributable to properties owned by an estate or a trust. The computation of the allowable deductions is made by the estate or trust in its capacity as a separate taxable person under section 7701.
>
> Accordingly, before apportioning the deduction for depreciation under section 167(h) of the Code and the deduction for depletion under section 611(b), such deductions first must be computed by the estate or trust based on the properties it holds in its capacity as a separate taxable person.
>
> Furthermore, it is possible under section 167(h) and section 611(b) of the Code to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust. This is so because although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.

Thus, generally limitations on losses, such as basis and at-risk limitations,[2651] would be applied first at the trust level. However, that does not end the analysis regarding how a beneficiary deducts these directly apportioned deductions; see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

For an in-depth discussion of allocating depreciation, see Lawson, "Tax Planning for Rental Real Estate Owned by a Trust," *Estate Planning Journal* (Vol. 40, No. 9, Sept. 2013), and Ransome, "Allocating Partnership Depreciation Between Trusts and Beneficiaries," *The Tax Adviser* (7/1/2007), the latter saved as Thompson Coburn LLP doc. no. 6682178.

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss

Although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.[2652]

Therefore, a fiduciary might be able to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust.[2653]

[2651] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
[2652] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.
[2653] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.

For application of the Code § 469 passive loss rules to depreciation and depletion deductions, see part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property

If the trust holds depreciable property through a partnership, the trustee might not be making any decision regarding depreciation reserve, if the trustee is counting on the partnership to make any appropriate reserve.[2654] In that case, presumably the depreciation deduction would be allocated solely to the beneficiaries who do or may receive current distributions. Furthermore, passing the deductions through to any beneficiaries who participate in the business would simplify any passive loss issues (if and to the extent that the passive loss rules do not supersede this part II.J.11.a.ii),[2655] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[2656]

If a trust holds depreciable property through an S corporation, consider the following:

- If a nongrantor trust is permitted to hold the stock without making an ESBT or a QSST election,[2657] then see the discussion above regarding partnerships.

- If and to the extent an ESBT is a nongrantor trust, the depreciation deductions are trapped inside the trust.[2658] (This is a bad result if the trust is included in a person's estate.)[2659]

[2654] Query whether the aggregate theory of partnership taxation affects this analysis any.

[2655] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

[2656] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

[2657] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation and III.A.3.e QSSTs and ESBTs.

[2658] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, which generally traps in a trust all items on an S corporation's K-1. Reg. § 1.641(c)-1 does not expressly discuss the depreciation issue, the only authority being Reg. § 1.641(c)-1(d)(2)(i):

> (i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. [then discusses ESBT elections for a partial year]

The second sentence tends to suggest applying this part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) would apply to S corporation K-1 items. However, in requiring breaking out separately stated items, Code § 1366(a)(1)(A) cross-references Code § 702(a)(4), (6), but depreciation deductions under this this part II.J.11.a.ii would fall under Code § 702(a)(7) by reason of Reg. § 1.702-1(a)(8)(ii). On the other hand, fiduciary income tax return form instructions refer to items under this part II.J.11.a.ii from a pass-through; by not specifying the type of pass-through, do these instructions suggest that S corporation items would fall under this part II.J.11.a.ii? Ultimately, the issue appears decided in favor of trapping these deductions in the trust by the language at the end of Code § 641(c)(2)(C), "…no item described in this paragraph shall be apportioned to any beneficiary," which per Code § 641(c)(2)(C)(i) includes any item described in Code § 1366.

[2659] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

- If and to the extent the trust is grantor trust deemed owned by the grantor or the beneficiary (the latter including QSSTs), the deemed owner (including the deemed owner of an ESBT)[2660] would be allocated the depreciation deductions, because the grantor trust rules supersede everything.

II.J.11.b. Code § 1244 Treatment Not Available for Trusts

Individuals may deduct as an ordinary a loss incurred on the first $50,000 or $100,000 on the sale of small business corporation stock under Code § 1244.[2661]

Trusts and estates are not entitled to this treatment.[2662]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[2663] so that the S corporation's ordinary losses will provide current annual benefit to the trust, and the trust's basis in the stock would be correspondingly reduced, which reduces the chance of the trust having a capital loss on disposition of the S corporation stock. Therefore, this issue is much more of concern for trusts owning C corporation stock than for trusts owning S corporation stock.

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act

Articles by Dobris (1979)[2664] and Blattmachr (1984)[2665] seem to be the leading authority in this area. In exercising tax elections, trustees may have these duties:[2666]

(1) the duty to minimize the overall tax burden on the estate and its beneficiaries;

(2) the duty of impartiality; and

(3) the duty to abstain from self-dealing.

Harris Trust & Sav. Bank v. MacLean, 542 N.E.2d 943 (1st Dist. Ill. 1989), involved a common situation: Trust recognizes big capital gain and pays federal and state capital gain tax. Both taxes are charged to principal. However, the income beneficiaries benefitted the following year by deducting the state capital gain tax. The court held that the trustee could not reduce the

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[2660] Reg. § 1.641(c)-1(c).
[2661] Part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation.
[2662] Code § 1244(d)(4).
[2663] See part II.G.4.d Basis Limitation for Shareholders in an S Corporation.
[2664] "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms," 65 *Iowa L. Rev.* 103 (1979), saved as Thompson Coburn doc. no. 6174776.
[2665] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).
[2666] *Estate of Rappaport*, 467 N.Y.S.2d 814 (N.Y. 1983), citing Carrico and Bondurant, "Equitable Adjustments: A Survey and Analysis of Precedents and Practice," 36 The Tax Lawyer, 545–6. Earlier the opinion discussed with approval Dobris, "Limits on the Doctrine of Equitable Adjustment in Sophisticated Post-mortem Tax Planning," 66 Iowa L. Rev., 273, 297–8. When administrative expenses are not needed to be deducted on an estate tax return to save estate tax, consider deducting them for income tax purposes. *Matter of Ettinger*, 564 N.Y.S.2d 691 (1990). When fiduciaries have conflicts of interest in exercising tax elections, a court may resolve the issue. *Matter of Estate of Spear*, 553 N.Y.S.2d 985 (1990).

beneficiaries' income account by the tax benefit they received, because a trustee should be able to make an equitable adjustment only for inequities resulting from a trustee's discretionary decisions.[2667] The court viewed the tax benefit from the deduction of state income taxes to be very small compared to the sales proceeds that benefitted the principal beneficiaries, even though the benefit was probably hundreds of thousands of dollars. Blattmachr had indicated mixed results on this issue before this case was decided.[2668]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[2669] takes the following approach:[2670]

[2667] The court reasoned and held:

> The question of whether a trustee is required to make an equitable adjustment between the trust's income and principal accounts where inequitable consequences result from the mandatory application of tax laws is one of first impression in Illinois. Several courts in other jurisdictions have addressed this issue. Some courts have suggested that an equitable adjustment should only be applied in response to a trustee's election or discretionary decision (*In re Dick's Estate* (1961), 29 Misc.2d 648, 218 N.Y.S.2d 182; *In re Kent's Estate* (1964), 23 Fla. Supp. 133), while one court has approved an adjustment to correct inequities not caused by any discretionary decision of the trustees (*Rice Estate* (1956), 8 Pa. D & C 2d 379) and another has rejected a distinction between discretionary decisions and mandatory applications (*In re Holloway's Estate* (1972), 68 Misc.2d 361, 327 N.Y.S.2d 865).
>
> We believe the better view is that equitable adjustments should be applied only in response to inequities resulting from a trustee's discretionary decisions which favor one beneficiary or class of beneficiaries over another. We agree with the trustees' position that the common law doctrine of equitable adjustments should only be employed in such circumstances because this concept is grounded in the fiduciary duty of a trustee not to be partial in making decisions or elections impacting on successive beneficiaries. (See *In re Warms' Estate* (Surr. Ct. 1955), 140 N.Y.S.2d 169; *In re Bixby's Estate* (1956), 140 Cal.App.2d 326, 295 P.2d 68.) The fiduciary should not be required to cure the inequities resulting from the application of mandatory tax laws; rather, any corrective action is more properly left for the legislature. *In re Dick's Estate*, 29 Misc.2d 648, 218 N.Y.S.2d 182; accord *In re Kent's Estate*, 23 Fla. Supp. 133.

I have been told that a Massachusetts court reached the same result.

[2668] See fn. 2665, ¶ 1403.3 Corpus Expenses Benefit Income and Not Corpus but Not as a Result of Fiduciary Election, fns. 30-33. A leading case he cited, *In re Holloway's Estate*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held:

> It is this court's considered opinion, however, that the *Dick* case rationale lacks the requisite equitable approach. As one writer observed: "Sections of the 1954 Code dealing with estate and trusts yield other examples directly contrary to both estate and trust law and common sense. For example, subchapter J, part I, was apparently drawn by tax lawyers not entirely familiar with trust concepts or fiduciary accounting principles. *The fiduciary and the court must be free in such cases to repair the damage by equitable adjustment*" (Browning, Problems of Fiduciary Accounting, 36 N.Y.U.L.Rev. 931, p. 953 [1961]). (Italics supplied.)

[2669] However, 760 ILCS 15/3(b)(2) allows a trustee to reallocate receipts "if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal." The statute enacting the quoted provision was included in 1991 Ill. Legis. Serv. P.A. 87-714 (S.B. 717) (WEST).

[2670] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

Section 506. Adjustments Between Principal And Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

The official Comments include:

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of

cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

The Uniform Fiduciary Income & Principal Act (2018) ("UFIPA"), which replaces the Uniform Principal & Income Act, renumbered section 506 as follows:

Section 507. Adjustment Between Income And Principal Because Of Taxes.

(a) A fiduciary may make an adjustment between income and principal to offset the shifting of economic interests or tax benefits between current income beneficiaries and successor beneficiaries which arises from:

(1) an election or decision the fiduciary makes regarding a tax matter, other than a decision to claim an income tax deduction to which subsection (b) applies;

(2) an income tax or other tax imposed on the fiduciary or a beneficiary as a result of a transaction involving the fiduciary or a distribution by the fiduciary; or

(3) ownership by the fiduciary of an interest in an entity a part of whose taxable income, whether or not distributed, is includable in the taxable income of the fiduciary or a beneficiary.

(b) If the amount of an estate tax marital or charitable deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes and, as a result, estate taxes paid from principal are increased and income taxes paid by the fiduciary or a beneficiary are decreased, the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax, to the extent the principal used to pay the increase would have qualified for a marital or charitable deduction but for the payment. The share of the reimbursement for each fiduciary or beneficiary whose income taxes are reduced must be the same as its share of the total decrease in income tax.

(c) A fiduciary that charges a beneficiary under subsection (b) may offset the charge by obtaining payment from the beneficiary, withholding an amount from future distributions to the beneficiary, or adopting another method or combination of methods.

UFIPA's official Comments include:

Mandatory adjustments. The adjustments addressed by Section 507 are derived from the history of "equitable adjustments" largely associated with New York case law. For example, *Matter of Warms*, 140 N.Y.S.2d 169 (1955), involved estate administration expenses chargeable to principal that are allowed as either estate tax deductions or income tax deductions. If the items are claimed as income tax deductions and benefit income, Warms requires income to reimburse principal for any increased estate taxes. The Warms adjustment has been codified in some states, including New York in EPTL § 11-2.1(a).

Subsection (b), which requires reimbursement of principal from income, is derived from New York's EPTL § 11-2.1(a). Unlike the New York statute, however, it limits the mandatory reimbursement to cases in which a marital or charitable deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the United States Tax Court held that a reimbursement required by the predecessor of EPTL § 11-2.1(a) preserved for the estate the same charitable deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will typically elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries still receive the additional benefit of the difference in the benefit of the two deductions. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed by $20,000 and the net benefit to the income beneficiaries will be $10,000.

Other adjustments. A second occasion for adjustment is a "trapping distribution" – a distribution of principal that carries out income for income tax purposes. *Matter of Holloway*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held that a trust that made a trapping distribution must reimburse principal for the income taxes resulting from the distribution.

A third adjustment context arises when a trust's deductible expenses chargeable to principal reduce distributable net income and the taxable income of an income beneficiary, and the trust has taxable gains. Must income reimburse principal for the capital gains taxes that would have been saved if the expenses were used to reduce the gains? A Pennsylvania case, *Rice Estate*, 8 Pa. D&C2d 379 (1956), required an adjustment, but a New York case, *Matter of Dick*, 29 Misc.2d 648, 218 N.Y.S.2d 182 (1961), and a Massachusetts case, *New England Merchants Nat'l Bank v. Converse*, 373 Mass. 639, 369 N.E.2d 982 (1972), rejected an adjustment. A similar New York case, *Matter of Pross*, 90 Misc.2d 895, 396 N.Y.S.2d 309 (1978), required an adjustment from income to principal when a capital gain on a sale of real property resulted from a depreciation deduction that had benefitted the income beneficiary of the trust by reducing distributable net income.

Subsection (a) allows adjustments in cases like these, in the fiduciary's discretion (recognizing that local case law and statutory law, other than this Act, may require the exercise of that discretion under this Act).

Changes in the 2018 Act. Section 506(b) of the 1997 Act required that "each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid." The 2018 Act changes this, in Section 507(b), to "the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid" and adds subsection (c) to provide the fiduciary with options for accomplishing the "reimbursement" objective. One option in subsection (c) remains "obtaining payment from the beneficiary," but the possibly more practical option of withholding amounts from future distributions is also included.

See also part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation.

Settlement of an ambiguous provision allocating capital gain tax between income and principal should not carry with it any gift, GST, or income tax consequences (except, of course, to the extent that they modify cash distributions that carry out DNI).[2671] Similarly, when a trust erroneously reported capital gain as taxable to the beneficiary instead of to the trust, reimbursing the beneficiary for tax paid on the capital gain did not have gift, estate, or GST tax consequences.[2672]

[2671] Letter Ruling 201528024, addressing construction of a provision directing the trustee to collect all the income and out of such income pay or provide for "all proper taxes."

[2672] Letter Ruling 201735005, involving a QSST that sold its S corporation stock. For the income tax consequences of such a transaction, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). In the ruling:

> On or about Date 2, Trustee sold Trust's share of stock in Corporation in a transaction that resulted in capital gain to Trust for federal and state tax purposes. Pursuant to State law, the capital gains should have been allocated to Trust principal and all income taxes due on the capital gains were required to be paid from Trust principal. However, Trustee in connection with Trust's Form 1041, U.S. Fiduciary Income Tax Return, erroneously issued Daughter a K-1, Beneficiary's Share of In-come, Deductions, Credits, Etc., which treated the capital gain as a taxable distribution to Daughter for both federal and state tax purposes. As a result of receiving the K-1 Daughter reported the entire amount of the capital gain on her individual Federal and state income tax returns which she jointly filed with Spouse. The errors on the Schedules K-1 were in Year 1. Trustee distributed $A to Daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by Daughter and Spouse. Daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.
>
> Trustee prepared a draft of its first accounting as Trustee on Date 3. Upon receipt of the draft accounting, Daughter became aware that she was due an additional reimbursement from Trustee for the income taxes paid by Daughter and Spouse in connection with the sale of S Corporation stock.
>
> On or about Date 4, Trustee filed a Petition for Adjudication with Court seeking judicial approval of its first intermediate accounting (Accounting) from Date 5 to Date 6. On Date 7, Daughter, through her counsel, filed an objection (Objection) to the Accounting alleging that it failed to provide for the additional reimbursement to Daughter from Trust for state income taxes in the amount of $B, together with interest on the unreimbursed taxes at a specified rate, and reimbursement of Daughter's attorney's fees incurred in connection with the Accounting and Objection.
>
> On Date 8, Court entered an order (Order) ruling that the statute of limitations remains open for Daughter to object to any and all matters disclosed in the Accounting; and that the Accounting fails to provide for an additional reimbursement from Trust to Daughter for the unreimbursed taxes, interest and attorney's fees associated with the Accounting and Objection. Trustee intends, in accordance with the Order, to reimburse Daughter for the amount of the unreimbursed taxes, interest, and attorney's fees due for the erroneous payment of income taxes by Daughter and Spouse in Year 1.

The ruling held:

> 1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).
> 2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.

When an estate deducted administrative expenses on its income tax return and reimbursed the principal for the income tax saved, the estate was allowed an estate tax deduction for the increased residue passing to charity (even though post-mortem actions normally do not affect the charitable deduction).[2673]

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3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust does not constitute a gift to Trust for federal gift tax purposes where Daughter and Spouse have a right of recovery from Trust, they have exercised their rights, and Trustee, in fact, has previously reimbursed Daughter and Spouse a portion of the income taxes, and will further reimburse Daughter and Spouse the balance of income taxes together with, interest and attorney's fees.
4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate.

[2673] Rev. Rul. 78-445, reasoning:

In *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), *acq.* and *nonacq.*, page 3, this Bulletin, the decedent bequeathed a remainder interest in the residuary trust to charity. The court, in effect, concluded that a reimbursement paid pursuant to section 11-1.2(A) of the Estates, Powers and Trusts Law (which actually codified the New York case law relied upon by the court) should be included in determining the amount passing to charity for purposes of section 2055(a).

The court determined that the purpose of such reimbursement (under section 11-1.2(A)) is to ensure that the amount passing to the residuary legatees in accordance with the decedent's will is not diminished by the additional estate tax payable as a result of the estate's election under section 642(g). To accomplish this, the statute requires a reimbursement, which effectively limits the amount of estate tax charged against the residue to the tax that would have been due had the administration expenses been deducted from the federal gross estate. The reimbursement is not properly characterized as an additional gift to the residuary legatees from the income recipient. Rather, the reimbursement ensures that the residuary legatees receive the amount they are otherwise entitled to receive under the terms of the decedent's will. The Service's acquiescence in Britenstool related to this issue.

Similarly, in the instant case, for purposes of section 2055(a), the value of the charitable deduction should be computed based on a residue of $825x, and not $800x. In accordance with the court's decision in Britenstool, $825x represents the amount passing to the residuary trust from D, under the terms of D's will. The $25x reimbursement, which was paid pursuant to state law, merely ensured that this $825x amount would not be diminished as a result of the executor's section 642(g) election.

Reg. § 20.2055-3(b)(2)-(4) provide:

(2) *Effect of transmission expenses*. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate transmission expenses paid from the charitable share.

(3) *Effect of management expenses attributable to the charitable share*. For purposes of determining the charitable deduction, the value of the charitable share shall not be reduced by the amount of the estate management expenses attributable to and paid from the charitable share. Pursuant to section 2056(b)(9), however, the amount of the allowable charitable deduction shall be reduced by the amount of any such management expenses that are deducted under section 2053 on the decedent's federal estate tax return.

(4) Effect of management expenses not attributable to the charitable share. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate management expenses paid from the charitable share but attributable to a property interest not included in the charitable share.

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not

A nongrantor trust's NII passes through to beneficiaries as NII.

For a nongrantor trust, the determination of whether business income is passive and therefore constitutes NII is made at the trust level.

If the beneficiary is active but the trustee is not, considering doing the following:

1. The trust contributes its interest in the partnership or sole proprietorship into one or more S corporations.

2. The trust converts into a trust eligible to be subjected to a QSST election.

3. The beneficiary makes a QSST election.

For cautions in applying this strategy, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

II.J.14. Application of 3.8% NII Tax to ESBTs

Electing small business trusts (ESBTs)[2674] are separated into S and non-S portions[2675] and subjected to the NII tax as follows:[2676]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[2677] and then combine these amounts to calculate the ESBT's undistributed net investment income.

2. The ESBT calculates the non-S portion's-adjusted gross income,[2678] increased or decreased by the S portion's net income or net loss, after taking into account all the S portion's deductions, carryovers, and loss limitations, as a single item of ordinary income (or ordinary loss).

[2674] See part III.A.3.e.ii ESBTs.

[2675] Reg. § 1.1411-3(c)(1) provides:

> The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

[2676] Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

[2677] In the manner described in Reg. § 1.1361-3(e).

[2678] As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

3. The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income, or (b) the excess of the ESBT's adjusted gross income[2679] over the dollar amount at which the highest fiduciary income tax bracket begins.

Beyond the 3.8% tax on NII, consider parts II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, particularly noting the IRS' position on NOLs incurred by an ESBT when the S corporation stock it owns generates losses.[2680]

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax)

The preamble to the 2013 proposed regulations for net investment income tax generally explains the regular income tax treatment of sales involving QSSTs when discussing how the proposed regulations would treat the sales for net investment income tax purposes:[2681]

> H. <u>Qualified subchapter S trusts (QSSTs)</u>
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).
>
> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.
>
> For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST

[2679] As calculated under Reg. § 1.1361-3(c)(2)(ii).
[2680] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5657.
[2681] REG-130843-13.

and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.

One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.

This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.

First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.

Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity

For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs [2682] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

For planning issues relating to the dispositions described in this part II.J.15.a, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

II.J.15.b. QSSTs and State Income Tax Issues

As a grantor trust with respect to S corporation items, the trust is not subjected to state income tax on those items; instead, the beneficiary is.

A state might even treat the trust as not existing while it is a grantor trust, providing the opportunity to treat the trust as a nonresident trust if the grantor moves to another state (for example, a state with no income tax).[2683] Thus, if a QSST holds only S corporation stock, then the QSST election might allow the trust's residency to be determined at a later, perhaps more favorable date.[2684]

Some trust agreements provide that any S corporation will be held in a separate QSST, leaving the original trust undisturbed as to any provisions that might be consistent with QSST status. This approach would appear to maximize the possibility of the delayed residence determination described above.

Of course, one would also want to consider the other factors mentioned in part II.J.3 Strategic Fiduciary Income Tax Planning rather than focusing exclusively on this issue.

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets

Consider the following:

- The sale of ownership of a business entity is allocated to principal. Assuming the business interest is a capital asset, any capital gain is included in DNI only if certain exceptions are satisfied[2685] and any ordinary income[2686] is automatically included in DNI.[2687]

[2682] Particularly the text accompanying fns. 5604-5606, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). See also part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs, especially part III.A.3.e.v.(b) Implementation and, within that, the paragraph that includes a reference to fn. 5707.

[2683] See part II.J.3.e.iii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

[2684] Illinois Schedule K-1-P, which partnerships and S corporations use to report K-1 income includible in their owners' income, has a separate line, line 9b, which was "expanded to allow grantor trusts and other federally disregarded entities to identify the taxpayer that will report the income or loss shown on the Schedule K-1-P…." See Illinois Dept. of Rev. Info. Bulletin, No. FY 2013-09, 01/01/2013. That line was also on 2014 returns.

[2685] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

- A flow-through entity might sell its assets, or a sale of S corporation stock might be taxed to the shareholders as a sale of the entity's assets followed by the corporation liquidating.[2688] Generally, assets used in business activities do not constitute capital assets, so capital gain from their sale is included in DNI without needing to apply the special rules for gain from the sale of a capital asset,[2689] and of course any ordinary income generated by depreciation recapture is included in DNI as well. Goodwill is a capital asset unless it has been subject to any amortization.[2690] Because this gain/income is included in DNI, the allocation of such gains to principal does not cause any particular limits to be placed on shifting them to beneficiaries if they are properly paid, credited, or required to be distributed.[2691] However, if and to the extent that they are not paid or credited during the year or within 65 days thereafter[2692] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[2693]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[2694] Often the best way to prevent these items from triggering AMT is to pay them in the year in which the income that generated them is recognized. Given that a state might allow one to use the prior year's income tax as a safe harbor or might not require estimated tax payments at all, one might easily overlook the need to pay state income tax in the year of the sale (or other major income recognition event).

Although items on a K-1 from an S corporation generally are taxed the beneficiary as if the QSST were a grantor trust, gain from sale of the stock and gain from the sale or deemed sale of the corporation's assets (even if reported on a K-1) are taxed to the trust, not as part of the grantor trust portion.[2695] However, if the beneficiary's federal and state/local income taxation (including the 3.8% tax net investment income) are more favorable than the trust's and a distribution form the trust would not frustrate the trust's objectives, consider using the ideas in the bullet points above to shift taxation on any items otherwise taxable to the trust. It is not unusual for an income tax preparer to be unfamiliar with the QSST rules regarding taxation of the sale or deemed sale of the corporation's assets and not to plan for the correct taxation, so be sensitive to this issue up front and also consider reallocating principal to income if the trust is

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[2686] For example, the sale of a partnership interest might generate ordinary income from the sale of "hot assets" – see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.
[2687] Code § 643(a).
[2688] See parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[2689] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[2690] See fns. 3838-3843.
[2691] Code § 661(a)(1), (c).
[2692] See part II.J.2 Tactical Planning Shortly After Yearend.
[2693] See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[2694] Code § 56(b)(1)(A)(ii).
[2695] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs (particularly the text accompanying fns. 5604-5606, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale) and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result.

a mandatory income trust.[2696] Although one might initially view the election to tax a stock sale as a sale of the business' assets (followed by liquidation) as merely substituting gain on the sale of assets for gain on the sale of stock, note that state income taxation might also generate surprising results; see part II.H.8.a.ii State Income Tax Disconnect.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[2697] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[2698] making an allocation to the S portion even more desirable. In addition to that concern, allocating state income tax to the non-S portion might generate a large alternative minimum tax bill,[2699] which would not be owed if allocated to the S portion and paid in the year of sale.

If the trust is a QSST or if the trust is a grantor trust that would be converted to an ESBT shortly before the sale, consider making the trustee active in the business to maximize opportunities to avoid the 3.8% tax on net investment income and, in the case of a grantor trust, converting it to an ESBT far enough in advance of the sale for the trustee to accumulate sufficient hours of participation. See generally part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

If the trustee mistakenly taxes the sale to the beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[2700]

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax

This part II.J.17 assumes that avoiding NII characterization is the most important objective. Before making that assumption, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.[2701]

Making income from operations and gain on sale be nonpassive income is the key to avoiding NII characterization:

- Generally, income from a trade or business is exempt from the 3.8% tax if it is nonpassive income.[2702]

[2696] See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation. In a QSST, one might be able to allocate principal to income to make up for expenses ordinarily allocated to principal that were allocated to income as an adjustment needed due to cash flow issues; see text accompanying fns. 5593-5596 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 2532, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2697] For ESBT tax issues, see parts II.J.14 Application of 3.8% NII Tax to ESBTs and III.A.3.e.ii.(b) ESBT Income Taxation - Overview, the latter especially including fns. 5659-5660.
[2698] Code § 642(h). See part II.J.3.i Planning for Excess Losses.
[2699] Code § 56(b)(1)(A)(ii).
[2700] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act, especially fn. 2672.
[2701] Particularly note the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5657.
[2702] See part II.I.8 Application of 3.8% Tax to Business Income.

- Gain on the sale of assets used in a nonpassive trade or business (or from the part of the sale of a partnership interest or S corporation stock allocable to such assets) is exempt from the 3.8% tax.[2703]

- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[2704]

Consider the following:

- In an ESBT, the trust is the taxpayer.

- In a QSST, for normal operations, the beneficiary, as deemed owner under the grantor trust rules, is the taxpayer.

- In a QSST, when the business is sold, generally the trust will be the taxpayer.[2705]

- In a grantor trust, the deemed owner is the taxpayer, but the deemed owner might turn off the grantor trust powers before selling the business, generally making the trust the taxpayer, whether the trust is an ESBT or a QSST (or the business is taxed as partnership).

Thus, even when a trust is taxable to the grantor or beneficiary under the grantor trust rules, one might consider establishing the trustee's material participation at least a year before the business might be sold;[2706] whether this would count given the trust's being disregarded for income tax purposes has never been addressed, but, with rules regarding trust material participation so uncertain, these extra precautions might be worthwhile if the tax at risk is significant enough. This might require jumping through extra hoops if the entity was formed as a state law corporation, because a traditional corporate structure does not lend itself to the type of participation the IRS seeks.[2707]

For more discussion of QSSTs and ESBTs, see generally part III.A.3.e QSSTs and ESBTs, which compares and contrasts those types of trusts and discusses strategies for switching back and forth.

II.J.18. Trust Divisions, Mergers, and Commutations; Decanting

Although most trust divisions and distributions are not subject to income tax, some changes in a beneficial interest in a trust are.

Trust divisions (part II.J.18.a), mergers (part II.J.18.b), and decanting (part II.J.18.c) may be structured to avoid any income or transfer tax consequences. However, if any beneficial interest is reduced, which is more likely to be the case in a decanting than a straight division or merger (because divisions and mergers generally continue the underlying beneficial interests, and decanting may or may not do so), severe transfer tax consequences may ensue.

[2703] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2704] See part II.K.1.a Counting Work as Participation.
[2705] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[2706] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2707] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

If the parties wish to change their beneficial interests without any transfer tax consequences, that change may constitute a commutation (part II.J.18.d), which may generate income tax consequences in that beneficial interests are themselves assets owned by the beneficiaries for income tax purposes, the sale or exchange of which is subjected to income tax.

A nice summary of the above issues is in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations. To me, the income tax question is whether a course of action is more in the nature of a nontaxable continuation of existing beneficial interests – just rearranged somewhat to avoid conflicts in administrative issues resulting from beneficiaries' differing goals or needs – or is a material change in beneficial interests constituting an exchange.

II.J.18.a. Trust Divisions

See part II.D.5 Severing Trusts with Multiple Grantors.

Generally, a partition of jointly owned property is not a sale or other disposition of property when the co-owners of the joint property sever their joint interests.[2708]

Rev. Rul. 69-486 held the following, addressing a trustee making non-pro rata distributions to beneficiaries C and X:[2709]

[2708] Rev. Rul. 56-437 provides:

> The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy in capital stock of a corporation into a tenancy in common is a nontaxable transaction for Federal income tax purposes. Likewise, the severance of a joint tenancy in stock of a corporation, under a partition action instituted under sections 103-1-1 to 10 of Colorado Revised Statutes, 1953, compelling partition and the issuance of two separate stock certificates in the names of each of the joint tenants, is a nontaxable transaction. In each case there was no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss. See I.T. 1761, C.B. II-2, 56 (1923), holding that although the transfer of stock from the name of an individual to the name under which the individual does business is subject to tax under the stamp tax law (Schedule A-3, Title XI of the Revenue Act of 1921), it is not a sale within the meaning of the income tax law. See also Rev. Rul. 55-77, C. B. 1955-1, 339, and Rev. Rul. 55-179, C.B. 1955-1, 340.

[2709] Rev. Rul. 69-486 posited the following facts:

> Under terms of the trust instrument, the trustee is required to distribute currently all trust income to B for her life and upon her death distribute one-half of the trust corpus to C, an individual, and one-half to X, a charitable organization exempt from tax under section 501(c)(3) of the Internal Revenue Code of 1954.
>
> B died on July 1, 1967. At the time of her death, the trust had ordinary income of 20x dollars to be reported in its current calendar year period. Subsequent to B's death the trust received no income up to its termination on August 1, 1967. The distributable net income of the trust for 1967 as defined by section 643(a) of the Code was 20x dollars. The trustee properly distributed currently 20x dollars to B's successor in interest.
>
> At the time of B's death, the trust corpus to be distributed to C and X consisted in part of notes that had been purchased by the trust and that had a total adjusted basis of 300x dollars and a total fair market value of an equal amount. The balance of the trust corpus consisted of common stock acquired by purchase with a total adjusted basis of 100x dollars and a total fair market value of 300x dollars.
>
> The trust instrument as well as local law was silent as to the authority of the trustee to make a non-pro rata distribution of property in kind.

> Since the trustee was not authorized to make a non-pro rata distribution of property in kind but did so as a result of the mutual agreement between C and X, the non-pro rata distribution by the trustee to C and X is equivalent to a distribution to C and X of the notes and common stock pro rata by the trustee, followed by an exchange between C and X of C's pro rata share of common stock for X's pro rata share of notes.

Being aware of this issue and seeking to avoid it, Uniform Trust Code ("UTC") § 816 (promulgated in 2000 and last revised or amended in 2010) provides that "a trustee may":

> … (22) on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation ….

The UTC's official Comments include:

> Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale.

Letter Ruling 200552009, involving trust mergers followed by divisions, is discussed in part II.J.18.b Trust Mergers.

> By mutual agreement, the two beneficiaries requested that the trustee distribute all of the notes to C and all of the common stock to X. The trustee complied with this request on August 1, 1967.
>
> The first issue to be decided is how the non-pro rata distribution by the trustee to C and X will be treated for Federal income tax purposes.
>
> [see text in main body]
>
> The second issue to be decided is the basis of the pro rata share of notes and common stock in the hands of C and X.

Rev. Rul. 69-486 reasoned and concluded:

> Inasmuch as the 20x dollars of income required to be distributed currently to the estate of B is equal to the distributable net income of the trust, no amount is includible in the gross income of C and X as a result of the pro rata distribution of notes and common stock by the trustee. See section 662(a) of the Code as implemented by section 1.662(a)-2 of the regulations.
>
> The basis of the pro rata shares of notes and common stock in the hands of C and X is the same as the adjusted basis in the hands of the trust. See section 1.1015-2(b) of the regulations.
>
> Furthermore, C in substance exchanged his pro rata share of common stock with X for X's pro rata share of notes. The amount of recognized gain to C is determined under sections 1001 and 1002 of the Code. Since X is a charitable organization exempt from tax under section 501(c)(3) of the Code, it has no tax consequence as a result of the exchange.

Reg. § 1.1001-1(h), "Severances of trusts," which was issued long after Rev. Rul. 69-486 was released, provides:[2710]

> (1) *In general*. The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of § 26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if -
>
> (i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and
>
> (ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.
>
> (2) *Effective/applicability date*. This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

Note that the regulation applies to any severance, not just a qualified severance. Reg. § 26.2642-6(j), Example (3), "Severance based on actuarial value of beneficial interests," recognizes the following as a nonqualified severance:

> In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate. T properly elects, under section 2632(c)(5), not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2009, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified

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[2710] Reg. § 1.1001-1(h) was promulgated as part of project to facilitate severing trusts for GST purposes. T.D. 9348 (8/2/2007) explained:

> One commentator noted that § 1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator requested that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which § 1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in § 1.1001-1(h)(1).

severance. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[2711] If a trust divides but distributes property to satisfy a pecuniary obligation to one of the beneficiaries, the latter distribution is a deemed sale, but the rest of the distribution is nontaxable.[2712] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI.[2713]

Whether a trust division shifts the grantor does not affect whether the division constitutes a distribution that carries out DNI.[2714]

Letter Ruling 201928004 held:[2715]

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or

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[2711] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting. For a similar result for decanting, see part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

[2712] Letter Ruling 201722007 held:

In accordance with the conclusion that the post-equalization property divisions of Trust 1 and Trust 2 will not result in gain or loss under § 61 or § 1001, we also conclude that, based solely on the facts submitted and representations made, the proposed divisions of the post-equalization property will not result in income, gain or loss to the trusts under § 661, § 662, or § 1.661(a)-2(f). Consistent with Rev. Rul. 82-4, gain will be recognized on funding of Successor Trusts to the extent appreciated assets are used to satisfy the Equalization Distribution in kind.

Rev. Rul. 82-4 is described in fn 2554 in part II.J.8.d.i Distribution in Kind - Generally

[2713] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting.

[2714] T.D. 8831 (8/6/1999), provides:

Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

See parts II.D.3 Trust as Grantor of a Trust and III.B.2.h.i Who Is the Grantor, the latter including fns. 6178-6181.

[2715] For the facts in Letter Ruling 201928004, see text following fn 2639 in part II.J.9.c Multiple Trusts Created for Tax Avoidance. The ruling also held:

Based on the facts submitted and the representations made, we conclude that because § 1001 does not apply to the Proposed Division, under § 1015 the basis of the assets received by Subtrusts will be the same as the respective basis of the assets held by Trust. We further conclude that under § 1223(2) the holding period of the assets received by the Subtrusts will be the same as the holding period of the assets in Trust.

additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507 (conversion of a joint tenancy in stock to a tenancy in common in order to eliminate the survivorship feature and the partition of a joint tenancy in stock are not sales or exchanges).

Similarly, divisions of trusts are also not sales or exchanges of trust interests where each asset is divided pro rata among the new trusts. See Rev. Rul. 69-486, 1969-2 C.B. 159 (pro rata distribution of trust assets not a sale or exchange).

In the present case, the legal entitlements, as well as the rights and powers, of the beneficiaries will remain the same in kind and extent after the Proposed Division of Trust into the Subtrusts. Accordingly, based on the facts submitted and representations made, the Proposed Division of Trust will not result in the realization of gain or loss under § 61 and § 1001.

Moreover, based on the facts submitted and representations made, we conclude that the Proposed Division is not a distribution under § 661 or § 1.661(a)-2(f). We further conclude that the Proposed Division of Trust assets among the Subtrusts will not cause Trust, the Subtrusts, or beneficiaries to recognize any income, gain, or loss under § 662.

II.J.18.b. Trust Mergers

For trust mergers, followed by divisions, Letter Ruling 200552009 stated:

We also conclude that because § 1001 does not apply to the proposed division of merged Trust 4, under § 1015, the tax basis that the New Trusts have in the assets of the New Trusts immediately after the division will be the same as the tax basis of the merged Trust 4 in such assets immediately before the division. The tax basis of the historic assets in the New Trusts immediately after the division will be the same as the tax basis that the merged Trust 4 had in those assets immediately before the division. We further conclude that each asset transferred by the merged Trust 4 to the New Trusts will have the same holding period in the hands of the New Trusts immediately after the division that it had in the hands of the merged Trust 4 immediately before the division. Each historic asset of the New Trusts will have the same holding period immediately after the division that it had immediately before the division.

We additionally conclude that in each of the mergers of the Family Trusts into Trust 4, the merged Trust 4 will succeed to and take into account any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts. Each asset transferred by the merging Family Trusts to the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. Each historic asset of the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts immediately before the mergers will survive and remain available to the merged Trust 4 after the mergers and no limitation will be imposed as a result of the proposed mergers on the merged Trust 4 ‘s use of such tax attributes.

Finally, we conclude that on the division of the merged Trust 4 into New Trusts, each of the New Trusts will succeed to and take into account c of any net operating loss carry

> forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4. Each asset transferred by the divided merged Trust 4 to the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. Each historic asset of the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4 immediately before the division will survive and remain available to the divided New Trusts after the division and no limitation will be imposed as a result of the proposed division on the New Trusts' use of such tax attributes.

Letter Ruling 200743019 held:

> In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.
>
> We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

If a trust merger constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2716]

[2716] See Letter Ruling 201941006, described in the text accompanying fn 5617 in part III.A.3.e.ii.(a) Qualification as an ESBT.

II.J.18.c. Decanting

II.J.18.c.i. What Is Decanting

Generally, decanting is the trustee distributing assets from one trust to another trust. For over 100 years, it has been a tool to allow a trustee to change a trust's terms in some manner – whether to facilitate administration or to change a beneficial interest.

For what decanting is, see Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S.Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. The Uniform Trust Decanting Act authorizes amending a trust without transferring assets,[2717] a power that makes decanting a QSST much more comfortable, given that a QSST may not distribute principal other than outright to the beneficiary.[2718]

II.J.18.c.ii. Tax Consequences of Decanting

Because decanting originally took the form of distributing from one trust to another, it may be the same as or similar to a trust division. See part II.J.18.a Trust Divisions. Similarly, when a trustee decants by creating a new trust and merging the old trust into it, it can be viewed as a merger. See part II.J.18.b Trust Mergers.

Be sure to consider whether a decanting that reduces a beneficiary's interest in a trust may be valued under Code § 2702 as a gift of the beneficiary's entire interest in the trust, without any reduction for what the beneficiary retained. For this rule and trying to plan around it, see part III.B.7.d Code § 2702 Overview.[2719]

Decanting does not change who is the grantor under the grantor trust rules, even if a beneficiary is deemed to have made a gift.[2720]

ACTEC comments on decanting (http://www.actec.org/resources/comments-on-transfers-by-a-trustee) proposed a revenue ruling saying no new tax ID but do not cite authority for that conclusion. However, they mentioned that Letter Ruling 200607015 treated a decanted trust[2721]

[2717] Uniform Trust Decanting Act § 2(23)(A), authorizes amending a trust without transferring assets. The official Comments state:

> Thus the authorized fiduciary may exercise the decanting power by modifying the first trust, in which case the "second trust" is merely the modified first trust. The decanting instrument can, when appropriate, merely identify the specific provisions in the first trust that are to be modified and set forth the modified provisions, much like an amendment to a revocable trust. If the decanting power is exercised by modifying the terms of the first trust, the trustee could either treat the second trust as a new trust or treat the second trust as a continuation of the first trust. If the second trust is treated as a continuation of the first trust, there should be no need to transfer or retitle the trust property. Further, subject to future tax guidance, if the second trust is a continuation of the first trust, there may be no need to treat the first trust as having terminated for income tax purposes and no need to obtain a new tax identification number.

[2718] See fn 5582 and accompanying text in part III.A.3.e.i.(a) QSSTs Generally.

[2719] Especially text accompanying fns 6853-6862.

[2720] See part III.B.2.h.i Who Is the Grantor, especially fn 6178.

[2721] Letter Ruling 200607015 described decanting as an inter vivos power of appointment held by a trustee:

as a continuation of the original trust.[2722] On the other hand, they also referred to Letter Ruling 200736002, which involved a trust division and also treated the division as being a continuation and not a distribution,[2723] but the three successor trusts were treated as different trusts from each other, which means that at least two trusts needed to get new tax IDs. So I don't know how much to read into whether being considered a continuation trust would require a tax ID.

Combination merger and decanting: When identical trusts merged into a new trust that was identical other than administrative trustee issues, Letter Ruling 200743022 held no change in grandfathered-GST status and:

> In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The

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> State 1 law permits a trustee who has absolute discretion, under the terms of a trust, to invade the principal for the benefit of one or more proper object of the exercise of the power, to exercise such discretion by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument, provided, however that the exercise of such discretion does not reduce any fixed income interest of any income beneficiary of the trust and is in favor of the proper objects of the exercise of the power. The State 1 law provides that the trustee may act without the consent of any interested person and without prior court approval. The Trustees herein represent that they will petition the appropriate court and provide notice to all interested parties.

However, section 2(17) of the Uniform Trust Decanting Act takes a different approach:

> "Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.

Rather, section 2(10) of the Uniform Trust Decanting Act views decanting as a fiduciary distribution:

> "Decanting power" or "the decanting power" means the power of an authorized fiduciary under this [act] to distribute property of a first trust to one or more second trusts or to modify the terms of the first trust.

[2722] Letter Ruling 200607015 held:

> Based solely on the facts and the representations submitted, we conclude that the trustees' appointment of the four Trusts into four New Trusts will not be viewed as a distribution or termination under § 661 or § 1.661(a)-2(f)(1) and should therefore not result in the realization by the Trusts, the New Trusts, or any beneficiary of any of the Trusts of any of the New Trusts, of any income, gain , or loss under §§ 661 and 662.

[2723] Letter Ruling 200736002 held:

> Based upon the facts submitted and the representations made, we conclude that because the creation of the successor trusts is a modification of Trust for Federal income tax purposes, the successor trusts are treated as a continuation of Trust. Therefore, the transfer of assets from Trust to the successor trusts will not be treated as a distribution or termination under § 661, and will not result in the realization by Trust, the successor trusts, or by any beneficiary of Trust or the successor trusts of any income, gain, or loss.

beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.

We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

Letter Ruling 201642028 involved the following facts:

On Date 1, a date prior to September 25, 1985, Husband and Wife created five irrevocable trusts with substantively similar terms for different beneficiaries. Trust 1 was created for the primary benefit of Grandchild 1, Trust 2 was created for the primary benefit of Grandchild 2, Trust 3 was created for the primary benefit of Grandchild 3, Trust 4 was created for the primary benefit of Daughter, and Trust 5 was created for the primary benefit of Grandchild 4.

Article I of Trust 1 provides that the trustees are to pay to or for the benefit of Grandchild 1 so much of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support (HEMS) of said beneficiary. In the event that net income is not sufficient to provide for the health, education, maintenance, and support of said beneficiary, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article II of Trust 1 provides that, upon the death of Grandchild 1, the trustees are to pay to or for the benefit of the issue of Grandchild 1 such part of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support of such issue. In the event that the trustees determine that the net income is not sufficient to provide for the health, education, maintenance, and support of any one or more of such issue, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article III of Trust 1 provides that, in the event that Grandchild 1 and all issue of Grandchild 1 shall die prior to the final distribution of Trust 1 properties, the remaining Trust 1 properties, principal, and any accumulated income, shall be paid over and delivered in equal shares among the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Article XII of Trust 1 provides that Trust 1 will terminate 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Upon termination,

all of the properties remaining in Trust 1 shall be distributed to the then living beneficiaries of Trust 1, share and share alike.

Trust 1 appoints seven initial individual trustees and Article VIII of Trust 1 identifies seven successor individual trustees of Trust 1. Article VIII of Trust 1 additionally provides that when fewer than four trustees are currently serving, the remaining trustees shall have the power and authority to appoint one or more individuals as trustees, so that at least four and not more than seven individuals may serve as trustees. Further, Article VIII of Trust 1 grants the trustees then serving the power to appoint a bank as successor trustee, to serve thereafter as the sole trustee.

Grandchild 4 died in Year without issue. Pursuant to the terms of Trust 5, the assets remaining after the death of Grandchild 4 were distributed equally among Trust 1, Trust 2, Trust 3, and Trust 4.

Currently, Trust 1, Trust 2, and Trust 3 (the GC Trusts) hold limited partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2. Corporation 1 is a bank holding company and Corporation 2 is a closely-held corporation. Each of the GC Trusts' interests in LP2 and Corporation 2 is a significant percentage (approximately a percent) of the GC Trusts' net value, with the remaining assets consisting of cash and marketable securities.

Currently, Individual 1, Individual 2, Individual 3, Individual 4, Individual 5, and Individual 6 (the current individual trustees) serve as co-trustees of Trust 1, Trust 2, Trust 3, and Trust 4.

On Date 2, Grandchild 1 petitioned State Court, pursuant to State Statute, to modify Trust 1, specifically requesting the appointment of a corporate trustee to replace the current individual trustees. Grandchild 2, Grandchild 3, and Daughter filed similar petitions for modifications to the respective trust of which each is a beneficiary. The petitions allege that the current individual trustees failed to sufficiently communicate with the beneficiaries of the trusts concerning the investment strategies for each of the respective trusts and the respective beneficiary's needs in relation to his or her health, education, support, and maintenance. In addition, the petitions filed by Grandchild 1, Grandchild 2, and Grandchild 3 allege that the current individual trustees failed to sufficiently diversify trust assets and made questionable investments despite the potential for conflicts of interests. The current individual trustees denied the allegations in the petitions and opposed the request to appoint a corporate trustee for each trust.

After an extended period of negotiations, including mediation, Grandchild 1, Grandchild 2, Grandchild 3, Daughter, and the current individual trustees entered into Settlement Agreement, which State Court approved by order dated Date 3. Settlement Agreement is contingent on the receipt of favorable rulings from the Internal Revenue Service.

Settlement Agreement provides for similar modifications to apply to each of Trust 1, Trust 2, and Trust 3. In regard to Trust 1, Settlement Agreement provides as follows: (1) Trust 1 will be divided into Successor Trust and Trust A; (2) Bank will be appointed to serve as the sole corporate trustee of Successor Trust; (3) Individual 1, Individual 2, and Individual 3 will be appointed to serve as co-trustees of Trust A; (4) Successor Trust and Trust A will have the same beneficiaries in the same proportions as Trust 1;

(4) Successor Trust will be funded with the balance of Trust 1 assets after the funding of Trust A; (5) Trust A will be funded with Trust 1's partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2, and $b in cash or other liquid assets; (6) Successor Trust and Trust A will be governed by the same terms found in the Trust 1 instrument, except as modified by Settlement Agreement. Trust 4 will not be divided, but Bank will be appointed to serve as the sole corporate trustee of Trust 4.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, upon application to and order of State Court at State Court's discretion, the power to remove at any time and without cause any then-serving corporate trustee of Successor Trust by written notice delivered to such trustee, and the power to replace such trustee with another corporate trustee that—(1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. Further, the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, in the event the then-serving corporate trustee resigns or can no longer serve as trustee, the power to appoint a successor corporate trustee, without application to and approval by State Court, that— (1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. The term "distributees" refers to a majority of the competent adult beneficiaries who are at the time authorized to receive distributions of principal or income from the trust.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Trust A so that the number of individuals serving as co-trustees of Trust A shall be three as of the date of the division of Trust 1 into Successor Trust and Trust A. Upon the first of Individual 1, Individual 2, or Individual 3, to die, resign, become incapacitated, or otherwise fail to serve, the distributees of Trust A will be empowered to select one individual to serve as successor trustee of Trust A. The trustee selected by the distributees will be subject to the approval of the other two then-serving trustees. Succession to the office of trustee for the other two trustees shall continue to be determined by the co-trustees.

Under Settlement Agreement, the beneficiaries of Trust A agree to look to, and the trustees of Trust A agree to utilize, the income and principal of Successor Trust first for the beneficiaries' HEMS distributions. Settlement Agreement provides that the governing instrument of Trust A will provide that in making distributions in accordance with the HEMS standard, the trustees are to take into consideration a beneficiary's distributions of income and principal received from Successor Trust and other sources of income.

Settlement Agreement provides that the beneficiaries of Trust A and the beneficiaries of Successor Trust are and will be the same and each beneficiary has an identical interest in Trust A as he or she has in Successor Trust. However, Settlement Agreement provides that the trustees of Trust A will make all transfers and distributions to the trustee of Successor Trust in order to satisfy any transfers or distributions the trustees of Trust A may be required to make to Successor Trust or its beneficiaries under the governing instrument of Trust A, by law, or under Settlement Agreement, so that no distributions will be made directly from Trust A to the beneficiaries.

The termination date of Successor Trust is the termination date of Trust 1, which is 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Settlement Agreement provides that the governing instrument of Trust A will provide for a termination date d years after the effective date of Settlement Agreement, unless trustee of Successor Trust elects, after consultation with the distributees of Successor Trust, to extend the termination date of Trust A for an additional e years. Since the sum of d years and e years is less than 21 years, and Grandchild 1, Grandchild 2, Grandchild 3, and Daughter were all alive on the effective date of Settlement Agreement, the termination date of Trust A will be before the termination date of Successor Trust. Upon termination of Trust A, the assets of Trust A will be distributed to the trustee of Successor Trust to form part of the corpus of Successor Trust.

After the modification, both Successor Trust and Trust A continue to be subject to the rule in Article III of Trust 1, which provides that in the event that Grandchild 1 and all issue of Grandchild 1 all predecease the required termination date, the remaining trust assets will be distributed equally to the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Under Settlement Agreement, attorneys' fees and expenses incurred by the trustees and beneficiaries relating to the litigation and the Settlement Agreement will be paid or reimbursed by Trust 1, Trust 2, Trust 3, and Trust 4. The direct payments and reimbursements shall be made from each of Trust 1, Trust 2, Trust 3, and Trust 4, pro rata, in relation to the total value of each trust.

Finally, Settlement Agreement includes several provisions that concern the trustees' administration of Successor Trust and Trust A, such as provisions addressing communications with beneficiaries and conflicts of interest.

The current individual trustees of Trust 1 represent that no other additions have been made to Trust 1 since September 25, 1985.

Under the law of State, in administering a distribution standard tied to the needs of a beneficiary, a trustee will consider all income enjoyed by the beneficiaries from any and all sources, so long as it is available for support of the beneficiary. Citation.

As to GST issues, Letter Ruling 201642028 concluded:

With regard to the proposed modifications of Trust 1, we conclude:

a The division of Trust 1 pursuant to the terms of Settlement Agreement will not shift any beneficial interest in Trust 1 to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division will not extend the time for vesting of any beneficial interest in Trust 1 beyond the period provided for in the original trust. Therefore, the two trusts resulting from the division, Successor Trust and Trust A, will not be subject to the provisions of chapter 13.

b The modification of Trust 1 pursuant to the terms of Settlement Agreement to provide for a change in trustee and to modify the trustee succession procedures is viewed as

pertaining to the administration of the trust, comparable to the administrative modification in Example 10 of § 26.2601-1(b)(4)(i)(E).

c In addition, all other terms and trust modifications set forth in Settlement Agreement (including the trustee procedures regarding HEMS distributions, the payment of attorneys' fees, trustee communications with beneficiaries, and conflicts of interest) are viewed as administrative in nature and, under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust 1.

Accordingly, based upon the facts submitted and the representations made, we further conclude that after the division and modification of Trust 1 pursuant to Settlement Agreement, Trust 1, Successor Trust, and Trust A will not be subject to the provisions of chapter 13.

Letter Ruling 201642028 viewed the beneficial interests as not changing, so the modification did not have any gift or estate tax consequences. Because the trustees could makes distributions only for ascertainable standards, the right to change trustees also had no estate tax consequences. As to income tax issues:

> … the division of Trust 1 into Successor Trust and Trust A pursuant to the Settlement Agreement will not result in a distribution under § 661 from Trust 1; and accordingly, will not result in gross income to Successor Trust or Trust A under § 662. Additionally, we conclude that a transfer from Trust A to Successor Trust pursuant to the Settlement Agreement that is made for a purpose other than to facilitate a HEMS distribution to a beneficiary will not result in a distribution under § 661 from Trust A; and accordingly, will not result in gross income to Successor Trust under § 662.
>
> We further conclude that a transfer from Trust A to Successor Trust for an immediate HEMS distribution to a beneficiary will result in a deduction pursuant to § 661 for Trust A (to the extent of Trust A's distributable net income) and (ii) inclusion of an equivalent amount in the recipient beneficiary's gross income pursuant to § 662.

Letter Ruling 201642028 also allowed the trusts to reimburse the beneficiaries' legal fees and deduct them as Code § 212 expenses:[2724]

> Legal fees relating to the proper investment of trust assets are a function of the management of the trust property and are deductible if they are ordinary and necessary. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 376 (1945). In *Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq.*, 1968-2 C.B. 21, the Service challenged the trustee's deduction of certain attorneys' fees in computing the trust's income. These fees arose from an action brought by the testator's children to accelerate their beneficial interests in the trust. Pursuant to state law, the court ordered that the attorneys' fees for the trust, the beneficiaries and the guardian ad litem be paid from trust income. The court decided that (1) the state court decision aided the trustee in its management of the trust property, and (ii) the trust benefitted by the involvement of the

[2724] For Code § 212, see part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.

beneficiaries and the guardian ad litem in the litigation. Thus, the court held that all of the litigants' attorneys' fees paid from trust income were deductible under § 212(2).

In the present case, the legal fees paid by beneficiaries seeking to change the trustee of the trust are not payments to acquire, create, or facilitate the acquisition or creation of an intangible. The litigation involved only the proper administration of the trust and not the beneficiaries' ownership interests in the trust. The beneficiaries already had an ownership interest in the trust and were not seeking a redetermination of that ownership interest, but rather, merely a change in the administration of the trust. Therefore the legal fees are not subject to capitalization under § 1.263(a)-4.

Based on the facts submitted and the representations made, we conclude that the purpose of the action brought by the beneficiaries of Trust 1 was to improve the investment of the assets of the trust. Further, Trust 1 benefited by the involvement of the beneficiaries in the proceedings. Thus, subject to allocations under § 1.265-1, we conclude that the attorneys' fees paid by Trust 1, Successor Trust, or Trust A to a beneficiary of Trust 1, Trust 2, Trust 3, Trust 4, or one of the resulting divided trusts pursuant to Settlement Agreement as reimbursement for the beneficiary's prior payment of attorney's fees and expenses will result in a deduction for the reimbursing trust under § 212. Since the attorney's fees and expenses are deductible under § 212, it is implicit that those expenses are not deductible under § 661 or includible by the beneficiaries under § 662.

Letter Ruling 201711002 involved the following facts:

On Date 1, Settlor established Trust A, an irrevocable trust, for the benefit of Settlor's granddaughter (Granddaughter), Granddaughter's spouse (Spouse), and Granddaughter's children, GGC1 and GGC2, and Granddaughter's issue. Date 1 is a date before September 25, 1985. Trust A was governed by the laws of State 1.

Trust A provides that, during Granddaughter's life, the trustees shall distribute one-half of the net income to Granddaughter. The corporate trustee, in its absolute discretion, may direct the trustees to distribute the other one-half of the net income to Granddaughter and any of her children or issue. Further, the corporate trustee, in its absolute discretion, may direct the trustees to distribute principal to Granddaughter, Granddaughter's children or issue, but none to Granddaughter's husband, as the corporate trustee deems necessary for the support, maintenance, and education of such person.

Trust A provides that when Granddaughter dies, if Spouse predeceases her, then the corporate trustee, in its absolute discretion, may direct the trustees to distribute the entire net income to Granddaughter's children or issue.

Trust A provides that the trust will terminate (Termination Date) upon the death of the last survivor of Granddaughter, Spouse, GGC1, and GGC2 (measuring lives). Upon termination, the trust will be divided into equal shares to Granddaughter's children as are living at the death of the last survivor and to the then living issue of each child of Granddaughter who is deceased, the issue of each deceased child of Granddaughter to take per stirpes a share equal to the share which a child of Granddaughter would have taken if alive. If upon the Termination Date, there are no living children or issue of Granddaughter, then the trust estate will pass to Settlor's Grandson, and if he is

deceased, to Grandson's issue, per stirpes. If none, the trust estate will pass, in equal shares, one-half to University A and one-half to University B.

After Spouse died, on Date 5, Trust A was divided, pursuant to court order and the statutes of State 1, into three separate trusts, one trust to benefit Granddaughter and her issue (Trust A1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust A2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust A3). Trust A1 received one-half of the assets of Trust A. Trusts A2 and A3 each received one-half of the remaining assets.

Trust A1 provided that during Granddaughter's life, the trustees must pay Granddaughter all of the net income from the trust and the corporate trustee, in its sole discretion, may direct the trustees to distribute so much of the principal to Granddaughter and her issue, as the corporate trustee deems necessary for the support, maintenance, and education of such person. Upon Granddaughter's death, the remaining assets of Trust A1 would be distributed one-half to Trust A2 and one-half to Trust A3. Trust A1 retained the same Termination Date of Trust A. Upon the Termination Date, Trust A1 assets would be distributed in equal shares to Trust A2 and Trust A3. In the event, Granddaughter died without leaving children or issue, Trust A1 assets would be distributed, per stirpes, to Grandson's issue. If none, to University A and University B, in equal shares.

Trust A2 provided that the corporate trustee, in its sole discretion, may direct the trustee to distribute so much of the entire net income to Granddaughter, GGC1 and any of GGC1's issue. Any net income not distributed would be accumulated. Further, the corporate trustee, in its sole discretion, may direct the trustee to pay or expend for the benefit of Granddaughter, GGC1 and GGC1's issue any portion of the net income and so much of the principal as the corporate trustee deems necessary for the support, maintenance, and education of such person. Trust A3 contained the same provisions, except the beneficiaries included Granddaughter, GGC2 and GGC2's issue. Each trust retained the same Termination Date as Trust A. Upon the Termination Date, Trust A2 assets would be distributed to GGC1's children and to the then living issue of a deceased child, such issue to take per stirpes. Upon the Termination Date, the same provisions applied to Trust A3, except that the trust assets would be distributed to GGC2's children or issue. Trusts A2 and A3 also provided that, upon the Termination Date, in the event GGC1 or GGC2 died without leaving issue, the assets in his trust would be distributed in equal shares to his brothers' children or issue. Further, in the event, upon the Termination Date, GGC1 and GGC2 die without leaving children or issue, then the trust assets would be distributed to Grandson's issue. If none, the trust assets would be distributed, in equal shares, to University A and University B.

After Granddaughter died, on Date 6, pursuant to court order and the statutes of State 1, Trust A2 was divided into six separate trusts. Trust 1 benefits GGC1, GGGC1 and GGGC1's issue. Trust 2 benefits GGC1, GGGC2 and GGGC2's issue. Trust 3 benefits GGC1 and GGC1's children and issue. Three other trusts (Trusts X, Y, and Z) were established to benefit GGC1's other children and that child's issue. This private letter ruling pertains to Trust 1, Trust 2, and Trust 3.

Trust 1 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1, GGGC1 and GGGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1, GGGC1 and GGGC1's

issue, as the corporate trustee, in its sole discretion, determines appropriate. Trust 2 contains the same provisions, except that the beneficiaries include GGC1, GGGC2 and GGGC2's issue. Trust 3 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1 and GGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1 and GGC1's issue as the corporate trustee, in its sole discretion, determines appropriate.

Trusts 1, 2, and 3 retain the same Terminate Date as Trust A. Upon the termination Date, Trust 1 assets will be distributed outright to GGGC1, if living. Trust 2 assets will be distributed outright to GGGC2, if living, and Trust 3 assets will be distributed in equal shares to Trusts 1, 2, X, Y, and Z.

On Date 2, Settlor established Trust B, a revocable trust, for the benefit of Granddaughter, GGC1, and GGC2. Trust B was amended and restated on Date 3. Trust B became irrevocable upon Settlor's death on Date 4. Dates 2, 3 and 4 are all dates prior to September 25, 1985. Trust B contains the same income and principal distribution provisions, Termination Date, and dispositive provisions as Trust A, except that Spouse was not a beneficiary or a measuring life.

On Date 5, pursuant to court order and the statutes of State 1, Trust B was divided into three separate trusts, one trust to benefit Granddaughter and her issue (Trust B1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust B2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust B3). These trusts contain the same provisions as the three divided trusts under Trust A.

After Granddaughter died, on Date 7, pursuant to court order and the statutes of State 1, Trust B2 was divided into six separate trusts. Trust 4 benefits GGC1, GGGC1 and GGGC1's issue. Trust 5 benefits GGC1, GGGC2 and GGGC2's issue and Trust 6 benefits GGC1 and GGC1's issue. Three other trusts (Trusts L, M, and N) were established, one for each of GGC1's other children and each child's issue. This private letter ruling pertains to Trusts 4, 5, and 6.

Trusts 4 and 5 contain the same income and principal provisions, Termination Date, and dispositive provisions as Trusts 1 and 2, respectively. Trusts 6 contains the same income and principal provisions, Termination Date, and dispositive provisions as Trust 3, except that on termination Trust 6 assets will be distributed equally to Trusts 4, 5, L, M, and N. The current trustee of Trusts 1 through 6 is Trustee.

It is represented that no additions, actual or constructive, have been made to Trust A, Trust B, or Trusts 1 through 6 after September 25, 1985.

GGC1 and Trustee propose to establish six new trusts, Trusts 7 through 12, for the purpose of merging Trusts 1 through 6 into the newly established trusts. Trust 1 and Trust 4 benefit GGC1, GGGC1 and GGGC1's issue. Each of these trusts will merge into Trust 7 and Trust 10, respectively. Trusts 7 and 10 will retain the same income and principal distribution provisions as merged Trusts 1 and 4. Trusts 7 and 10 will not terminate until GGGC1 dies, as opposed to upon the death of the last to die of GGC2 and GGC1. However, Trusts 7 and 10 each grant GGGC1 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC1's issue and the creditors of GGGC1.

Trust 2 and Trust 5 benefit GGC1, GGGC2 and GGGC2's issue. Each of these trusts will merge into Trust 8 and Trust 11, respectively. Trusts 8 and 11 will retain the same income and principal distributions provisions as merged Trusts 2 and 5. Trusts 8 and 11 will terminate when GGGC2's dies, as opposed to upon the death of the last to die of GGC1 and GGC2. However, Trusts 8 and 11 each grant GGGC2 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC2's issue and the creditors of GGGC2.

Trust 3 and Trust 6 benefit GGC1 and GGC1's issue. Each of these trusts will merge into Trust 9 and Trust 12, respectively. Trusts 9 and 12 will retain the same income and principal distributions provisions as merged Trusts 3 and 6. Upon the death of the last to die of GGC1 and GGC2, Trust 9 will terminate and distribute in equal shares to Trusts 7, 8, X, Y and Z, and Trust 12 will terminate and distribute in equal shares to Trusts 10, 11, L, M, and N.

In addition, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable.

At the time Trusts 7 and 10 terminate, to the extent GGGC1 has not exercised her testamentary general power of appointment, the trustees shall distribute Trust 7 and 10 to GGGC1's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes. Similarly, at the time Trusts 8 and 11 terminate, to the extent GGGC2 has not exercised her testamentary general power of appointment, the trustees shall distribute Trusts 8 and 11 to GGGC2's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes.

Trusts 7, 8, 10, and 11 each provide for the same default dispositive provisions as Trusts 1, 2, 4, and 5, respectively. To the extent GGGC1 or GGGC2 dies leaving no children or issue of a deceased child, the trust estates pass in equal shares to the trusts established to GGC1's other children. If the trusts for the other children have terminated and there are no other children or issue of deceased children of GGC1, the trust estates of Trusts 7, 8, 10, and 11 will pass to Grandson's issue, and if none, the trust estates will pass one-half to University A and one-half to University B.

It is represented that the purpose of the merger is to retain the assets of Trusts 1 through 6 in further trust after the death of GGC1 and GGC2 and to appoint successor trustees for Trusts 7 through 12. Currently, Trusts 7 through 12 are not funded and it is represented that these trusts will remain unfunded until the mergers. It is represented that all of the current and remainder beneficiaries of Trusts 1 through 6 have consented to the proposed mergers.

Statute 1 provides that a trustee may declare one or more new trusts for the purpose of merging all, or a portion, of an existing trust or trusts with and into the new trust or trusts, whether or not created by the same trustor and whether or not funded prior to the merger, to be held and administered as a single trust if such a merger would not result in a material change in the beneficial interests of the trust beneficiaries, or any of them in the trust.

> Statute 2 provides that a trustee, without authorization by the court, may exercise powers conferred by the terms of the trust; and except as limited by the terms of the trust, any other powers conferred by this chapter.
>
> Statute 3 provides that whenever a trust (a transferor trust) is merged with and into another trust (the transferee trust) the separate existence of the transferor trust shall cease and the transferee trust shall possess all of the rights and privileges, and shall be subject to all of the obligations of, the transferor trust.

Note that Trusts 8 and 11 provided earlier termination than the original trusts but grant a general power to the beneficiary whose death would trigger termination. Thus, also they accelerate distribution to the remaindermen, they make that subject to a general power of appointment, thereby dimishing the remaindermen's beneficial interest.

After reviewing the regulations governing trusts grandfathered from GST, including Reg. § 26.2601-1(b)(4)(i)(E), Example (6), Letter Ruling 201711002 held:

> In the instant case, although initially administered in State 1, Trusts 1 through 6 have been administered in State 2 since the appointment of Trustee, who has its principal place of business in State 2. Therefore, State 2 law is applicable. The merger of Trusts 1 through 6 (Transferor Trusts) into Trusts 7 through 12 (Transferee Trusts), respectively, is permitted under State 2 law if such merger would not result in a material change in the beneficial interests of the trust beneficiaries. Statute 1. Statute 2 provides that a trustee may act under Statute 1 without authorization by the court. Statute 3 provides that, following the merger, the governing instruments of Transferee Trusts control the disposition of the property of their respective Transferor Trusts.
>
> During the lifetime of GGC1 and GGC2, the dispositive terms of the Transferor Trusts and their respective Transferee Trusts are the same. After the merger, Trusts 9 and 12 will terminate upon the death of the survivor of GGC1 and GGC2, Trusts 7 and 10 will terminate on the date of GGGC1's death, and Trusts 8 and 11 will terminate on the date of GGGC2's death. However, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable. In addition, GGGC1 is granted a general power of appointment over Trusts 7 and 10, which will cause Trusts 7 and 10 to be includible the gross estate of GGGC1 at her death under § 2041(a)(2). Further, GGGC1 will be treated as the transferor of the corpus of Trusts 7 and 10 for GST tax purposes under § 2652(a)(1). Similarly, GGGC2 is granted a general power of appointment over Trusts 8 and 11, which will cause Trusts 8 and Trust 11 to be includible in the gross estate of GGGC2 at her death under § 2041(a)(2). Further, GGGC2 will be treated as the transferor of the corpus of Trusts 8 and 11 for GST tax purposes under § 2652(a)(1).
>
> Accordingly, the terms of Trusts 7 through 12 will not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the period provided for in the original trusts, Trust A and Trust B. Moreover, Trusts 7 through 12 will not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the trustee action.

> Therefore, based on the facts submitted and representations made, we conclude that upon the merger of Trust 1 into Trust 7, Trust 2 into Trust 8, Trust 3 into Trust 9, Trust 4 into Trust 10, Trust 5 into Trust 11 and Trust 6 into Trust 12, the Transferee Trusts (i.e. Trusts 7 through 12) will be exempt from GST tax under § 26.2601-1(b).

If a decanting constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2725]

II.J.18.d. Trust Commutations

Reg. § 1.1001-1(a), "General rule," begins with and then concludes with:

> Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained…. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

Code § 1001(e), "Certain term interests," provides:[2726]

> (1) *In general*. In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.
>
> (2) *Term interest in property defined*. For purposes of paragraph (1), the term "term interest in property" means -
>
> (A) a life interest in property,
>
> (B) an interest in property for a term of years, or
>
> (C) an income interest in a trust.
>
> (3) *Exception*. Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

In other words, under Code § 1001(e)(1), a person who sells a life interest in property, an interest in property for a term of years, or an income interest in a trust receives no basis with respect to the trust's assets and recognizes gain on the entire value. On the other hand, if all of

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[2725] See Letter Ruling 201941006, described in the text accompanying fn 5617 in part III.A.3.e.ii.(a) Qualification as an ESBT.

[2726] In this part II.J.18.d, see text accompanying fn 2746 for additional explanation of Code § 1001(e).

the beneficiaries get together and simultaneously sell their interests in the trust to a third party, under Code § 1001(e)(3) they would be able to use basis. Also note that Code § 1001(e)(1) and regulations implementing it do not prevent basis frombeing allocated to remaindermen.

The legislative history for when Code § 1001(e) was first enacted in the Tax Reform Act of 1969 (P.L. 91-172), is as follows (excerpted from BNA):

> House Committee Report
>
> [Page 156]
>
> 6. Sales of life estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)
>
> Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property divided between the life estate and the remainder. (As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.)
>
> The life tenant is not permitted to amortize his basis over the length of the life estate because this would reduce for tax purposes the
>
> [Page 157]
>
> amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used in reducing the gain he receives on the sale. In addition, such a life estate (or an estate for a term of years) is frequently treated by the courts as a capital asset, and any amount received upon its sale in excess of the adjusted basis of the life estate is treated as a capital gain. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.
>
> General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income because he is treated as having a basis in the life estate when he sells it and, in addition, the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. Your committee does not believe that income should be allowed to completely escape taxation by this means.
>
> Explanation of provision.—Your committee's bill provides a new rule for determining the amount of gain or loss from the sale or other disposition of a life interest (or an interest for a term of years) in property or an income interest in a trust. In such a case, the bill provides that any portion of a taxpayer's adjusted basis determined under sections 1014 or 1015 of the code (dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust) is disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property.

Thus, where there is a sale or other disposition of a life (or term of years) interest in property, or an income interest in a trust—which was acquired by gift, bequest, inheritance, or by a transfer in trust—there is to be no cost or other basis to offset the proceeds received from the disposition. Accordingly, the person disposing of such an interest is to be required to treat as gain the entire amount he receives from the disposition of his interest, rather than only the excess of the amount received over his basis.

The bill, however, does not change present law in the situation where there is a sale or other disposition of a life or term of years interest in property (or an income interest in trust) which is a part of a transaction in which the entire fee interest is transferred to any person or persons. Thus, where a life tenant and remainderman simultaneously sell the entire fee interest in property in a single transaction, it is to be treated in the same manner as under existing law; the gain each receives is to be measured by the excess of the proceeds received on the disposition over the adjusted basis in the life estate. Your committee believes this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Supplemental Report

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SECTION 516. OTHER CHANGES IN CAPITAL GAINS TREATMENT

(a) Sales of life estates and term interests.—Subsection (a) of section 516 of the bill adds a new subsection (e) to section 1001 of the

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code (relating to determination of amount of and recognition of gain or loss).

General rule

Paragraph (1) of new section 1001(e) provides that, in determining the gain or loss from the sale or other disposition of a "term interest in property" (as defined in new section 1001(e) (2)), that portion of the adjusted basis of such interest which is determined under section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gifts and transfers in trust) is to be disregarded to the extent that such adjusted basis is a portion of the entire adjusted basis of the property. Under this provision, a person who sells a term interest in property, such as a life interest, to which new subsection (e) applies and the basis of which is an amount computed by apportioning the basis of such property between the life interest and the remainder interest, may not reduce the amount realized by his adjusted basis in such interest.

Term interest defined

Paragraph (2) of new section 1001(e) defines the term "term interest in property" as an interest which is: (A) a life interest in property, (B) an interest in property for a term of years, or (C) an income interest in a trust.

Exception

Paragraph (3) of new section 1001(e) provides that the rules stated in paragraph (1) of new section 1001(e) do not apply to a sale or other disposition which is a part of a transaction in which a fee interest is transferred to any person or persons. For example, new subsection (e) does not apply to a case in which a life tenant and a remainderman simultaneously sell the entire fee interest in property to a third party in a single transaction.

Example.—A devises Blackacre to B for life, with the remainder to C in fee simple. The fair market value of Blackacre at A's death is $10,000. B is considered to hold a life interest in property under new section 1001(e) (2) (A). B and C share the $10,000 basis determined pursuant to section 1014. Assume B and C each have a basis under section 1014 of $5,000 for their respective interests. If B sells his life interest in Blackacre to D for $20,000, B is treated as having gain of $20,000 since his $5,000 adjusted basis is disregarded under new section 1001(e)(1).

House Discussion

Congressional Record

(August 7, 1969)

[Page H7132]

Mr. HELSTOSKI * * * * *

23. Capital Gains. —Capital gain and loss treatment is revised in several respects. First, the alternative capital gains tax for individuals was repealed, with the result that in the case of those in the top tax brackets, the rates may rise to as much as 35 percent (or 32½ percent under the new rate structure provided by this bill); second, long-term capital losses of individuals are reduced by 50 percent before being available as an offset against ordinary income; third, the offset against ordinary income in the case of husbands and wives filing separate returns is limited to $500 for each or to the same aggregate amount as if they filed a joint return; fourth, the sale of papers by a person whose efforts created them, or by a person for whom they were produced, is to give rise to ordinary income; fifth, the holding period for capital gains is increased from 6 months to 12 months; sixth, employees' contributions to pension plans, when paid out as a part of a lump-sum distribution, is to be taxed as ordinary income; seventh, life interests are not to be accorded a cost basis when sold; eighth, casualty losses and gains are to be consolidated in determining whether they give rise to ordinary loss or to gain which is consolidated with other section 1231 gains or losses; and ninth, transfers and franchises are not to be treated as giving rise to capital gains if the transferor retains significant rights.

House Action

Summary of H.R. 13270

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6. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

House solution.—The bill provides that the entire amount received on the sale or other disposition of a life (or term-of-years) interest in property, or an income interest in a trust (which was acquired by gift, bequest, inheritance, or by a transfer in trust), is to be-taxable, rather than only the excess of the amount received over the seller's basis for his interest. This provision applies to sales or other dispositions after July 25, 1969.

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The House bill, however, does not change present law where a life interest is disposed of as part of a single transaction in which the entire fee interest is transferred (e.g., where a life tenant and remainderman simultaneously join in a sale of the entire property interest) to any person or persons. In such a case, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the disposition over his adjusted basis in the property.

Argument For.—The present tax law has the effect of allowing a large part, and in some cases almost all, of the income from a life estate to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income he receives from the sale because he will usually have a tax basis equal to, or almost equal to, the sales price. This is regarded as particularly undesirable by those who view such transactions as an anticipatory assignment of income rather than as the sale of a property interest.

Argument Against.—A sale of a property interest is involved and therefore it is appropriate in measuring the amount of gain to reduce the proceeds by the amount of the life tenant's basis.

SENATE Finance Committee

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Hon. Edwin S. Cohen

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Additional changes made by the bill include a provision that life interests received by gift, bequest or inheritance, are not accorded a tax basis when sold. Under the bill, all casualty gains and losses on capital assets and section 1231 property are consolidated for the purposes of determining whether they give rise to an ordinary loss or to a gain which is consolidated with other section 1231 gains and losses. Finally, the bill provides that transfers of franchises will not give rise to capital gain treatment if the transferor retains any significant rights in connection with the transfer.

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In all other respects, we support the capital gain and loss provisions of the bill.

Committee Decisions—Compilation

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Sales of Life Estates.—The Committee also adopted the provision of the House-passed tax bill which relates to the sales of life estates. In general, this provision provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property, or income interest in trust (whether acquired by gift, bequest, inheritance, or by a transfer in trust), is to be taxable without any reduction for the taxpayer's basis. Presently, only the excess of the amount received over the seller's basis is taxed. The Committee, however, did change the effective date for the provision. Under the Senate version, this provision would become effective as to sales or other dispositions after October 9, 1969 (the House bill would have applied with respect to sales or other distributions after July 25, 1969).

Summary of Bill as Reported by Committee

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8. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property

may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

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Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

Finance Committee decision.—The House bill and the committee amendments provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust), is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law where a life interest is disposed of as a part of a single transaction in which the entire fee interest is transferred to any other persons. This occurs, for example, where a life tenant and remainderman join in the sale of the entire property interest. In such a case the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his basis for his interest.

The House bill would apply to sales or other dispositions after July 25, 1969. The committee amendment moves this effective date up to October 9, 1969.

Committee Report

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8. Sales of Life Estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called “uniform basis” rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant is not permitted to amortize his basis over the length of the life estate and thereby reduce for tax purposes the amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale.

The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income to the extent of the basis which he is treated as having in the life estate when he sells it and, in addition the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible

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loss. The committee agrees with the House that income should not be allowed to completely escape taxation by this means.

Explanation of provision.—The House bill and the committee amendments, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the bill provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, there is to be no basis to be offset against the proceeds received on a disposition of this type of interest, and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. The committee agrees with the House that this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Committee Report—Individual Views of Senator Albert Gore

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(3) Sales of life estates.—A fundamental rule of the tax laws is that a person cannot convert ordinary income into capital gain by transferring the right to receive the future income.

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An exception to this basic rule has been permitted to develop in the case of a person who has the right to income for life from a trust or other property. Present rules permit such a person to sell his income interest and pay capital gains rates. This result is inconsistent with basic tax rules.

The House bill modified the present rule somewhat by providing that the total amount realized on the sale would be treated as capital gain; that is, there would be no reduction in the gain realized for the taxpayer's basis. This provision merely replaces one inconsistent rule with another.

The proper tax treatment of these transactions is to give the tax-payer the benefit of any basis, but to tax all gain as ordinary income under regular rules dealing with transfer of future rights to receive income. The Senate should adopt the proper rule as a substitute for the House provision.

Senate Action

Summary of Senate Amendments

[Page 109]

8. Sates of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

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Senate amendments.—Both versions of the bill, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Finance Committee amendments, make only one change in the House bill. They apply to sales or other dispositions after October 9, 1969. The House bill is effective with respect to sales or other dispositions made after July 25, 1969.

HOUSE-SENATE CONFERENCE

Conference Action

Conference Report

[Page 318]

6. Sales of life estates, etc. (sec. 1001 of the code)

The House bill provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust, if such interest was acquired by gift, bequest, inheritance, or a transfer in trust, is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

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The provision does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property or an income interest in trust where such sale is a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Senate amendment makes the provision applicable to sales or other dispositions after October 9, 1969, rather than with respect to sales or other dispositions made after July 25, 1969, as under the House bill.

The conference substitute (sec. 516(a) of the substitute and sec. 1001 of the code) follows the Senate amendment.

POST-ENACTMENT

Joint Committee General Explanation of The Tax Reform Act

[Page 174]

7. Sales of Life Estates, Etc. (sec. 516(a) of the Act and sec. 101 of the code)

Prior law.—When a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called “uniform basis” rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder

interest is increased in the same amount; hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant in this case is not permitted to amortize his basis over the period of the life estate and thereby reduce for tax purposes the amount of income he reports. However, under prior law, where the life tenant sold his right to receive future income, his basis in the property at the time of sale was used to reduce the gain he received on the sale. The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above had the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it. In addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In some cases the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

Explanation of provision.—In general, the Act provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the Act provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, in the type of situations considered here, there is no basis to be offset against the proceeds received on a disposition of this type of interest; and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

The Act does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. This exception appeared appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Implementing this rule, Reg. § 1.1001-1(f), "Sale or other disposition of a term interest in property," which was adopted by T.D. 7142 (9/23/1971) without any explanation,[2727] provides:

> (1) *General rule*. Except as otherwise provided in paragraph (f)(3) of this section, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of this section), a taxpayer shall not take into account that portion of the adjusted basis of such interest that is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest:
>
> (i) Is determined pursuant to sections 1014, 1015, or 1022; and
>
> (ii) Is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph (f) to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See paragraph (f)(2) of this section for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies.[2728] That portion of the adjusted uniform basis of the entire property that is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest that is not a portion of the adjusted uniform basis of the entire property.
>
> (2) *Term interest defined*. For purposes of section 1001(e) and this paragraph, a "term interest in property" means -
>
> (i) A life interest in property,
>
> (ii) An interest in property for a term of years, or
>
> (iii) An income interest in a trust.
>
> Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse

[2727] Proposed regulations were published June 24, 1971 at 36 F.R. 12018-12019. They did not include any explanation, either. Reg. § 1.1001-1(f)(3) does not differ from its proposed form; I have not compared the other provisions.

[2728] [My footnote:] Code § 351 is described in part II.M.2.a Initial Incorporation – Generally, which is the beginning of part II.M.2 Buying into or Forming a Corporation.

of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A "term interest in property" also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception*. Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014-5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations*. For examples illustrating the application of this paragraph, see paragraph (d) of § 1.1014-5.

Reg. § 1.1001-1(f)(3) requires a transfer "to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common." This narrows Code § 1001(e)(3), which requires a transfer "to any person or persons."

Rev. Rul. 72-243 held:

> The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Second Circuit in the case of *Beulah Eaton McAllister v. Commissioner*, 157 F.2d 235 (1946), certiorari denied, 330 U.S. 826 (1946), which held that the proceeds received by the life tenant of a testamentary trust in consideration for the transfer of her entire interest in the trust to the remainderman, are to be treated as an amount realized from the sale or exchange of a capital asset under section 1222 of the Internal Revenue Code of 1954.

Letter Ruling 8316135 involved the following facts:

> … a ruling is requested concerning the sale of certain interests in L to M, a foreign charity not subject to United States taxation.
>
> The information provided indicates that prior to his death on January 12, 1978, A, your father, created L. It is represented that L, a foreign organization, would be taxable as a trust if it conducted activities in the United States.
>
> Article 1 of the by-laws of L provides that during his life all rights to L's assets and net income thereof belong to A. Article 3 provides that upon A's death, B, A's wife, and you are to share L's net income as equal life beneficiaries. Articles 4 and 5 provide that upon the death of A and B, you or your children, if any, shall have all the rights to L's assets and income. Article 6 provides that the net income and assets of L shall be transferred to

> M in the event of the death of all other designated beneficiaries. Thus, M presently possesses a contingent remainder interest in L.
>
> You and B propose to sell your interests in L to M. It is represented that subsequent to this proposed sale, M will own the entire fee interest in L. It is also represented that your adjusted basis in your interests in L, and B's adjusted basis in her interest in L are determined pursuant to section 1014 of the Internal Revenue Code.

Letter Ruling 8316135 held:[2729]

> The exception in section 1001(e)(3) for the simultaneous sale of the life interest and the remainder interest in a single transaction is appropriate because "in this case the purchaser acquires a single entire interest in property and, therefore, he is not allowed to amortize the separate life interest". H.Rep. No. 91-413, 91st Cong., 1st Sess. 157 (1969), 1969-3 C.B. 200, 298.
>
> In the instant case subsequent to its purchase of your interest and B's interest in L, M will own the entire fee interest in L and, thus, would not be able to amortize any portion of this fee interest.
>
> Based upon the information submitted and representations made, we conclude as follows:
>
> 1. The amount of gain or loss you will recognize from your proposed sale of your interests in L will be measured by the difference between the amount realized on the sale of your life interest in L and your remainder interest in L and your adjusted basis in your life estate in L and your remainder interest in L.
>
> 2. The amount of gain or loss B will recognize from her proposed sale of her interest in L will be measured by the difference between the amount realized on the sale of her life interest in L and her adjusted basis in her life estate in L.

Letter Ruling 8316135 did not cite Reg. § 1.1001-1(f)(3) (which was adopted in 1971) or compare it to Code § 1001(e)(3). Implicit in its ruling is that a contingent remainderman qualifies as a "third person." Also, only the life tenants were selling their interests; the ruling was silent as to how the contingent remainderman acquired the other remaindermen's interests.

Letter Ruling 8448059 involved the following facts:

> Your late wife died testate on August 6, 1982. At the time of her death, she owned a certain parcel of improved real estate (the "Real Estate"). Pursuant to her will and codicil the Real Estate was devised and bequeathed as follows: a life estate to you (as "Life Tenant") with the remainder in equal shares to each of A, B, C, and D. Presently, you and each of A, B, & C propose to sell your respective life estate and remainder interests to D…

[2729] In this part II.J.18.d, see text preceding and accompanying fn 2745 to explain the comment in the legislative history referring to amortization.

Letter Ruling 8448059 reviewed Reg. § 1.1014-5 - especially Reg. § 1.1014-5(c) - Example (5)(b), and held:

> … if you consummate the proposed sale of your life estate to D, your section 1014 basis will be disregarded (you will have a zero basis for purposes of the sale); your taxable gain will be an amount equal to the sale price of the life estate; and D will have allowable amortization deductions against his basis in the life estate, which may be taken over the period of your remaining life expectancy. (Should D ever convert the property to business use, such deductions will be actually allowed.)

Letter Ruling 8948023 involved the following facts regarding charitable remainder unitrusts:

> A, B, C, and D wish to terminate the trusts. It is represented that M and N have agreed to the proposed termination. It is contemplated that one of the apartment buildings used to fund the Trusts will be sold and some of the proceeds therefrom will be distributed to M and N in satisfaction of their rights to the remainder interests in the Trusts. The balance of the cash and the other apartment building will be distributed to A,B, C, and D in satisfaction of their rights to the unitrusts amounts from the Trusts.

Letter Ruling 8948023 reviewed Reg. § 1.1014-5 – especially Reg. § 1.1014-5(c), Example (5), and held:

> In this case, A and B are selling their interests in Trust 1 to the remaindermen, M and N. C and D are selling their interests in Trust 2 and Trust 3, respectively, to the remainderman, N. Provided the cash and the property interests received by A, B, C, and D are distributed to each of them in accordance with their respective interests in the Trusts, the amount each realizes from the sale of his or her interest in the Trusts is the amount of cash and the fair market value of the property received by each.
>
> Pursuant to section 1001(e)(1) of the Code, the portion of the adjusted uniform basis assigned to the respective interests of A, B, C, and D in the Trusts is disregarded. The exception contained in section 1001(e)(3) is not applicable, because the entire interest in the Trusts' assets is not being sold, or otherwise disposed of, to a third party. A, B, C, and D have no basis in their respective interests in the Trusts.

Rev. Rul. 98-8, in addressing the gift tax consequences to the surviving spouse of the acquisition by the surviving spouse of the remainder interest in a trust subject to a QTIP election, recited the following facts:

> The decedent, D, died in 1993 survived by S, D's spouse. Under the terms of D's will, a trust (the QTIP Trust) was established under which S was to receive all of the trust income, payable at least annually, for S's life. On S's death, the remainder was to be distributed outright to C, D's adult child.
>
> S was not given a general power of appointment over the trust property.
>
> On the federal estate tax return filed for D's estate, the executor made an election under section 2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to D's estate for the value of the property passing from D to the QTIP Trust.

> Subsequently, S, C, and the trustee of the QTIP Trust entered into the following transaction: (1) S acquired C's remainder interest in the QTIP Trust; (2) S gave C a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest; (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to S; and (4) S thereupon paid x dollars from those assets to C in satisfaction of the promissory note.
>
> At the conclusion of the transaction, the QTIP Trust was terminated; S held QTIP Trust assets having a value of y dollars (which was equal to the value of S's life interest in the trust); and C held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). S contended that the transaction was not subject to gift tax because S received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by S to C.

Inserting Code § 2519[2730] into the mix, Rev. Rul. 98-8 reasoned:

> The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, a transfer (estate or gift) tax is paid. *United States v. Stapf*, 375 U.S. 118, 128 (1963), 1964-1 (Part 1) C.B. 535, 537; *Estate of Clayton v. Commissioner*, 976 F.2d 1486, 1491 (5th Cir. 1992); *Estate of Letts v. Commissioner*, 109 T.C. 290, ___ (1997) ("It is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the estate of the surviving spouse.")
>
> The statutory scheme of the QTIP provisions is consistent with this congressional intent. Thus, a marital deduction is allowed under section 2056(b)(7) for property passing from a decedent to a QTIP trust in which the surviving spouse possesses a lifetime income interest. Sections 2519 and 2044 act to defer the taxable event on the marital deduction property only so long as the surviving spouse continues to hold the lifetime income interest.
>
> Under section 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (*i.e.*, all interests in the property other than the income interest). Correspondingly, under section 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.
>
> The term "disposition," as used in section 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:

[2730] See part II.H.2.c QTIP Trusts - Code § 2519 Trap, which cites Rev. Rul. 98-8 at fn 1922. It also mentioned that Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.

A commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under section 2519 of the value of the remainder interest. The commutation of the spouse's income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the income interest. Sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations. Section 25.2519-1(g), Example 2 (illustrating that the sale by the spouse of the spouse's income interest to the trust remaindermen is a disposition of the income interest); section 25.2519-1(f) providing that "[T]he sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee- spouse's income interest, is considered a disposition of the qualifying income interest". See also, *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989), in which the surviving spouse and remainderman divided the sale proceeds of QTIP property proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of section 2519 and was thus subject to gift tax.

There is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where S acquired the remainder interest. In both cases, after the transaction the spouse's income interest in the trust is terminated and the spouse receives outright ownership of property having a net value equal to the value of the spouse's income interest. Similarly, the remainderman receives ownership of property equal in value to the remainder interest. Thus, the transaction in the instant case essentially effectuates a commutation of S's income interest in the trust, a transaction that is a disposition of S's income interest under section 2519. Therefore, under section 2519, S is regarded as making a gift of x dollars, the value of the remainder interest in the QTIP Trust. Section 25.2519-1(f).

This conclusion that S has made a gift is also supported by an additional analysis. S acquired an asset (the remainder interest in the QTIP Trust) that is already subject to inclusion in S's transfer tax base under section 2044. In analogous situations, the courts have recognized that the receipt of an asset that does not effectively increase the value of the recipient's gross estate does not constitute adequate consideration for purposes of the gift and estate tax. See *Commissioner v. Wemyss*, 324 U.S. 303, 307 (1945), 1945 C.B. 416, ("The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate.")

A companion case to *Commissioner v. Wemyss*, *Merrill v. Fahs*, 324 U.S. 308 (1945), 1945 C.B. 418, and the cases that preceded it, involved situations where A, an individual, transferred property to B, A's spouse (or future spouse), in exchange for B's relinquishment of marital rights in A's property. The Court held that B's relinquishment of the marital rights did not constitute adequate and full consideration for A's transfer because the assets subject to the marital rights were already includible in A's taxable

estate. The property subject to dower and marital rights is clearly included in the gross estate of the property owner. Thus, to conclude that the relinquishment of dower and marital rights by the spouse of the property owner constituted adequate and full consideration for a transfer by the property owner for gift tax purposes would effectively subvert the legislative intent and statutory scheme of the gift tax provisions. *Merrill v. Fahs*, at 311-312. See also, *Commissioner v. Bristol*, 121 F.2d 129, 136 (1st Cir. 1941).

Likewise, in the present situation, property subject to the QTIP election was intended to be subject to either gift or estate tax. S's receipt of the remainder interest does not increase the value of S's taxable estate because that property is already subject to inclusion in S's taxable estate under section 2044. Rather, S's issuance of the note results in a depletion of S's taxable estate that is not offset by S's receipt of the remainder interest. Thus, for estate and gift tax purposes, S's receipt of the remainder interest cannot constitute adequate and full consideration under section 2512 for the promissory note transferred by S to C. As was the case in *Merrill v. Fahs*, any other result would subvert the legislative intent and statutory scheme underlying section 2056(b)(7). Therefore, under section 2511, S has made a gift to C equal to the value of the promissory note S gave to C.

In addition, a gift tax would be imposed under the above alternative rationales even if S acquired only a portion of C's remainder interest; *e.g.*, S acquired 60 percent of C's remainder interest. If, under applicable state law, such a transaction results in a partial termination of the trust, S would be treated as disposing of part of S's income interest in the trust, and the commutation analysis would apply. See, *e.g.*, Restatement (Second) of Trusts section 340(2) (1959). See also, section 25.2519-1(g), Example 4, (illustrating the estate and gift tax consequences of the disposition of a portion of the spouse's income interest). If the trust does not terminate, S would nonetheless be treated as making a transfer under sections 2511 and 2512 for less than adequate and full consideration to the extent of the value of the property or cash S transfers in exchange for the partial remainder interest.

Further, the conclusion of this revenue ruling would be the same if S transferred to C property or cash rather than the promissory note. The economic effect of the transaction is identical, regardless whether S uses S's own funds to finance the transaction or gives a promissory note and discharges the note using some of the QTIP Trust assets received in the transaction. Thus, the result is the same for transfer tax purposes.

Rev. Rul. 98-8 held:

If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under section 2056(b)(7) in connection with the transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift both under section 2519 and sections 2511 and 2512. The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to section 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to sections 2511 and 2512).

Letter Ruling 200152018 held that the swap of a unitrust interest for an annuity interest was eligible for a charitable income tax deduction to the extent that the present value of the former exceeded the present value of the latter. It also held:

> In the instant case, because Taxpayer's basis in his unitrust interest is in a trust, that basis is determined pursuant to section 1015. Thus, in determining Taxpayer's basis in his unitrust interest upon his transfer of the unitrust interest to the Academy in exchange for an annuity interest from the Academy, the portion of the adjusted uniform basis assigned to Taxpayer's unitrust interest will be disregarded pursuant to section 1001(e)(1). The exception to section 1001(e)(1) in section 1001(e)(3) is not applicable, because the remainder beneficiary is not receiving the entire interest in Trust in a single transaction.
>
> As stated above, Taxpayer's unitrust interest is a capital asset. The annuity Taxpayer will receive from Academy will be nonassignable or will be assignable only to Academy, and Taxpayer will be the only annuitant. Accordingly, upon the transfer of his unitrust interest in the Trust to the Academy in exchange for an annuity payable by the Academy, Taxpayer will have long-term capital gain in the amount of the value of the annuity, reported as provided in example (8) of section 1.1011-2(c) of the regulations.

Letter Ruling 200314021 held:

> Upon its termination, Trust proposes to distribute to Taxpayer as the income beneficiary and to Foundation as the remainder beneficiary lump sums equal to the present value of their respective interests on the date of termination. Trust represents that the values will be determined using the discount rate in effect under Section 7520 on the date of termination and using the methodology under Section 1.664-4 of the Income Tax Regulations for valuing interests in charitable remainder trusts…
>
> … Taxpayer is selling his interest in Trust to the remainderman. Provided that the money and other property received by Taxpayer are distributed to Taxpayer in accordance with his interest in Trust, the amount Taxpayer will realize from the sale of his interest in Trust is the amount of money and the fair market value of the property received by Taxpayer.
>
> Pursuant to Section 1001(e)(1), the portion of the adjusted uniform basis assigned to Taxpayer's interest in Trust is disregarded. The exception contained in Section 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, Taxpayer will be treated as though he has no basis in his interest in Trust and, therefore, Taxpayer will realize gain under Section 1001(c) in the amount received from the disposition of his interest in Trust.

Letter Ruling 200127023 was similar to Letter Ruling 200314021.

Letter Ruling 200833012, after acknowledging the rules in Code § 1001(e)(3) and Reg. § 1.1001-1(f)(3), held:

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of A, B, and the charities, in substance it is a sale of A and B's interest to the charities. The amount received by A and B as a result of the termination

of Trust is an amount received from the sale or exchange of a capital asset. Under § 1015(b), A and B's basis in the life estate is a portion of the entire basis of the property, and the disposition of A and B's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party. Therefore, under § 1001(e), A and B's adjusted basis in their interest is disregarded. A and B's holding period in the life interest exceeds one year. Accordingly, under § 1222(3), the entire amount realized by A and B as a result of the early termination of Trust will be long-term capital gain.

This ruling is conditioned on any assets distributed in-kind from Trust being distributed on a pro-rata basis between A, B, and the charities.

Similar holdings were in Letter Rulings 200827009,[2731] 200739004,[2732] 200733014,[2733] 200727013,[2734] 200648017,[2735] 200648016,[2736] 200441024,[2737] and 200403051.[2738]

[2731] "A is assigning A's income interest in Trust to Charity in exchange for a distribution equal to the present value of the unitrust income interest. Because the disposition of A's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, the portion of the uniform adjusted basis assigned to A's income interest is disregarded under § 1001(e)."

[2732] "Accordingly, although the proposed transaction takes the form of a distribution of the present values of the respective interests of each Beneficiary and the Charity, it is in substance a sale of each Beneficiary's unitrust interest to the Charity, the remainder beneficiary. Because the disposition of each Beneficiary's interest is not part of a transaction in which the entire interest in the Trust is transferred to a third party, the adjusted basis in each Beneficiary's interest is disregarded under § 1001(e)(1) in determining gain realized by each Beneficiary."

[2733] "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, in substance it is a sale of Grantors' interest to Charity, the remainder interest holder. The amount received by Grantors as a result of the termination of Trust is an amount realized from the sale or exchange of a capital asset. Rev. Rul. 72-243. If, as represented by Grantors, Grantors' basis in the unitrust income interest is a portion of the entire basis of the property as determined under §1015(b), Grantors' adjusted basis in their interest is disregarded under § 1001(e) because the disposition is not part of a transaction in which the entire interest in Trust is transferred to a third party. Consequently, if Grantors' adjusted basis is disregarded under § 1001(e), the entire amount realized by Grantors as a result of the early termination of Trust will be gain to Grantors."

[2734] Similar to fn 2733.

[2735] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Granddaughter 1, A, B, C, D, and E, in substance it is a sale of Granddaughter 1, D and E's interests to A, B, and C, the remainder interest holders entitled to receive Trust 1 assets at termination under the terms of Trust 1. The amounts received by Granddaughter 1, D and E as a result of the termination of Trust 1 are amounts received from the sale or exchange of a capital asset. Rev. Rul. 72-243. Because Granddaughter 1's basis in the income interest of Trust 1 is a portion of the entire basis of the property under section 1015(b), and because the disposition of Granddaughter 1's term interest is not part of a transaction in which the entire interest in Trust 1 is transferred to a third party, Granddaughter 1's adjusted basis in Granddaughter 1's interest in Trust 1 is disregarded under section 1001(e)."

[2736] Completely or substantially the same as the quote in fn 2735.

[2737] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of X and Foundation, in substance it is a sale of X's interest to Foundation, the remainder interest holder. The amount received by X as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Because X's basis in the unitrust income interest is a portion of the entire basis of the property under § 1015(b), and because the disposition of X's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, X's adjusted basis in X's interest is disregarded under § 1001(e)."

Reg. § 1.1001-1(f)(4) refers to Reg. § 1.1014-5(d), which also effectuates the rest of Reg. § 1.1014-5. Let's go through that first:

Reg. § 1.1014-5(a), "Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent," provides:

(1) Except as provided in paragraph (b) or (c) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II, subchapter O, chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in § 20.2031-7 or, for certain prior periods, § 20.2031-7A, of Part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

Reg. § 1.1014-5(b), "Sale or other disposition of certain term interests," provides:

(1) *In general*. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022

[2738] Similar to fn 2733.

(relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

(2) *Effective/applicability date*. The provisions of paragraph (b)(1) of this section relating to section 1022 are effective on and after January 19, 2017. For rules before January 19, 2017, see § 1.1014-5 as contained in 26 CFR part 1 revised as of April 1, 2016.

Explaining Reg. § 1.1014-5(c) below, T.D. 9729 (8/12/2015) said:

> These final regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. Such transactions are those in which the sale or other disposition of the CRT term interest is part of a transaction in which all interests in the CRT are transferred. In these cases, these final regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1);and (2) the amount of undistributed net capital gain described in section 664(b)(2). These final regulations do not affect the CRT's basis in its assets but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3). The rules in these final regulations are limited in application to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664.

Reg. § 1.1014-5(c), "Sale or other disposition of a term interest in a tax-exempt trust," provides:

(1) *In general*. In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in §1. 1001-1(f)(2)) in a tax-exempt trust (as defined in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary's share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is -

(i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of -

(A) The trust's undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664-1(d)(1)(ii)(a)(1) for the current and prior taxable years of the trust, if any; and

(B) The trust's undistributed net capital gains within the meaning of section 664(b)(2) and §1.664-1(d)(1)(ii)(a)(2) for the current and prior taxable years of the trust, if any.

(2) *Tax-exempt trust defined*. For purposes of this section, the term tax-exempt trust means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) *Taxable beneficiary defined*. For purposes of this section, the term taxable beneficiary means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) *Effective/applicability date*. This paragraph (c) and paragraph (d) Example 7 and Example 8 of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014.

Reg. § 1.1014-5(d) provides examples for Reg. §§ 1.1001-1(f) and 1.1014-5, cross-referencing actuarial tables contained in the estate tax regulations:

Example (1). Securities worth $500,000 at the date of decedent's death on January 1, 1971 are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 × 0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example (2). The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to § 20.2031-7A(c), the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000 × 0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000 × 0.36774). W sells her life interest for $410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($650,000 × 0.63226). Pursuant to section 1001(e). W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example (3). Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life

interest is $15,012.55 ($18,800 × 0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example (4). The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to § 20.2031-7A(c), the remainder factor for age 39 male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800 × 0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example (5).

(a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000 × 0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001-1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example (6). Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488, and the

remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000 × 0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001-1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001-1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

Example (7).

(a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is $110x and CRUT's total undistributed net capital gains are $100x.

(c) Later, when the fair market value of CRUT's assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is $110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to the full $110x of basis.

Example (8).

(a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock. Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664-1(d) is $90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $126x for the retained annuity interest, and Charity receives $14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to determine its actuarial share of the full $140x of basis.

Letter Ruling 200027001 analyzed a settlement involving a QTIP trust. The surviving spouse was entitled to the income, and the "trustee is authorized, in the trustee's discretion, to pay or apply additional funds from the principal of the Marital Trust to provide for Spouse's reasonable maintenance, support, comfort and welfare as the trustee deems necessary or advisable." The remainder would pass to or for the benefit of the decedent's other family members. The surviving spouse argued with the trustee over distributions and investment strategy. A settlement agreement resolved some disputes over which property belonged to the decedent and which to the surviving spouse – and:

> The agreement also directs that the trustee of the QTIP Trust pay the amount of $y to Spouse in exchange for Spouse's release of her rights to any part of the principal of the QTIP Trust. The agreement further provides that Spouse will sell her income interest in the QTIP Trust to [the remaindermen] for cash or other property valued at $z. The consideration will be paid proportionately in accordance with the respective interests of [the remaindermen] in the remainder of the QTIP Trust.
>
> The purchase price of the qualifying income interest in the QTIP Trust, $z, is equal to the actuarial value of Spouse's income interest as of Date 3, determined under section 20.2031-7 of the Estate Tax Regulations, based on the value of the corpus of the QTIP Trust as of Date 3. Until the sale of Spouse's interest in the QTIP Trust is completed, the QTIP Trust will continue to pay the income therefrom to Spouse according to the terms of the trust. However, income earned after Date 3 and paid to Spouse will reduce the purchase price, dollar-for-dollar. The settlement agreement recognizes that federal gift taxes will be imposed, as a result of the sale of Spouse's qualifying income interest in the QTIP Trust, under section 2519. The agreement confirms Spouse's right to recover such taxes from the persons who will receive the QTIP property, pursuant to section 2207A of the Internal Revenue Code. The settlement agreement, however, places a ceiling on Spouse's right of recovery. The settlement agreement provides that the QTIP Trust will terminate upon completion of the sale of Spouse's qualifying income interest, and the corpus will be distributed [to the remaindermen]…. The settlement agreement is contingent on court approval, which has been obtained by the parties, and favorable rulings from the Internal Revenue Service.

The surviving spouse asked the IRS to rule that any post-Date 3 income that reduced purchase price would constitute sale proceeds, making it taxable as capital gain rather than ordinary income, but the IRS declined to recharacterize the income:

> When a taxpayer receives a lump sum in exchange for the taxpayer's right to receive future income from property that does not represent a conversion of a capital investment, the taxpayer cannot characterize the transaction as a sale of property. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The conversion of income already received by a beneficiary of an estate into principal was not permitted as part of a compromise agreement of a wife's claim against her deceased husband's will. *Lemle v. United States*, 579 F.2d 185 (2d Cir. 1978). This is especially the case in the present situation in which Spouse will already have received the payments from the trust at the time the sale of the income interest is consummated, and Spouse will be entitled to keep the payments whether or not the sale is consummated.
>
> The fact that the amount that will be paid for the income interest will be reduced by the amount of income that is paid by the QTIP Trust to Spouse after Date 3 and before the sale is made final does not change our conclusion.

As to taxing gain on sale, the IRS ruled:

> The sale of Spouse's interest in the principal of the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. Any gain or loss on the sale of Spouse's interest in the principal of the trust would be recognized under section 1001. The gain would be long-term capital gain, since the Decedent died on Date 1. Since section 1001(e) applies to income interests in trust, but not rights to principal, Spouse's basis in her interest in trust principal would not be disregarded.

As to gift tax consequences, the IRS reasoned and ruled:

> Section 2519 provides that any disposition of all or a part of a qualifying income interest for life in property for which an election had been made under section 2056(b)(7) is treated as the transfer of all interests in the property other than the qualifying income interest.
>
> Section 25.2519-1(c)(1) provides that the amount treated as a transfer under section 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. (The gift tax consequences of the disposition of the qualifying income interest are determined separately under section 2511 as discussed above in #5). [Ruling 5 said no gift assuming that "the sale is one made in the ordinary course of business, in that it is bona fide, at arm's length, and free from any donative intent."]
>
> Section 25.2511-2(a) provides that the gift tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.
>
> Section 2207A(b) provides that if a gift tax is paid with respect to any person because of a transfer made by that person under section 2519, then that person shall be entitled to recover the tax attributable to the transfer from the person receiving the property.
>
> Rev. Rul. 75-72, 1975-1 C.B. 110, holds that gift tax imposed on a transfer that is paid by the donee may be deducted from the value of the transferred property in determining the amount of the gift, if it is established that the payment of the tax by the donee or from the property is a condition of the transfer. If, at the time of the transfer, the gift is made subject to the condition that the gift tax is to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under section 2512(b), the value of the gift is measured by the fair market value of the property passing from the donor minus the amount of the gift tax to be paid by the donee.
>
> Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift, the gift tax liability assumed by the donee may be deducted from the value of the transferred property, if the payment of the tax by the donee is a condition of the transfer. The donor's available unified credit must be used to reduce the tax liability that the donee has assumed to the extent the unified credit is available.
>
> In a case like the present one, where the gift tax will be imposed as a result of a transfer under section 2519, section 2207A(b) statutorily shifts the tax burden, but not the liability, for paying the gift tax to the donee. In reimbursing the donor for the gift tax paid pursuant to the statute, the donee provides consideration for the gift. The donee's payment inures to the benefit of the donor because it reimburses the donor for gift tax that the donor was liable for and would otherwise be required to pay out of the donor's own funds.

> Accordingly, we conclude that upon Spouse's disposition of Spouse's qualifying income interest for life, Spouse will be treated as making a gift under section 2519. Under section 2519, the gift tax will be imposed upon on the entire value of the QTIP Trust as of the date that the actual transfer occurs, reduced by: 1) the value of the Spouse's qualifying income interest for life on the transfer date; 2) the amount paid to Spouse for the release of her interest in trust principal under the settlement agreement; and 3) the amount of gift tax that Spouse recovers under section 2207A(b) as limited under the terms of the settlement agreement.

Note that the gift tax liability would be included in the surviving spouse's estate if she died within three years of making the deemed gift.[2739] Ordinarily, that's a wash, in that the cash used to pay the gift tax is out of the estate, so the inclusion and reduction in cash offset each other. With a net gift, however, the tax reimbursement eliminates the reduction in cash, so this type of settlement does increase the surviving spouse's estate if she dies within that three-year period. Of course, given that the remaindermen were not beneficiaries of her estate, she would rather have the cash, minus any estate tax, than not have the cash.

In Letter Ruling 200231011, Grandson was the income beneficiary and charities were the remaindermen.[2740] When disputes about administration arose (again), the parties entered into the following agreement, subject to court approval:

> Under the terms of the proposed agreement, corpus of Trust in excess of Z dollars will be distributed immediately to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. Upon distribution, the charities' interest in Trust will terminate. The remaining assets of Trust will continue in trust for the benefit of Grandson. Grandson will receive at least annually an amount equal to seven percent of the net fair market value of the property held in Trust determined on a specified date in each calendar year. In addition, the trustee may

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[2739] Code § 2035(b), "Inclusion of gift tax on gifts made during 3 years before decedent's death," provides:

> The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

[2740] The background was:

> Decedent died testate on Date 1, prior to 1985. Pursuant to the terms of Decedent's will, a residuary testamentary trust (Trust), was established primarily for the benefit of Decedent's grandson (Grandson). Under the terms of Trust, Grandson was to receive S dollars each year during his life. Upon Grandson's death, the corpus was to be distributed as follows: 1/3 to Charity 1; 1/3 to Charity 2; 1/6 to Charity 3; and 1/6 to Charity 4. The terms of Trust provide that no beneficiary could alienate or encumber his/her interest in the income or principal and no beneficiary's interest was subject to claims of his/her creditors prior to distribution. Trust was funded with stock of Corporation with an approximate value of X dollars.
>
> In Year 1, pursuant to a court order, the investments of Trust were restructured and the dispositive provisions of Trust were modified to provide for annual income distributions to Grandson in accordance with a Performance Chart. The order required distributions to Grandson of an amount equal to the lesser of the maximum income amount set forth in the Performance Chart or the actual net income of Trust. Grandson was guaranteed a minimum income amount even if actual Trust income was less than that minimum income amount. Thus, if earnings of Trust are sufficient, Grandson would receive more than the minimum stated amounts each accounting period. In addition, Charities 1, 2, 3 and 4 received a lump sum payment. Upon Grandson's death, the remaining corpus was to be distributed to the Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion as set forth in Trust.

distribute income or principal to provide adequately for the reasonable support of Grandson. On Grandson's death, the remaining corpus will be distributed pursuant to Grandson's exercise of a testamentary general power to appoint the remaining corpus to anyone, including his estate or the creditors of his estate. Any portion of the Trust not effectively appointed by the exercise this power will be distributed to Grandson's surviving descendants free of trust.

After reviewing *Cottage Savings*, Letter Ruling 200231011 held:

The application of § 1001(a) to trust interests is illustrated by two cases. In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged her income interest in a trust for an annuity, and the court concluded that this was a realization event. Taxpayer's income interest had entitled her to dividends paid by a corporation, the stock of which was owned by the trust. She transferred the income interest to her husband, who agreed in exchange to pay her fixed sums annually until her death.

A contrary result was reached in *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969). In that case, the taxpayer exchanged an interest in a trust for a right to specified annual payments from the remainderman of the trust, and the court held that taxpayer did not as a result dispose of her trust interest. After the transaction, taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The court distinguished the transaction from that found to be a realization event in Evans: "the amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this `uncertainty' for definitely ascertained yearly payments from her husband." 419 F.2d. at 1003.

The proposed trust modification in this case more closely resembles the situation in *Evans* than that in *Silverstein* and should be considered a realization event. Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.

Pursuant to § 1001(e)(1), the portion of the adjusted uniform basis assigned to Grandson's interest in Trust is disregarded. The exception contained in § 1001(e)(3) is not applicable because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, for purposes of this transaction, Grandson has no basis in his interest in Trust. Therefore, the amount of gain Grandson realizes under § 1001(c) is the amount Grandson realized from the disposition of his assets in Trust. The gain realized by Grandson from the disposition of his interest will be long term

> capital gain. See Rev. Rul. 72-243, 1972-1 C.B. 233, providing that a sale of an income interest in a trust is a sale of a capital asset within the meaning of §§ 1221 and 1222.

Note that this ruling was issued before Reg. § 1.1001-1(h) was issued in its current form.[2741]

In Letter Ruling 201932001, lifetime distributions were as follows:

> On Date 1, a date prior to September 25, 1985, Settlor created an irrevocable trust, Trust, for the benefit of Son. The material purpose of Trust was to ensure that Son receive an income stream for his support. Under the terms of the Trust agreement, the trustees are required to distribute all of the net income of Trust to Son, and, upon his death, distribute the remainder to his issue, per stirpes. The Trust agreement does not authorize any distributions of principal during Son's life. Son has four living adult children (Current Remaindermen) and eight living grandchildren, four of whom are adults (Successor Remaindermen). None of Son's descendants has a predeceased child with living issue. Son and Bank are currently serving as co-trustees of Trust.

A court-approved agreement authorized the trustees to value the trust's assets, determine the appropriate distributions to be made upon the trust's termination under the agreement and terminate the trust. Upon the termination, the trustees would distribute, on a pro rata or in-kind basis, as the trustees in their sole discretion determine, all of the trust's assets to income beneficiary, immediate remaindermen and successor remaindermen according to their actuarial interests calculated as of the termination date. The ruling held that the termination did not blow the trust's grandfathering from GST tax and did not constitute a gift. However, the income tax rulings were not so innocuous:[2742]

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remaindermen, and the Successor Remaindermen, in substance it is a sale of Son's and the Successor Remaindermen's interests to the Current Remaindermen. Rev. Rul. 69-486.
>
> The amounts received by Son as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. Rev. Rul. 72-243. Because Son's basis in the income interest of Trust is a portion of the entire basis of the property under § 1015(b), and because the disposition of Son's term interests is not part of a transaction in which the entire interest in Trust is transferred to a third party, Son's adjusted basis in Son's interest in Trust is disregarded under § 1001(e). Son's holding period in the life interests in Trust exceeds one year. Accordingly, based on the facts submitted and representations made, the entire amount realized by Son as a result of the early termination of Trust will be long-term capital gain under § 1222(3).
>
> Similarly, the amounts received by the Successor Remaindermen as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. *Cf. Helvering v. Gambrill*, 313 U.S. 11, 15 (1941), 1941-1 C.B. 364 (The phrase "property held by the taxpayer" under a prior law holding period

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[2741] Reg. § 1.1001-1(h) is reproduced in fn 2710 in this part II.J.18.

[2742] I have heard that this ruling was procured by David Handler and that the income tax consequences, although adverse, were relatively small in that particular case.

rule relating to capital gains and losses includes not only full ownership, but also any interest owned whether vested, contingent, or conditional). The Successor Remaindermen's holding period in their interests in Trust also exceeds one year.

Accordingly, under § 1222(3), the gain determined under § 1001(a) by the Successor Remaindermen as a result of the early termination of Trust will be long-term capital gain.

In addition, to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remainderman will recognize gain or loss on the property exchanged. Accordingly, based on the facts submitted and representations made, for purposes of determining gain or loss, the amount realized by each Current Remainderman on the exchange of property for Trust interests held by Son and the Successor Remaindermen will be equal to amount of cash and fair market value of the trust interests received in exchange for the transferred assets. Section 1.1001-1(a) and Rev. Rul. 69-486.

Letter Ruling 201932001 is further analyzed in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations.

Reg. § 1.1014-8 governs the basis of a remainder interest, but it has not been updated for various changes in the law.

Code § 167(e), "Certain term interests not depreciable," provides:

(1) *In general*. No depreciation deduction shall be allowed under this section (and no depreciation or amortization deduction shall be allowed under any other provision of this subtitle) to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.

(2) *Coordination with other provisions*.

(A) *Section 273*. This subsection shall not apply to any term interest to which section 273 applies.

(B) *Section 305(e)*. This subsection shall not apply to the holder of the dividend rights which were separated from any stripped preferred stock to which section 305(e)(1) applies.

(3) *Basis adjustments*. If, but for this subsection, a depreciation or amortization deduction would be allowable to the taxpayer with respect to any term interest in property—

(A) the taxpayer's basis in such property shall be reduced by any depreciation or amortization deductions disallowed under this subsection, and

(B) the basis of the remainder interest in such property shall be increased by the amount of such disallowed deductions (properly adjusted for any depreciation deductions allowable under subsection (d) to the taxpayer).

(4) *Special rules*.

(A) *Denial of increase in basis of remainderman*. No increase in the basis of the remainder interest shall be made under paragraph (3)(B) for any disallowed deductions attributable to periods during which the term interest was held—

(i) by an organization exempt from tax under this subtitle, or

(ii) by a nonresident alien individual or foreign corporation but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States.

(B) *Coordination with subsection (d)*. If, but for this subsection, a depreciation or amortization deduction would be allowable to any person with respect to any term interest in property, the principles of subsection (d) shall apply to such person with respect to such term interest.

(5) *Definitions*. For purposes of this subsection—

(A) *Term interest in property*. The term "term interest in property" has the meaning given such term by section 1001(e)(2).

(B) *Related person*. The term "related person" means any person bearing a relationship to the taxpayer described in subsection (b) or (e) of section 267.

(6) *Regulations*. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations preventing avoidance of this subsection through cross-ownership arrangements or otherwise.

Code § 267 is described in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.

Code § 273, "Holders of life or terminable interest," provides:

Amounts paid under the laws of a State, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

The committee reports for Code § 167(e) (P L. 101-239, 12/19/89) explain:[2743]

House Explanation

Present Law.

The purchaser of a term interest in property is, for income tax purposes, entitled to amortize the cost of the interest over its expected life. The purchaser of a remainder

[2743] Excerpted from RIA Checkpoint, USTR, "COMREP ¶1671.004 Disallowance of Depreciation for Certain Term Interests."

interest in property generally does not include currently in income increases in the value of the interest.

On the other hand, a person who divides an interest in property into two parts cannot create an amortizable asset where none previously existed. Thus, a person who retains a term interest in property while transferring the remainder in that property cannot amortize the cost of the term interest.[1]

[1] See, *e.g.*, *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 682-83 (1980); *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 288-89 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

Explanation of Provision.

No depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person. The provision does not affect a depreciation deduction which is not attributable to a term of years of life estate. Thus, the owner of a term interest in a building cannot amortize the term interest but may claim the depreciation deduction with respect to the underlying building allowed under present law.

The taxpayer's basis in a term interest is reduced by the deductions disallowed by the provision, and the remainderman's basis in the remainder is increased by those deductions. In the joint purchase described in the above example, the child's basis in the preferred stock would be increased in each of the six years by $72.61, the amount of the amortization deduction denied to the parent by reason of the provision.

A term interest in property is a life interest in property, an interest in property for a term of years, or an income interest in a trust. A related person is any person bearing a relationship to the taxpayer described in section 267(b) or 267(e). In determining whether persons are related, the constructive ownership rules of section 267(c) apply.

The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purposes of the provision, including regulations preventing avoidance of the provision through cross-ownership arrangements or otherwise. Such regulations shall prevent avoidance of the provision by one family owning a term interest in one property and a remainder interest in a second property, while another family owns a remainder interest in the first property, and a term interest in the second property. Such regulations would also prevent avoidance through the joint purchases of interests in substantially similar property. For example, a parent could not avoid the provision by purchasing a life interest in stock of a corporation while a child purchases a remainder interest in other stock of the same corporation.

The committee does not intend to change the taxation of transactions in which the remainderman is taxed on his accretion in wealth. Thus, for example, the provision does not affect the taxation of a stripped bond under section 1286 or transactions in which the lessor is imputed income under section 467(f).

Effective Date.

The provision applies to life or terminable interests acquired or created after July 27, 1989, in taxable years ending after such date.

Conference Report

Conference Agreement.

The conference agreement follows the House bill, with the following modifications. First, the remainderman's basis in the remainder is not increased for any disallowed deductions attributable to periods during which the term interest was held by (1) an organization exempt from tax under subtitle A of the Code or (2) a nonresident alien individual or foreign corporation (but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States).

Second, the holder of an interest in property for a term of years whose amortization deduction would be allowed but for the provision is permitted a depreciation deduction computed as if he were absolute owner of the property. Thus, the provision does not allow such a depreciation deduction to a person whose amortization deduction is disallowed under present law.

Third, the increase in the remainderman's basis in his interest is reduced by any depreciation allowable to the term holder with respect to the underlying property.

Fourth, the provision does not apply to any term interest to which section 273 applies.

In addition, the conferees intend that the remainderman's basis in the property is increased only if the term holder's amortization deduction would be allowed but for the provision.

The confereees intend no inference regarding the divisibility of property for tax purposes under present law. Nor do they intend any inference regarding the character of income or gain from property so divided.

Rev. Rul. 62-132 held:

The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Sixth Circuit in *Commissioner v. William N. Fry, Jr., et al.*, 283 Fed.(2d) 869 (1960), and the decision of the United States Court of Appeals for the Seventh Circuit in *Laird Bell v. Harrison, et al.*, 212 Fed.(2d) 253 (1954).

These cases hold that a remainderman of a trust, the corpus of which consists of corporate stock, who purchases the interest of a life beneficiary of the trust, is entitled to recover his cost through amortization over the period of the beneficiary's life expectancy, by ratable annual deductions.

The Service had argued that the purchased life interest became merged with the remainder interest, with the result that the cost of the purchased life interest could be recouped only at the time of the sale or other disposition of the stock.

> The Service noted that the transactions in these cases appeared to be bona fide and without a tax avoidance motive. These cases will be followed in the disposition of other cases in which the facts are substantially the same.
>
> [1] Based on Technical Information Release 392, dated July 16, 1962.

Thus:

- Under Code § 273, the holder of a life or terminable interest acquired by gift, bequest, or inheritance cannot amortize its basis. Note that none of these events is a purchase, so Code § 273 does not affect purchases.
- Under Code § 167(e)(1), a taxpayer holding a term interest cannot amortize that interest when the remainder interest is held (directly or indirectly) by a related person.
- Rev. Rul. 62-132 allows the purchaser of a term interest to amortize it if Code § 167(e)(1) does not apply.
- The seller of a term interest cannot apply basis against sale proceeds unless the overly narrow Reg. § Reg. § 1.1001-1(f)(3), which requires a transfer "to a third person or to two or more other persons," applies.

In *Garvey v. U.S.*, 369 F.Supp.2d 1328 (D. Kan. 2005), in 1987 Mr. and Mrs. Garvey bought life interests and 1983 irrevocable trusts they had created bought remainder interests in interests in a newly formed partnership. A 1986 letter from their investment advisor described the plan:

> Although the initial objective was to determine if there is an opportunity by utilization of split purchases of property to transmit it to subsequent generations with no transfer tax costs, an additional objective emerged and that is as a method of extracting corporate [or partnership] assets to others without the imposition of either a dividend or capital gains tax.
>
> "It" is the split purchase of assets from unrelated parties with the older generation buying a life estate or a term of years and the younger generation purchasing the remainder interest with the cost allocated based on the actuarial tables….
>
> Upon the expiration of the term interest, the entire property, including accumulated capital gains or less accumulated capital losses, passes to the remainderman free of income, gift and estate taxes….
>
> The practical limiting factor is the availability of funds by the persons or entities to purchase the remainder interest. Simultaneous gifts of funds for the acquisition of the interest contains an element of risk in collapsing the transaction into one of being a "retained" interest rather than a "purchased" interest, in which case the favorable estate tax results do not occur. Gifts separated by time or gifts by the spouse of the purchaser of the term interest would work.
>
> There is no gift tax imposed in any point in time in the described transaction because there is no gift, *i.e.*, each party is paying the market value of its interest as determined the actuarial tables.

While the term interest is in effect its holder may amortize and deduct for Federal income tax purposes the aliquot portion of the cost of the term interest although the property may otherwise be nondepreciable, *e.g.*, securities or land.

Properly drafted, any capital gains realized during the time of the term interest are subjected to tax but not to either the holder of the term interest or the remainderman, but to an “implied trust” which constitutes a separate taxpayer, presumably at lower rates, with the tax paid from the proceeds of the transaction giving rise to the gain, and with the remainder of the proceeds being retained with the income therefrom, being paid to the holder of the term interest.

Upon expiration of the term interest there is no income tax liability to the remainderman upon receipt of the property, with the only unfavorable factor being the remainderman's tax basis in the entire property is only his cost of the remainder interest.

In a life estate, of course, upon death of the life tenant there would be no estate tax, which is a potentially significant advantage of utilizing a life estate other than a term interest.

From 1987-1996, deductions from amortizing their life estate in the partnership were $1,496,073, and their share of the partnership income was $898,475. When the IRS disallowed the amortization deductions, the taxpayers paid and sued for a refund. The *Garvey* court explained:

Plaintiffs assert that they are entitled to a refund of the income taxes in issue because during the periods here pertinent, relevant tax law provided that to recover plaintiffs' tax basis in the assets they contributed to Joy, an amortization deduction was available over the limited life of their interests in the partnership. They contend that the law provided that an asset (in this case a partnership interest) owned for a limited term with other related parties qualified for an amortization deduction. (See, *e.g.*, *Richard Hansen Land, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2869 (1993)). Plaintiffs cite the general rule that a taxpayer who purchases a term interest in property which is used in a trade or business, or held for the production of income, is entitled to deduct ratably the cost of that interest over its expected life.[1] See, *e.g.*, Tres. Reg., 1.1014-5(c), Examples 1, 2 and 3; Rev. Rul. 62-132, 1962-2 CB 73; *Early v Commissioner*, 445 F.2nd, 166, 169 (5th Cir. 969 [sic, 1971]); *Manufacturers Hanover Trust Co., v Commissioner*, 431 F.2nd 664 (2nd Cir. 1970). Plaintiffs contend that the general rule applies to their investment in Joy.

[1] An exception to the general rule is sec. 167(e) (as amended and in effect currently), which prohibits a taxpayer from amortizing a term interest where a related person holds the remainder interest. This section, however, applies only to term interests acquired or created after July 27, 1989. Since plaintiffs' term interests were created before that date, sec. 167(e) is inapplicable to the present case.

Defendant counters that plaintiffs formed Joy as the result of an integrated plan by which the plaintiffs transferred assets to other partners, who in turn then joined with the plaintiffs in the formation of the partnership. Defendant cites an exception to the general rule which occurs where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest. In such a situation, amortization deductions are not allowable. See, *e.g.*, *Lomas Santa Fe, Inc. v.*

> *Commissioner*, 693 F.2nd 71 (9th Cir. 1982); *United States v Georgia R.R. & Banking Co.*, (348 F.2nd 278 (5th Cir. 1965)). Defendant contends that the exception to the general rule applies because the formation of Joy was the culmination of singular steps in an agreed-upon plan, and thus the steps can be amalgamated and treated as part of a single transaction. See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Kornfeld v. Commissioner*, 137 F.3rd, 1231 (10th Cir. 1998).

After reviewing *Gordon v. Commissioner*, 85 T.C. 309 (1985)[2744] and *CGF Industries, Inc. v. Commissioner*, 77 T.C.M. (CCH) 1405 (1999), the court decided that the trusts were old and cold and that the taxpayers were entitled to deduct amortization of their life interests, based on these conclusions of law:

> During the relevant period, taxpayers who acquired a term interest in intangible property were allowed to amortize or depreciate the cost of the interest, even when the underlying property itself was not depreciable. Internal Revenue Code § 167(a) and Tres. Reg. 1.167(a)-3 and the cases cited herein. Thus, it was legal for Mr. and Mrs. Garvey to amortize or depreciate life estate interests in Joy.
>
> On the other hand, a taxpayer was prohibited from amortizing or depreciating the cost of term interest where, without additional investment, the taxpayer divides the nondepreciable asset into two parts, one of which is the term interest. Based upon the

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[2744] *Gordon* applied a step transaction theory to disallow the amortization, but only after commenting at 322-323:

> It is clear that a taxpayer may deduct ratably his or her cost basis in a purchased term, including a life, interest.[6] *Early v. Commissioner*, 445 F.2d 166, 169 (5th Cir. 1971), *revg.* on another ground 52 T.C. 560 (1969); *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg.* a Memorandum Opinion of this Court; *Gist v. United States*, 296 F.Supp. 526, 528 (S.D. Cal. 1968), *affd.* 423 F.2d 1118 (9th Cir. 1970); *Frank MacBoyle Lewis Trust B v. Commissioner*, 83 T.C. 246, 253 n. 10 (1984); *Elrick v. Commissioner*, 56 T.C. 903, 909 (1971), *revd.* on another ground 485 F.2d 1049 (D.C. Cir. 1973); see also secs. 167(h), 62(6).[7] This is true even where the property underlying the purchased term interest is itself nondepreciable. See, *e.g.*, *Early v. Commissioner*, *supra* ; *Manufacturers Hanover Trust Co. v. Commissioner*, *supra*; *Elrick v. Commissioner*, *supra*. However, it is also clear that where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest, amortization deductions are not allowable. *United States v. Georgia Railroad & Banking Co.*, 348 F.2d 278, 286-289 (5th Cir. 1965); *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 681-684 (1980), *affd.* 693 F.2d 71 (9th Cir. 1982).
>
> [6] There has been considerable controversy as to whether these ratable deductions are allowable as depreciation or amortization under sec. 167 or as amortization under secs. 162 and 212. See *Sohosky v. Commissioner*, 57 T.C. 403, 409 & n. 4 (1971), *affd.* 473 F.2d 810 (8th Cir. 1973); *Early v. Commissioner*, 52 T.C. 560, 568-572 (1969) (Tannenwald, J., dissenting). For purposes of discussion herein, we simply acknowledge that ratable deductions of some nature are allowable to a purchaser of a term interest in property either used in a trade or business or held for the production of income. For convenience, we have used the term "amortization" in discussing the transactions involved herein. In this connection, we note that respondent, in his opening brief, dropped the argument that petitioners' deductions are not allowable due to sec. 265(1), which disallows deductions allocable to tax-exempt income. See *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg.* a Memorandum Opinion of this Court.
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> [7] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

facts and the applicable law cited herein, the court concludes that plaintiffs have met their burden to establish that this did not occur.

Thus, on or before July 27, 1989, taxpayers could amortize life interests they purchased, if they did not themselves at the same time create the remainder interest. This rule explains Letter Ruling 8316135,[2745] which allowed the seller of a life estate to deduct basis in the life estate because the buyer was unable to amortize the life estate, given that the purchase there caused all interests in the trust to merge. So, let's take a fresh look at elements of Code § 1001(e):[2746]

- Code § 1001(e)(1), (2) disallow applying basis when selling a term interest.
- Code § 1001(e)(3) provides that this disallowance does "not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons."

According to Letter Ruling 8316135,[2747] the Code § 1001(e)(3) exception is designed simply to make sure that the buyer cannot amortize the life estate. However, now that Code § 167(e) disallows that amortization when related parties hold the remainder interest, Code § 1001(e)(1) should not apply to those situations. Rather, Code § 1001(e)(1) should apply only when unrelated parties hold the remainder interest. Unfortunately, the lack of coordination between Code § 167(e) and Code § 1001(e)(1) is puzzling and may undermine this reasoning.

Suppose the life tenant buys out the remaindermen. The remaindermen can use basis in such a sale. Economically, the parties are in the same position as if the remaindermen had bought out the life tenant, but with different tax results. For example, suppose the life estate is worth $400,000 and the remainder is worth $600,000, for a total of $1 million. The life tenant borrows $600,000 to buy out the remaindermen. The life tenant now has the full $1 million trust, sells enough liquid assets to repay the $600,000 loan, and has $400,000 left. Economically, that doesn't differ from the life tenant being bought out for $400,000. But the tax result is very different, and so are the logistics. If the trust has only marketable securities, the transaction may be very do-able. However, if the trust holds illiquid assets, the logistics may be quite difficult; the life tenant buys out the remaindermen and then turns around and sells the illiquid assets to them, the IRS might argue that the substance was a sale of the life estate.

II.J.18.e. Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations

"Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations," LISI Estate Planning Newsletter #2753 (October 9, 2019) at http://www.leimbergservices.com, reviews this ruling and its companions (201932001 to 201932010), discussing the income tax ruling.[2748] Except as otherwise indicated in footnotes, the rest of this part II.J.18.e is a direct quote, with Ed's permission.

It's the third ruling on the income tax effect that should wake up practitioners, especially when considering how the gain in ruling #3 was ultimately calculated. It is dangerous trap for

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[2745] In this part II.J.18.d, see text accompanying fn 2729 for details on Letter Ruling 8316135. For application of the remaining analysis of this part II.J.18.d, see fn 2754 in part II.J.18.f Commutation vs Mere Division.

[2746] Code § 1001(e) is reproduced in this part II.J.18.d in the text accompanying fn 2726.

[2747] In this part II.J.18.d, see text accompanying fn 2729.

[2748] Ed used dashes between the year and week of each PLR. I eliminated them.

commutations and potentially other variations of early trust terminations – and potentially avoidable. If the IRS is correct in its rulings, the cure of terminating a trust early will often be much worse than the perceived disease of continuing it….

Therefore, G2 must pay long-term capital gains tax on the entire amount of his interest (importantly, with **no amount of basis permitted to offset gain, discussed below**), whereas G4 pays long-term capital gains tax on the amount they receive minus their share of the trust's basis as determined actuarially under the uniform basis rules. The impact on G3 is a bit confusing in the ruling, but apparently G3 only pays tax to the extent of the unrealized appreciation triggered on amounts going to G2 and G4 for their share.[2] The sole consolation is that G3 does not have to pay any tax on their share of assets received until they are later sold. In total though, this still creates a huge income tax event, *potentially worse than if the trustees had sold all of the appreciated assets*, with G2's estate being dramatically increased by the amount received net of tax even though he didn't need the income! This is a heavy price to pay to get out of a trust, like cutting off an arm to cure the itch from a mosquito bite.

[2] This is basically Kenan gain (*Kenan v. Comm.*, 114 F.2d 217 (2d Cir. 1940)), also addressed in Treas. Reg. 1.661(a)-2(f). If G3 has an obligation to pay G2 $5 million and G4 $1 million, and distributes $6 million of property with a basis of $4 million to them, $2 million of gain is triggered to G3 on transfer, no different than if you owed someone $1000 and gave them appreciated assets in kind to pay the debt. Correspondingly, G2 and G4 would have a new FMV/Cost basis.

There are no dollar amounts in the various PLRs of course, but with a 35+ year old trust, there had to have been substantial appreciation. Let's imagine the trust corpus in these PLRs is $20 million, with $5 million basis and the actuarial value of G2's interest is $8 million and G3's interest is $11 million and G4's interest is $1 million (G4's interest should be relatively small, since they would only receive anything if their parent predeceases their grandparent).[3] The $5 million of basis would be divided under the uniform basis rules as $2 million, $2.75 million and $250,000 respectively. G2 pays long term capital gains tax (20% + 3.8% + potentially state) on $8 million (G2 cannot use his share of $2 million basis)! G4 pays long term capital gains tax on $1 million, but is permitted to use their $250,000 share of uniform basis to offset gain, incurring $750,000 of long-term capital gain.

[3] It is not a dynastic trust and pays outright at G2/Son's death to G3. For examples of such actuarial divisions under the uniform basis rules, see examples under Treas. Reg. § 1.1014-5, with various actuarial tables at Treas. Reg. § 20.2031-7 and IRS Pub. 1457, or your favorite financial planning software.

As a deemed *buyer* rather than a seller, G3 does not pay tax on receiving their share, but this transaction does trigger tax to G3 on the $9 million of assets going to G2 and G4 to "buy out" their share, minus the $2.25 million of basis attributed to those assets ($9 million - $2.25 million = $6.75 million net long-term capital gain, assuming that those assets have been held for more than one year, which may not necessarily be the case for all of them). Thus, the total gain triggered among the family is $11.5 million ($8 million + $750,000 +$6.75 million). If we assume a 30% tax rate including state income tax on this $11.5 million of gain, that's a **$3.45 million price tag to terminate the trusts** that could have largely been avoided by waiting until son's death, or releasing an interest or amending the trust or taking another path that would not cause such a tremendous income taxable event.

By way of quick contrast, let's say there was a market downturn after funding and the basis was $30 million instead of $5 million, but all other facts the same as in our above hypothetical. *G2 would still incur $8 million of long-term capital gains and $12 million of basis would be wiped off the face of the Earth.* G4 and G3 would have a long-term capital loss, but it would probably be denied them under related party rules.[4] Thus, the spectre of a large capital gains event is present even if done immediately after death, even if the trust is entirely funded in cash.

[4] IRC §267.

Effect on Later Estate Inclusion/Basis Step Up at Son (G2)'s Death

The immediate income tax disaster is not the only negative to the commutation. If son (G2) did not otherwise have a taxable estate, he could have been granted a formula testamentary power of appointment to increase some if not all of the basis at his death.

If son *did* have a taxable estate, which is perhaps more likely based on the stipulated fact in the PLRs that son didn't need the income, the effect of the commutation is even worse, since the settlement adds his entire share (minus beaucoup taxes) to his estate to later be taxed at 40% again at his death when it otherwise would have passed to them without any estate or GST tax!

"Now I am Become §1001(e), the Destroyer of Basis"[5]

As for the unique ruling on the destruction of G2's basis, it is a function of IRC § 1001(e)(1), which deems the sale of a trust income interest to have a *zero basis*.[6] There is an exception to this rule when the sale is part of a transaction in which the entire interest in property is transferred to any person or persons.[7] The Congressional intent of this provision was to prevent basis shifting abuse by letting remainderman continue to gradually increase their basis over time while the purchaser of an income interest still has a cost basis when a trust is not terminated.[8]

[5] A cheap reference to J. Robert Oppenheimer's quote of the Bhagavad Gita after the first successful test of nuclear bomb in New Mexico, "Now I am become Death, the destroyer of worlds.

[6] [quoting Code § 1001(e)(1)]

[7] [quoting Code § 1001(e)(13]

[8] See page 174-175 of the Joint Committee Explanation.

Arguably, since the trust will be completely terminated, this is part of a transaction "in which the entire interest in property is transferred to any person or persons" as required by IRC §1001(e)(3). The abusive situation and rationale in passing IRC §1001(e) is simply not present when the trust is terminated as it would be in a commutation.

Unfortunately, commutations do not fit into the wording of the statute well. Beneficiaries in a commutation are not transferring property to another in the traditional sense as much as transmuting it into a different form. Treasury regulations go beyond the code, moreover, and require a sale to a third party.[9] It seems extremely absurd to have completely different income tax treatment when parties transfer their interests to a straw man who will simply give them back the value of their interests in kind exactly as a commutation would (as the regulation appears to

require). It's been a maxim for centuries of Anglo-American jurisprudence that the law does not require a futile act.[10]

[9] [quoting Reg. § 1.1001-1(f)(3)]

[10] *Lex non cogit ad inutilia*, for those readers who prefer to speak in Latin. For an example of this maxim quoted in the context of tax law, see this IRS CCM.

That said, in planning mode one should not pick a fight with the IRS armed only with common sense, especially with a regulation seemingly requiring one to abandon it. There are many PLRs ruling that a commutation does not come under the IRC § 1001(e)(3) exception, so it's best to simply play along with the charade.

If the agreement were instead to eliminate the spendthrift clause so that each party could sell all their trust interests to another party (basically allowing the new owner to terminate the trust under merger of interest doctrine), then upon joint sale the application of the IRC § 1001(e)(3) exception and compliance with Treas. Reg. § 1.1001-1(f) would be clear; G2 could use his share of uniform basis to reduce his tax upon sale, just as G3 and G4 do.

Can the Disappearing Basis Be Preserved?

Although it's relatively rare, when taxpayers purchase a trust interest, they are permitted to depreciate the cost of this purchase.[11] By being deemed to have purchased G2 and G4 shares, we'd love to think that G3 is therefore deemed to receive this basis somehow. Normally a buyer receives cost basis for what they paid for an asset.[12] Here, the IRS deems G3 to have "in substance" purchased them. Does G3 get basis for this? Probably not, since G3 did not actually pay anything. The IRS gave no indication of this in the rulings. That said, some believe that the disappearing basis should be preserved for G3 to eventually unlock on later sale of assets. I am skeptical. More likely, it is completely obliterated and G3 will probably only have a pro rata carry over basis in their remaining assets.

[11] See, *e.g.*, Treas. Reg. § 1.1014-5(d), Examples 1, 2, 3 and 5. To quote the committee reports on why Congress passed IRC § 1001(e): "The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it."

[12] Treas. Reg. § 1.1012-1(a).

Is a Commutation Always a Sale, Exchange or Other Disposition?

But is a commutation (early termination) even a sale or exchange or "other disposition" at all? Generally, distributions on trust terminations are not sales or exchanges triggering income tax.[13] That an early termination ordered by a court is a sale/exchange subject to IRC §1001 is not obvious – the parties will only receive their own pro-rata share of the trust.

[13] *Pierson v. Comm.*, 253 F.2d 928 (3rd Cir. 1958). IRC § 643(e) generally provides that distributions in kind from a trust receive a carryover basis unless gain is triggered otherwise,

such as *Kenan* gain to satisfy a pecuniary obligation, or unless a trustee makes an election to trigger gain under (e)(3).[2749]

The IRS in these PLRs assumes that a commutation is a sale by referencing a revenue ruling that concerns non-pro rata distributions: [Ed then quotes the IRS' analysis from above]

The IRS may have a very good argument that a commutation agreed to by the parties is a sale or exchange under § 1001, since all the parties are receiving substantially different property interests as a result of the transaction. But Rev. Rul. 69-486 cited above is very dubious authority for that conclusion. In that Revenue Ruling, the trustee had no authority to make non-pro rata distributions and the two beneficiaries agreed between them as to the distribution and it was deemed to be a sale between them, no different than had they exchanged the different assets between each other.

By contrast, most trusts nowadays have authority under the instrument to make non-pro rata distributions, and if they don't, most state laws, such as UTC §816, now grant such authority,[15] and if state law does not grant such authority, the wide equitable powers granted to state courts under state law probably provide such authority, as has been previously acknowledged by the IRS in prior rulings. This PLR did not involve some rogue non-judicial settlement agreement contrary to state law. A court commuted the trust pursuant to state law and there was no allegation to the contrary. Thus, it's hard to see how Rev. Rul. 69-486 even comes close to applying. In fact, the natural corollary to Rev. Rul. 69-486 should be that a pro rata distribution in kind does ***not*** constitute a sale or exchange.

[15] UTC § 816(22) authorizes the trustee to "on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation." The UTC's comments to this section include: "Paragraph (22) *authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale*."

Thus, the paragraph discussing non-pro rata distributions is a *red herring*. There is no indication that the parties proposed anything but a pro rata distribution and if there were pro rata distributions, this would not have changed the IRS conclusions in this PLR one iota. Even if the trust corpus were invested entirely in cash stored under the trustee's mattress, the IRS would have found that the son (G2) incurred a large capital gain equal to the value of his interest.

The more important, and dangerous, paragraph is the second one quoted above. To the IRS, it's a sale or exchange *in substance*, regardless of what authority was granted under the instrument or state law. More intriguing is the equally dubious conclusion that it's only a sale by two of the three parties. Why is this commutation in substance a sale by G2 and G4, and not G3? The IRS offers no rationale or logic for this conclusion (other than Rev. Rul. 69-486 which is inapplicable). Any student of logic could just as easily conclude that G3 and G4 are selling their shares to G2 or that G2 and G3 are selling their shares to G4 (or other permutations). Each group of beneficiaries is getting different property, not just two groups out of three as the IRS summarily concludes.

[2749] [My footnote:] For Code § 643(e)(3), see text accompanying fns 2561-2565 in part II.J.8.d.i Distribution in Kind - Generally.

If a court-ordered commutation is a sale or exchange, it's not hard to imagine many other situations involving trust terminations to be *in substance* an exchange. *E.g.*, an agreed distribution of the trust assets to an income beneficiary followed by a gift to the remaindermen of their commuted value would probably be treated no differently, since that could *in substance* be a sale and exchange, even if the form of the transaction was a lawful distribution of corpus pursuant to the trustee's authority, followed by a gift.

The IRS has approved divisions of trusts in prior PLRs and concluded that to the extent the division was pro rata there was no taxable exchange, but to the extent the division was non-pro rata there would be deemed an exchange.[16]

[16] In PLR 200038014, the IRS acknowledged this when it found that a bifurcation of a trust into separate trusts via court order did not trigger capital gain, except to the extent the funding was non-pro rata:

"Neither the Will nor State law grants the Trustee power to make non-pro rata distributions from Trust 2. However, the court before which the petition seeking permission to divide Trust 2 is pending is a court of general jurisdiction in State with equity jurisdiction, and the court has the power to divide Trust 2 on a non-pro rata basis. ***The present case is distinguishable from Rev. Rul. 69-486 to the extent that assets of Trust 2 are divided on a pro rata basis.*** Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries. Further, to the extent that the assets are divided on a pro rata basis the distribution of the assets to the Separate Trusts will not be viewed as a pro rata distribution followed by an exchange of assets and will not give rise to a realization event as described in Rev. Rul. 69-486. As discussed above, to the extent that the assets are divided on a non-pro rata basis, the transaction will be treated in accordance with Rev. Rul. 69-486. Therefore, to the extent that the division of Trust 2 assets among the Separate Trusts is made on a pro rata basis, the division will not be considered a sale, exchange, or other disposition of property and will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize gain or loss under § 1001 and the division of Trust 2 into the Separate Trusts will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize income under § 61 or gain or loss under § 1001." Page 7 of ruling.

The PLRs did not address whether the commutation may be a tax-free *severance*. Treas. Reg. § 1.1001-1(h) provides that a severance is not an exchange if state statute or the governing instrument authorizes it and any non-pro-rata distributions. The regulation does not define "severance," however. Commutations seem to go beyond the common understanding of a severance, which implies continuation of multiple trusts.

Despite their citation to dubious authority, the IRS probably has the better argument on there being a taxable disposition. The parties bargained for and will receive fundamentally different interests in property (exchanging a trust interest for direct property interest), which is the core of IRC §1001 as discussed in the seminal Supreme Court case of *Cottage Savings*.[17] The IRS has so ruled many times before (see below).

[17] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991). In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged participation interests in different loans. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is

material to the Code so long as their respective possessors *enjoy legal entitlements that are different in kind or extent*.

But then, if we are primarily examining whether the parties in these ten PLRs are receiving materially different legal entitlements, which they clearly are, *why is it that G3 did not have to recognize any gain on its share?* There is no logic to this, other than that's the [sic] way the IRS has long construed such commutations in prior PLRs. I could find no citable authority on this artificial sale to G3 idea.

Does Beneficiary Involvement or Procurement Matter?

Many readers will wonder how the IRS or court would rule if, instead of the parties agreeing to divide the trust and handing the court and IRS an agreement to be blessed, the trustees had sought and the court ordered a commutation *without such an explicit agreement among the beneficiaries*. There is no clear answer from the PLR, but this would probably make no difference whatsoever. For gift tax purposes, it should, because gift tax generally requires a voluntary action on behalf of the donor.[18] Dispositions, however, do not – just ask anyone who has ever held stock in a company that went through a taxable merger or acquisition.

[18] For a discussion of gift and estate and income tax ramifications of amendments and settlements and why unilateral trustee actions such as decanting or court petitions may be treated differently for gift tax purposes than non-judicial or court actions involving beneficiary acquiescence, see Morrow, Edwin P., *The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)*, pages 132-156. Available at SSRN: https://ssrn.com/abstract=2436964, which is an update of the Optimal Basis Increase Trust, LISI Estate Planning Newsletter #2080 (March 20, 2013).

Earlier PLRs Concerning Commutations, Including CRT Commutation PLRs

This isn't the first PLR concerning commutations that found a taxable exchange. PLRs 200209007 and 200209008 also involved a commutation, but only a partial one. The trust beneficiary whose lifetime interest was commuted was deemed to have sold their interest, which would be a capital gain, with zero basis, just as in these recent PLRs. The other beneficiaries got off scot free without the IRS finding any sale or exchange of their interest because their interest in trust essentially continued with only minor modifications.

Similarly, in PLR 200231011, the trustee and the beneficiaries had agreed that the income beneficiary would receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) a testamentary general power of appointment over the remaining trust property, while the charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed (*i.e.* commuted). The IRS ruled that the transaction was in effect a sale or disposition under IRC § 1001(a), with the zero-basis rule applying to the sale of the son's interest, similar to the PLRs discussed in this article, even though the son's interest in trust continued in different form.[19]

[19] PLR 200231011.

There are several rulings in which the IRS deemed commutations of charitable remainder trusts (CRTs) to be sales/exchanges (by the income beneficiary to remaindermen) triggering IRC § 1001. There are compelling reasons for the IRS to have applied the zero basis rules in this manner to curb abuse in the tax-exempt context.[20] Treasury eventually issued regulations in this area to prevent such manipulations so that undistributed income and gains inside the CRT reduce the lead income beneficiary's basis even upon sale to a third party.[21]

[20] See IRS Notice 2008-99, Rev. Proc. 2008-3 where the IRS placed these on a "transaction of interest" list before Treasury issued new regulations. See Rev. Proc. 2015-3, § 3.01(68). It's abusive because if not curbed, a taxpayer could contribute a zero basis property worth $10 million, the CRT sells the property tax-free and has a basis of $10 million and if the lead income beneficiary could use their share of uniform basis in selling their interest to a third party utilizing the IRC § 1001(e)(3) exception, it would be completely evading tax on the gain.

[21] See Treas. Reg. § 1.1014-5(c) and (d), Examples 7 and 8. This is a logical way to curb such abuse, because by reducing the basis by the gains never taxed, the taxpayer is denied "free basis". The appreciation is ultimately taxed.

But the legitimate public policy rationale to prevent tax evasion shut down by those CRT sale regulations does not exist for commutations of ordinary irrevocable trusts that are not tax exempt. Arguably, the polar opposite of tax evasion occurs under the zero-basis rule when such a trust is terminated without the § 1001(e)(3) exception applying: basis is destroyed and the IRS receives a windfall.

In PLR 200127023, the IRS treated the commutation of a charitable remainder trust (CRT) as a taxable exchange and sale by the individual lead interest holder, generating capital gain with zero basis attributable under IRC § 1001(e). Regarding the exception, the IRS stated "The exception contained in § 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party."

PLR 200733014 was substantially similar, where the commutation was ruled in substance to be a taxable sale by the income beneficiary. Regarding the commutation, the IRS noted, "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, *in substance* it is a sale of Grantors' interest to Charity, the remainder interest holder."

Decanting and Reformations as Taxable Dispositions

Reading the description of the first two PLRs from 2002 discussed above combined with these newer PLRs, readers may be nervous that commonplace reformations and decantings could be a taxable sale or disposition under § 1001. I cannot completely reassure readers on this point. While there are many PLRs that have found minor changes not to be a disposition, there is no reason that reformations and decantings cannot trigger § 1001 if the changes are material enough. In defining what constitutes a "material difference" for purposes of § 1001(a), the Supreme Court stated that "properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent [echoing language in Treas. Reg. § 1.1001-1(a)]. ***Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are "materially different" -- that is, so long as they embody legally distinct entitlements."[22]

[22] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991).

Most reformations should be safe, but not all. Administrative changes don't give beneficiaries materially different legal entitlements. However, if it's a major change in economic rights, it might. Unitrust conversions have a safe harbor.[23] Mere changes between grantor and non-grantor trust status should be safe, absent extraordinary circumstances.[24] Severances, as discussed above, are also safe, but there is no clear rules as to when a change goes beyond a mere severance. This is a very grey area. For example, if the discretionary income beneficiary gets a new 5/5 withdrawal power and the remaindermen get a restriction on the income beneficiary's testamentary power to appoint to others, that gets closer to a quid pro quo, a material change in legal entitlements, similar to PLR 200231011. Splitting a pot trust in two where the two beneficiaries keep the same rights looks like a severance, but splitting a different trust in two where one beneficiary accelerates from remainderman to current beneficiary and the other gets additional rights may go beyond the severance safe harbor.

[23] Treas. Reg. § 1.643(b)-1 "***A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries."

[24] Rev. Rul. 85-13, CCA 200923024; see Treas. Reg. § 1.1001-2(c), Example 5 and TAM 200011005 and *Madorin v. Comm.*, 84 T.C. 667 (1985) for exceptions when relief of debt in excess of basis triggers gain.

The case law that is citable authority involving commutations and reformations is sparse but leans towards substantial reformations that materially change economic interests being deemed to be dispositions.[25] In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged an income interest in trust for a more certain fixed annuity, and this was found to trigger § 1001.

[25] See the discussion of *Evans v. Commissioner*, 30 T.C. 798 (1958) and *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969) in PLR 200231011. In *Evans*, taxpayer exchanged an income interest in trust for a more certain fixed annuity, and was found to trigger § 1001. In *Silverstein*, the trust was terminated, but the income beneficiary was to receive the exact same payments from the remaindermen rather than the trustee and the 7th Circuit found this not to be an exchange. *Silverstein* is not especially helpful, since it seems merely an assignment/change in obligors.

That said, the IRS has approved many reformations in the past that have minor changes in legal entitlements. PLRs 201702005 and 201702006 involved converting pot trusts into separate trusts, yet the IRS ruled that these changes did not trigger § 1001. More far-reaching, in recent PLR 201814005, the IRS ruled that a court reformation that converted a mandatory distribution to a discretionary distribution standard and replaced a beneficiary's rights to withdraw corpus at ages 25 and 30 with testamentary general powers of appointment ("GPOA") at that age did not trigger § 1001: "In this case, the Trust modification will result in increased trustee discretion and will not confer new rights to the beneficiaries or result in any relative shifting of interests between beneficiaries."

The IRS appears to be more sympathetic to cases such as above where the current beneficiary is arguably receiving a decrease rather than an increase in economic rights (as opposed to PLR 200231011 and *Evans*). Would the IRS have granted PL 201814005 had the requested change been reversed, *i.e.* granting a current discretionary beneficiary a mandatory distribution right, perhaps to qualify as a QSST or a BDOT? It's hard to say.

In all the PLRs discussed in this article, the local court approved the commutation or reformation. It's tempting to assume that decanting, which has spread like wildfire in recent years and is rumored to cure cancer, gets around this problem. That is questionable. If a trustee-initiated change approved by a court can be a disposition, there is no reason that an identical trustee-initiated change not approved by a court would not be. Advocates for more dramatic decanting (e.g. SD/NV proponents brag of their statutes permitting removal of mandatory distribution rights and accelerating remainder interests) claim it's completely different because decanting is framed as a distribution to another trust, but there is no clear authority for this distinction when it looks more like a substantial reformation. The IRS has been "studying" this for years and is skeptical where decantings substantially change beneficial interests.[26]

[26] IRS Notice 2011-101: The IRS "will not issue private letter rulings (PLRs) with respect to such transfers [decantings] that result in a change in beneficial interests. See Sections 5.09, 5.16, and 5.17 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111. The IRS generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period." Some state statutes, *e.g.*, the Uniform Trust Decanting Act § 19, have excellent language that may protect against decanted trusts being disqualified from various tax benefits, such as the marital deduction, designated beneficiary "see through trust" status or S corporation ownership qualification, but this is unlikely to be helpful in preventing the IRS from arguing a sale or disposition has occurred under *Cottage Savings*.

What about decanting to remove a right to receive the trust corpus at age 40 or otherwise, as in the infamous *Ferri* and *Kaestner* cases?[27] This is a favorite strategy advocated in countless tax and asset protection planning conferences in recent years. If the current beneficiaries keep a discretionary interest as sole current beneficiary coupled with a testamentary GPOA, it more closely resembles PLR 201814005 discussed above (but which, of course, is not citable precedent). Query whether beneficiaries retained a testamentary GPOA in those cases.

[27] These are discussed in prior LISI Newsletters, see *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, *Ed Morrow & Steve Oshins,* LISI Asset Protection Newsletter #240*, Ed Morrow, David Berek, and Raj Malviya on the North Carolina Supreme Court's Affirmation of Kaestner and Its Impact on both North Carolina and Other States' Abilities to Tax Trust Income* LISI Income Tax Planning Newsletter #153 (August 20, 2018).

It could be quite dangerous if the IRS applied IRC § 1001 to such amendments, even if the value of the current beneficiary's interest was dramatically reduced as in cases like *Ferri* and *Kaestner*, due to the zero-basis rule of § 1001(e) and the potential effect on other beneficiaries.[28] No PLRs or cases have gone that far – yet.

[28] The one consolation would be the amount of consideration received in return, if it is merely a discretionary interest in trust with no mandatory distribution, should be valued much lower than prior to the decanting. Some attorneys believe that a discretionary interest in trust has no value whatsoever and that it would not even be considered a property interest under federal tax law, but just because Alaska or some other state says it's not a property interest does not make it so for federal tax purposes. That said, the value of such an interest should be quite low. In PLR 8535020, a lifetime limited power of appointment was exercised in a trust wherein income payments to the powerholder/beneficiary were discretionary, thus requiring the IRS to value that interest to determine the amount of the gift. The IRS cited Rev. Rul. 79-327 and stated:

"The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest, but, as indicated by Rev. Rul. 67-370, the presence of the possibility of your receiving less than the entire income and principal does not warrant our finding that your transfer of the interest is not subject to the tax imposed by section 2501(a) of the Code."

The IRS had no further guidance on how to value a discretionary interest. The larger taxable ramifications in such decantings/reformations may therefore be to remainder beneficiaries, whose economic interest in the trust may dramatically increase. If deemed a disposition, they could use their share of uniform basis to offset such gain, but this may be phantom income if they can't access cash. In a truly dynastic trust where no one has more than a discretionary interest, many attorneys would argue that no beneficiary has any economic rights worth anything, even if the trust has $1 billion in it. Whether the IRS/courts would agree is questionable. I can cite no authority, but it's even possible that they ultimately apply a zero-sum analysis, *i.e.*, if the trust is worth $1 billion, then the collective equitable interests held by the various beneficiaries must be worth that amount so that as one beneficiary's interest decreases others must increase accordingly. The uniform basis rules have no examples of valuing discretionary interests, but consider a current discretionary interest a term interest. See Treas. Reg. § 1.1014-5(a) and § 1.1001-1(f)(2)(i).

It Could Be Much Worse…

In these PLRs, the trust had been established for over 30 years. What if the trust had been settled less than a year before the commutation? The tax rate would almost double due to short-term capital gains being taxed at ordinary income tax rates (top rate 37% v. 20% for long-term capital gains). Similarly, any assets that the trust had purchased within one year could also trigger short term capital gains as to the portion G3 is deemed to pay for G2 and G4's shares (the PLRs did not indicate whether there were any such assets).

It's unlikely that this trust contained inherited retirement plans, but many trusts do. Which bold reader wants to promise clients what the result of this would be? In compliance mode, we could argue that transferring an inherited IRA in kind from a trust to beneficiaries shouldn't trigger any income, but recall the IRS deems a commutation to be a sale by G2 and G4 to G3, with *Kenan* gain to G3 on paying off G2 and G4. The IRS does not take kindly to such transactions with inherited retirement plans involved.[29]

[29] See IRS Chief Counsel Memorandum (CCM) 200644020 regarding the *Kenan* rule applied to IRA/401(k) income in respect of a decedent funding a pecuniary obligation (which is a somewhat debatable conclusion, as IRC § 691(c)/IRD rules arguably trump this, but it's best in planning to avoid a fight).

Similarly, what if the trust was the party to an installment sale or had § 179 property or loss assets that had to fund those two shares? Related party rules could hold some nasty surprises.

Moreover, the rulings found that G3, the Current Remaindermen, did not incur any taxable sale or disposition despite turning a mere remainder interest into cold hard cash and other assets. This is hardly an inevitable conclusion under IRC § 1001. The more rational interpretation is that all three groups disposed of their shares.

Application of § 1001 to reformations and decantings that do not involve full terminations would involve even worse complications due to phantom income. In these PLRs, the beneficiaries all

have liquid funds to pay the income tax, but in a reformation deemed to be a constructive disposition, they may not.

Conclusions and Solutions Around the IRC § 1001(e) Destruction of Basis

In short, these PLRs point out significant income tax dangers to early termination of trusts (and potentially, extensive reformations). Practitioners should consider the pros and cons of less drastic alternatives that may solve the perceived problems of the trust without triggering § 1001 – or worse, the zero-basis apocalypse of § 1001(e). There may be several potential solutions when the parties wish to commute a trust (remember that spendthrift provisions generally prevent transfers of trust interests, but such provisions can be removed by decanting or other reformation):[30]

> [30] Some state statutes even permit a beneficiary/trustee to decant and do so, which may have significant estate tax and asset protection ramifications, see *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary Controlled, Irrevocable Trust*, LISI Asset Protection Planning Newsletter #339 (March 9, 2017). Simply removing a spendthrift provision should not be a material enough change by itself to cause a sale or disposition, see, *e.g.* PLR 201136011, PLR 201026014 (both of which involved multiple related sequential PLRs), which so ruled.[2750]

Either the income beneficiary or the remaindermen could gift their interest to the other rather than sell or commute the interest. This may be acceptable in smaller trust scenarios where estate/gift tax is not an issue. In these rulings, the Son's "net worth has grown significantly, such that he does not need income from [the trust] for his support". So why didn't he simply release his interest and unilaterally make a gift? Apparently he did not care about estate/GST tax too much if he was willing to add so much to his estate through a commutation. If that would be too much and cause a gift tax, they could bifurcate the trust via qualified severance and G2 could release only the interest corresponding to the amount of potentially taxable gift desired.[31] While a gift could be construed as a disposition triggering § 1001(e), provided it was not a net gift agreement, bargain sale or trigger debt in excess of basis issues, there would be no consideration to tax as capital gain even if the basis were deemed to be $0.

> [31] See Treas. Reg. § 1.1001-1(h) for qualified severances that do not trigger tax.

Similarly, Son (G2) could have gifted a portion or all of his interest to charity, sui generis or prior to a later commutation. Whether it's a zero-basis asset pursuant to § 1001(e) or not would be irrelevant (unless, perhaps if gifting to a CRT), and by longstanding case law, it's considered a capital asset, not an assignment of income.[32] This may be much better than simply gifting the income every year.

> [32] *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946) *cert. denied*, 330 U.S. 826 (1947); the Service acquiesced in Rev. Rul. 72-243.

The parties could structure a sale that more clearly meets the § 1001(e)(3) exception. Neither the statute nor the regulations have a related party rule. Treas. Reg. § 1.1001-1(f)(3) states that the exception in IRC § 1001(e)(3) applies when the entire interest in property is sold or

[2750] [My footnote:] Those rulings involved the sale of a remainder interest, which did not implicate Code § 1001(e).

otherwise disposed of as part of a single transaction to a third person or persons. Thus, both sets of parties could sell their interest to any third party, who would then own all trust interests and merge/collapse the trust and be able to pay them each their commuted value.[33] One might fear that the IRS could argue substance over form, but here the transaction would be squarely within the statute and regulation. Congress could have easily added a related party rule as it often does, but chose not to. Who else but a related or subordinate party would want to bother?

[33] Common law doctrine of merger can be found at UTC § 402(a)(5) and *Restatement of Trusts, Third*, § 69. If an LLC is used and then holds all beneficial interests, there may be another hurdle in that state law may prohibit LLCs acting as trustees without qualification as a bank or trust company, so it may be wise to research this issue under state law before so doing or use an individual buyer.

The parties could instead divide the trust via tax-free severance. Treas. Reg. § 1.1001-1(h) provides that a severance is not a taxable exchange if state statute or the governing instrument authorizes it and any non-pro-rata funding. State law may permit such a division and non-pro-rata funding (in fact, judges would be more likely to approve than an outright termination). What if the court order had instead divided the trust into two trusts (or more) with liberal current terms for each group of beneficiaries (G2, G3, G4)? Arguably this is still a severance. However, such a division between generations is quite different from most traditional severances (such as dividing a pot or separate share trust), so it's still unclear whether *Cottage Savings* analysis or the severance regulation would win the day.

If the driving force was that G3 or G4 needed money for consumption, they could sell all or a portion of their remainder interest. Provided they do not both sell to G2, this would not have terminated the trust or affected G2, yet the zero-basis rule would not apply and they could use their share of uniform basis to reduce gain on sale.

They might contribute their trust share to an LLC taxed as a partnership. The LLC, just like any other purchaser, would then own all interests in the trust and it could be merged/collapsed and the LLC would own the assets and each beneficiary would thereafter own a % of the LLC in proportion to the prior value of their trust interest. For some families, this might be a great result. Investment partnership diversification rules, which are an exception to the general non-recognition rule, should be considered.[34]

[34] IRC § 721(b), § 351. I did not fully research whether this might somehow be a diversification of the beneficiary's assets which is an exception to the general nonrecognition on contributions to partnerships rule in IRC § 721(a). The capital asset contributed to the LLC/partnership would arguably be the trust interest, not marketable securities that the Code prevents partners from diversifying. When the trust will be immediately merged/collapsed, will the IRS look through to the investments? The trust interests may represent equitable ownership in marketable securities (assuming that is how the trust is invested), but this is not a situation where the partners are diversifying their holdings in marketable securities, since all parties to the trust would be contributing shares in the same securities even if we looked through the trust. There may be other income triggering situations if the partnership/LLC

made non-pro-rata distributions in kind within seven years, but it does appear that the contribution itself should be non-taxable.[2751]

If there is wide discretion to make principal distributions to the income beneficiary (not present in these PLRs), the trustees under most state decanting laws could decant to grant the income beneficiary the lifetime limited power to appoint principal to remaindermen. The powerholder could then appoint the desired value to the remaindermen (over time or lump sum) and the trustee could make a distribution of the remaining principal to the income beneficiary. This may involve a small taxable gift due to the value of the income beneficiary's interest foregone, but the annual exclusion would be available to offset such gifts.[35] It does not seem so drastic as to be a material change that would be a disposition.

[35] Rev. Rul. 79-327, *Estate of Regester*, 83 T.C. 1 (1984), though contrary is *Self v. United States*, 142 F.Supp. 939 (1956). The IRS, in TAM 9419007, has indicated it will follow *Regester* (finding a gift) and not *Self*. The gift would not be the entire amount of the distribution. It does not necessarily affect GST exempt/grandfathered status – see *e.g.*, PLR 200243026.

Since the son (G2) didn't need the money, the parties could have simply amended the trust to grant son the power to withdraw the income instead of automatically receiving it – this is hardly a material change in the parties' rights that would be a sale or disposition, yet this would clearly shift the income taxation of such income to the son without requiring he take any of the money. This would permit the trust to grow income tax free, at least to the extent of any taxable income allocated to fiduciary accounting income, which might in many cases be all of the income (or easily could be, by change in investments or trustee allocation).[36]

[36] For more on this concept, see *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)*, LISI Estate Planning Newsletter #2587 (Sept 5, 2017), updated and reorganized at Morrow, Edwin P., *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*. Available at SSRN: https://ssrn.com/abstract=3165592. To avoid any contribution for gift/GST purposes, amounts over IRC §2514's 5/5 lapse protection should be withdrawn or hang. There may be compelling reasons to apply the withdrawal power over all taxable income instead of only over all accounting income, because in the latter case the 5% lapse would be calculated only on the accounting income rather than the entire corpus.[2752]

The trustees could instead petition the court to amend the trust to grant wide discretion to the trustees to distribute principal currently to both the income beneficiary and the remaindermen (a discretionary pot trust) and the trustees could thereafter use their discretion to make distributions of the proceeds to either or both. There would still be some risk here, since there is a chance of substance over form or step transaction attack, and radical modifications to a trust such as this might still be considered a disposition, as discussed previously. Moreover, whenever a party gives up a mandatory income right, there is the potential for a taxable gift to occur, even if only passively acquiesced to. Still, this stands a better chance at avoiding a disposition than a commutation.

[2751] [My footnote:] The most important analysis of this issue (but not of the specific transaction Ed is describing) is in part II.M.3.b Exception: Diversification of Investment Risk. Footnote 3246 in part II.M.2.a Initial Incorporation – Generally cross-references part II.M.3.b.
[2752] [My footnote:] See part III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made

If the driving force behind termination were to access capital for closely-held investments, they could have amended the trust to be a directed trust to permit the trust to invest in such assets (and reduce trustee fees from higher fully managed to lesser directed trust fees). This kind of change should not be a taxable event.

Similarly, depending on the driving force for termination, the trust could have been amended to permit loaning money to beneficiaries. Provided it's not a de facto termination, lending should not be a taxable event either.

There are probably many other variations on the above. Trusts with robust trust protector language may have the ability to make some of these changes without going to court or crafting a non-judicial settlement agreement.

Although not present in these PLRs, remember that for any transfer or commutation involving termination of a QTIP trust, IRC § 2519 would apply to trigger a net gift by the spouse of the remaindermen's portion of the trust (IRC § 2514 would apply to a gift involving a marital GPOA trust). This may not be a disaster, and in many cases could work out much better than had the spouse disclaimed and the estate paid estate tax instead of gift tax, but this should certainly be considered in the calculus.

In conclusion, be careful to weigh the potential income tax impact of commutations and early terminations and even dramatic amendments/reformations that materially change the economic interests of the parties (especially if a beneficiary is being removed). There is no bright line test as to when a sale will be deemed to occur and it could be a very expensive proposition if it is later found to be so but not reported as such.

II.J.18.f. Commutation vs Mere Division

I agree with the criticism in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations that Rev. Rul. 69-486 does not support the conclusion of Letter Ruling 201932001 (and its companion rulings) and his comment that Reg. § 1.1001-1(h) prevents gain recognition when the form and substance are a distribution rather than sale of beneficial interest, especially in light of Reg. § 26.2642-6(j), Example (3).[2753]

Furthermore, when the current beneficiaries and remaindermen are related, I do not see any policy reason for Code § 1001(e)(1) to apply.[2754]

Ultimately, however, one needs to reconcile the continued existence of law on commutations in part II.J.18.d, which was not altered when Reg. § 1.1001-1(h) was adopted, with the potentially broad protection of Reg. § 1.1001-1(h) that applies to divisions under part II.J.18.a. In weighing these arguments, consider Reg. § 1.1002-1(b), "Strict construction of exceptions from general rule," which provides:

> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying

[2753] Reg. § 1.1001-1(h) and Reg. § 26.2642-6(j), Example (3), are reproduced in the text accompanying and following fn 2710.

[2754] See text accompanying and following fn in part II.J.18.d Trust Commutations.

> assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

Absent Reg. § 1.1002-1(b), Reg. § 1.1001-1(h) could be broadly construed to protect most commutations. Reg. § 1.1002-1(b) informs us that we need to look deeply into the purpose of Reg. § 1.1002-1(b) and make sure it suffices to override the law of exchanges.

Ultimately, we need to see whether a beneficial interest constitutes an entitlement that one can compare to a measurable expectation of financial benefits. Certainly, an income interest or its equivalent (unitrust, annuity, etc.) can be measured. Ascertainable standards tend to constitute a measurable economic interest. For guidance in measuring beneficial interests for gift tax purposes, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts.

Transferring an entire beneficial interest to a new trust but in a modified form can trigger a Code § 2702 gift of the entire beneficial interest,[2755] so if the entire beneficial interest is transferred and the distribution rules are different then they may need to be in the form of a unitrust or annuity. A trust division, where the original trust continues intact and property is transferred to a new trust, would be limited in gift tax consequence to the amount transferred and therefore less risky than reforming the entire beneficial interest. Furthermore, guidance on trust divisions in part II.J.18.a tends to show that taking a trust with multiple beneficiaries and dividing it into a separate trust for each beneficiary with the same distribution standards does not constitute a gift or an income-taxable exchange.

When is a change of an expected series of distributions material? Given the lack of concrete examples for trusts, one might see whether a change in a right to a series of payments in other areas of the law might help. Reg. § 1.1001-3, "Modifications of debt instruments," provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Reg. § 1.1001-1(a).[2756] For that purpose, a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent.[2757] Generally, a modification of a

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[2755] See part III.B.7.d Code § 2702 Overview.

[2756] Reg. § 1.1001-3(a), which continues:

> This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

[2757] Reg. § 1.1001-3(b), which continues:

> A modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a). Paragraphs (c) and (d) of this section define the term modification and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (f) of this section also

debt instrument is any alteration of the payor's or payee's legal rights or obligations,[2758] unless that change occurs by operation of the terms of a debt instrument[2759] and is not within the list of changes that constitute a modification.[2760] Generally, a modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[2761] Although the rules for when a change of

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> provides rules for determining whether the modified instrument received in an exchange will be classified as an instrument or property right that is not debt for federal income tax purposes. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

[2758] Reg. § 1.1001-3(c)(1)(i), "Alteration of terms," provides:

> A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

[2759] Reg. § 1.1001-3(c)(1)(ii), "Alterations occurring by operation of the terms of a debt instrument," provides:

> Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

[2760] Reg. § 1.1001-3(c)(2), "Exceptions," provides:

> The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.
>
> (i) *Change in obligor or nature of instrument*. An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.
>
> (ii) *Property that is not debt*. An alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section). The rules of paragraph (f)(7) of this section apply to determine whether an alteration or modification results in an instrument or property right that is not debt.
>
> (iii) *Certain alterations resulting from the exercise of an option*. An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—
>
> (A) The option is unilateral (as defined in paragraph (c)(3) of this section); and
>
> (B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

[2761] Reg. § 1.1001-3(e), "Significant modifications," provides:

> Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e)(2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

Reg. § 1.1001-3(e)(1), "General rule," provides:

> Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are alt ered and the degree to which they are altered are economically significant.

yield are provided,[2762] consider that a trustee can have significant discretion in determining how much is allocated to income in a mandatory income trust without triggering any transfer tax consequences.[2763] A material deferral of scheduled payments[2764] is a significant modification unless it falls within a safe harbor.[2765] Other rules relate to a change in obligor (which might be

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In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

[2762] Reg. § 1.1001-3(e)(2), "Change in yield," provides:

(i) *Scope of rule*. This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272-1(c), debt instruments that provide for a fixed yield subject to § 1.1272-1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.

(ii) *In general*. A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—

(A) ¼ of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).

(iii) *Yield of the modified instrument*.

(A) *In general*. The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—

(1) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and

(2) payments equal to the payments on the modified debt instrument from the date of the modification.

(B) *Prepayment penalty*. For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275-2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments*. For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275-5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

[2763] See fns 2532-2536 and accompanying text in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law. Also note that ascertainable standards may include significant flexibility; see fn 2331 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

[2764] Reg. § 1.1001-3(e)(3), "Changes in timing of payments," begins with (i), "In general," which provides:

A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

[2765] Reg. § 1.1001-3(e)(3)(ii), "Safe-harbor period," which provides:

The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-

relevant in the context of a trust division) or security,[2766] changes in the nature of a debt instrument,[2767] and accounting or financial covenants.[2768]

However, modifying a mandatory income trust to allow the trustees to accumulate income and then require any accumulated income to be paid to the beneficiary's estate did not have any income, gift, or GST tax consequences. See part II.J.5.b.iii Modifying a Mandatory Income Trust to Make It Discretionary Income.

Considering all of the sources described above, if a trust is purely discretionary (nor ascertainable standards) and its remainderman are also current permissible distributees, then arguably nobody has any measurable interest, in which case the trustee may be able to divide the trust among all the beneficiaries without any income or gift tax consequences. How each situation compares to this ideal and whether any beneficiary is gifting or exchanging an interest in a trust depends on the circumstances.

II.J.19. Other Special Purpose Trusts

See part II.D Special Purpose Trusts, which includes parts II.D.1 Trust as a Business Entity, II.D.2 Business Entity as Grantor of Trust, II.D.3 Trust as Grantor of a Trust, II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, II.D.5 Severing Trusts with Multiple Grantors, II.D.6 Land Trusts, and II.D.7 Sham Trusts.

> harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

[2766] Reg. § 1.1001-3(e)(4). Generally, Reg. § 1.1001-3(e)(4)(vi)(A)(1) provides that "a change in payment expectations occurs if, as a result of a transaction":

> (1) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or
>
> (2) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

Quaery whether a similar analysis might apply as to whether a trust division leaves each trust with the ability to make the distributions that were expected before the distribution.

[2767] Reg. § 1.1001-3(e)(5).

[2768] Reg. § 1.1001-3(e)(6).

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates

A trust or estate participating might be important not only to prevent the passive loss rules from suspending a loss but also to prevent the 3.8% tax on net investment income from applying to the trust's business income. For details on the net investment income tax, see part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income. See also parts II.J.13 Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not, II.J.14 Application of 3.8% NII Tax to ESBTs, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

Grantor trusts are taxed to their deemed owners and generally are not cover further in this part II.K.2. Further below are discussions of current law and how to plan for estates and nongrantor trusts in light of it.[3015] Here is an overview of regulatory developments:

From when the Code § 469 passive loss rules were enacted until when the Code § 1411 tax on net investment income (NII) was enacted, the application of the passive loss rules to estates and nongrantor trusts generally was ignored. This idea was ignored because the issues were those of timing of deductions, estates and nongrantor trusts with excess deductions could not use them, and the suspending passive losses until sales occurred generally was favorable. However, the NII tax changed the paradigm, causing taxpayers to ask the government for guidance, to which the government responded by asked for comments on what those rules should look like.

Before discussing the comments, one needs to provide context to the government's general approach. The proposed regulations under Code § 1411 initially addressed the general application of the passive loss rules (not yet focusing on trusts) in a manner biased in favor of the government: the proposed regulations would have left taxpayers with income that was nonpassive for Code § 469 but passive for Code § 1411. This approach was inconsistent with the scant legislative history of Code § 1411, and pressure was applied (in a process in which I was not involved) that caused the final regulations to back away from that approach and simply apply Code § 469 (with certain pro-taxpayer exceptions) and let the Code § 1411 consequences fall where they may.

My understanding is that the government will be looking at comments on trust participation as purely Code § 469 issues and let the Code § 1411 consequences fall where they may. It has been suggested that Code § 469 comments that tend to favor characterizing income as nonpassive in the hands of an estate, nongrantor trust, or beneficiary would be an unwarranted boon for taxpayers. However, my understanding is that the government is concerned about what might if it adopts regulations with Code § 1411 in mind, Code § 1411 later gets repealed, and the government has shot itself in the foot under Code § 469 by making it difficult to characterize income as nonpassive. Thus, regulations under Code § 1411, not Code § 469, would be the appropriate place to address any concerns the government might have about the impact of Code § 469 regulations on Code § 1411.

[3015] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

Making fair rules for how trusts can materially participate will be a complex task. Fiduciary arrangements can be grantor trusts (in which case the trust is disregarded and the deemed owner is taxed), estates, or nongrantor trusts. Trustees can be individuals or entities. A trust might have one trustee or multiple trustees. Each trustee might have different skills or knowledge of the beneficiaries' needs, leading to slicing and dicing of trustees' authority and duties. Furthermore, the level of fiduciary duties varies according to state law and the document that created the trust.

Here is a description of comments by certain major groups, all of which I participated in varying degrees:

- AICPA comments were first.[3016] They pointed to taxpayer-friendly case law.

- The ABA's Section on Taxation submitted highly technical comments, which, among other matters, explored the relationship between the passive loss and the fiduciary income tax system.[3017]

- The American College of Trust & Estate Counsel (ACTEC), whose task force I chaired, focused on the fiduciary nature of a trust and explored how the government might handle the evolving roles of trustees.[3018]

ACTEC proposed that work in a business activity be considered work attributable to a trust in determining its material participation if performed by a person who is a qualifying fiduciary. To qualify under ACTEC's proposal, the person must hold a substantial related fiduciary power and personally owe fiduciary duties to the beneficiaries with respect to the power.

One set of comments (not mentioned above) suggested varying the rules depending on who serves (and perhaps how many people serve) as trustee. Considering those factors would punish trusts that do not conform to those comments' ideas of how trusts should be administered. In contrast, ACTEC's comments treat all trustees and trust arrangements the same, focusing on whether fiduciary duties are owed with respect to the work that is performed.

ACTEC's comments mention what little law there is and recommend changes to the law. When one needs a logical framework for trusts that have more than one trustee, when distributions are made to a beneficiary, or when my planning suggestions do not work out or were not followed, ACTEC's comments would form the basis for a well-reasoned argument about how the passive loss rules should be applied.

[3016] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHISrV/Yyi63VIdeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[3017] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[3018] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

II.K.2.b. Participation by an Estate or Nongrantor Trust

II.K.2.b.i. Participation by a Nongrantor Trust: Authority

Regulations do not address participation by a nongrantor trust.[3019] The legislative history provides:[3020]

> An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.

The legislative history does not state that this is the exclusive test for how fiduciaries may participate. For planning purposes, one should consider assuming that is the exclusive test, because the IRS takes that position. For reporting purposes, however,

"Fiduciary" means a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[3021] The term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[3022] A mere agent is not a fiduciary; for example, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[3023]

The IRS has litigated whether one should test based only on actions directly by the trustee or whether actions by others, such as an agent, should be considered.

In *Mattie K. Carter Trust v. United States*,[3024] the IRS argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

[3019] Note that participation of the activity of the deemed owner of a grantor trust would be a matter if that individual's personal participation. Thus, for example, this discussion in this section would not apply to a revocable trust. The rules for the Code § 1411 tax on passive business income expressly recognize this treatment of grantor trusts; see fn. 2124.

[3020] Committee Reports for Senate Bill 99-313, P.L. 99-514. A footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.

[3021] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.

[3022] Reg. § 301.7701-6(b)(1).

[3023] Reg. § 301.7701-6(b)(2).

[3024] 256 F.Supp.2d 536 (N.D. Tex. 2003).

TAM 200733023 rejected the taxpayer's reliance on *Mattie Carter* and asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Letter Ruling 201029014 involved a trust that owned a partnership interest. The partnership interest was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling failed to mention the *Mattie K. Carter Trust* case or to address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The IRS' Audit Technique Guide discusses the topic as follows:[3025]

> **Trusts Material Participation**
>
> If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S corporations or LLCs.
>
> The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.[3026]
>
> As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).

[3025] Chapter 6, found by starting with http://www.irs.gov/pub/irs-mssp/pal.pdf or http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-6-Entity-Issues. The footnotes in the excerpt below are direct copies from the IRS' audit guide, although the footnote numbers have been changed from footnote numbers 15-19 to those used below.

[3026] Note that Reg. § 1.469-5T(g) is "Reserved".

Grantor Trusts: Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

Qualified Subchapter S Trust[3027] **(QSST):** The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;[3028] and,

2. Working interests in oil and gas activities.[3029] Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.

- Partnership or S corporation with losses.

- Entity with an EIN and address a long distance from the trust or trustee.

- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.

- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.

- Copies of Schedule K-1s from related entities.

- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S corporations.

[3027] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.
[3028] Reg. § 1.469-1T(e)(6).
[3029] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).

- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S corporation.

- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law:

- The **Senate Report**[3030] clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.

- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, "Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary."

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[3031]

> Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.
>
> In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:
>
> > (a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[3032]
> >
> > (b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.[3033]
> >
> > (c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.[3034]

[3030] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.

[3031] The footnotes below use my numbering rather than the numbering used in the report. The report is at http://www.regulations.gov/contentStreamer?objectId=090000648127f7c2&disposition=attachment&contentType=pdf.

[3032] See Temp. Reg. § 1.469-5T(a)(1)-(5).

[3033] See Temp. Reg. § 1.469-5T(a)(7).

It explained its recommendations as follows:

> The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.
>
> Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust*[3035] found the trust to be analogous to a closely held C corporation and concluded that "the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]." The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust's other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.
>
> The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the "snippet" of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust's participation in a business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation's Explanation, but did not find it helpful.
>
> In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation.[3036]

[3034] Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).

[3035] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[3036] In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. See also PLR 201029014 (July 23, 2010). A person "required to hold and conserve the property, or the proceeds of the sale thereof, for future distribution" to others is a trustee. Rev. Rul. 61-102; see also Rev. Rul. 74-273. So is a person with "certain discretionary powers of administration and management with regard to the property ….[who] could vote at any stockholders' meeting; approve or oppose any reorganization or refinancing proposal; invest earnings in government obligations; retain counsel; exercise or sell conversion or subscription rights; hold the property in its own name or in a street name; and petition the court with respect to any other disposition concerning the property it considered to be in the best interest of the unknown owner." Rev. Rul. 69-300. A bank was not a fiduciary when it held an estate's money during

> The IRS Audit Technique Guide for Passive Activity Loss (the "ATG"), addresses material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.[3037]
>
> The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

Although neither the Audit Technique Guide nor the above comments focus on whether the trustee's participation is in the trustee's fiduciary capacity, TAM 201317010 did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

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litigation over the estate, paid interest, but performed no administrative duties for the estate. Rev. Rul. 82-177.

[3037] TAM 200733023 (Aug. 17, 2007).

Because this issue has a big impact on the 3.8% tax on net investment income,[3038] the Treasury Department and IRS are considering whether issue formal guidance at some point, even though they did not issue guidance when they finalized the regulations they issued in December 2012.[3039]

Meanwhile, the Tax Court held that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trust was able to count the trustees' participation.[3040] However, rather than simply disregarding the LLC (which was a disregarded entity for income tax purposes) and holding that the trustees were working for the trust (for income tax purposes), instead the court focused on the trustee's duty to the trust when working for the LLC.[3041] That focus might open the door for an attack on

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[3038] See part II.I 3.8% Tax on Excess Net Investment Income (NII), particularly part II.I.8 Application of 3.8% Tax to Business Income.

[3039] The preamble to the final regulations issued in T.D. 9644 stated:

> F. Material participation of estates & trusts
>
> Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.
>
> Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.
>
> A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.
>
> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

[3040] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[3041] The court said:

> Even if the activities of the trust's non-trustee employees should be disregarded,[15] the activities of the trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations.

the premise of TAM 201317010 that a trustee who acts as an individual is not also serving as a trustee.

Since then, the AICPA,[3042] ABA Section on Taxation,[3043] and ACTEC[3044] have made formal comments to the government.

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues

Some have suggested that the trustee's participation in the business will cause the trust to be taxed as a business entity. For trusts created for traditional estate planning purposes, that concern is not justified. See part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.[3045]

The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]

[15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.

[16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[3042] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VIdeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3043] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3044] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3045] Particularly fn. 3063.

Consider giving a beneficiary who participates in the activity a role as a trustee, whose authority is limited to acting on behalf of the trust with respect to investments that need to be tested under the passive activity rules. Depending on the state, one might be able to use a nonjudicial settlement agreement to not only add a special trustee for this purpose but also protect the trustee from liability.[3046] Note that the legislative history refers to ***an*** executor or fiduciary, not ***the*** executor or fiduciary, implying that material participation by any one co-trustee will cause a trust to be treated as materially participating in an activity.

At first glance, it might seem an easy matter simply to designate as a special trustee an employee of the business. Note, however, that the special trustee must be participating on behalf of the trust and not merely on his or her own behalf. The trustee's work on behalf of the trust as an investor in an activity is not treated as participation in the activity unless the trustee is directly involved – on behalf of the trust - in the day-to-day management or operations of the activity.[3047] Consider these issues:

- What activities would an owner of that entity typically perform?
- Does the company want the individual to be protecting the trust's interests rather than the company's?[3048]
- As an active participant in running the business, the trust might have fiduciary duties to the other owners that it might not have as a passive owner. The trust might already have duties to other owners if the trust has a controlling interest, but being active in the business would tend to strengthen these duties to others. If the business entity is an LLC, these duties to other owners might be more easily reduced than perhaps for other types of entities, depending on applicable state law.
- Because the trustee is participating on behalf of the trust rather than for his or her own benefit, should the trust be compensated for the trustee's services and then pay the trustee itself, rather than the trustee receiving compensation directly from the company? If so, then the trustee needs to consider whether the trustee is an employee or independent contractor (generally the latter) and the related employment taxes and insurance.
- Because the trust itself is participating in a trade or business, it might subject itself to Form 1099 filing requirements for payments it makes.
- A very significant purpose of using a business entity is to protect its owners from liability. However, to the extent that the trust is directly involved in the business activity, it would subject itself to liability for the trustee's actions or omissions as the trust's agent. The

[3046] Section 111 of the Uniform Trust Code, found at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf; RSMo § 456.1-111. Subsection 4 authorizes a nonjudicial settlement agreement to interpret the terms of the trust, approve a trustee's report/accounting, direct a trustee to refrain from performing a particular act, grant a trustee any necessary or desirable power, accept a trustee's resignation, appoint a trustee, determine a trustee's compensation, transfer a trust's principal place of administration, and resolve the liability of a trustee for an action relating to the trust.

[3047] See part II.K.1.a.v What Does Not Count as Participation.

[3048] See part III.A.4.c.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 regarding the trustee's fiduciary duties to beneficiaries when the trustee is active in the business.

trust may form an LLC that it wholly owns to provide those services and have the trustees provide those services through the LLC;[3049] if run in a financially responsible manner, the LLC might shield the trust from liability for managing the business.

Additionally, consider the trust's legal rights as an owner. If the entity is a corporation, to what course of action could a trustee commit a trust with respect to stock the trust owns other than voting it and selling it? Note that the trustee's actions as an investor do not count in determining material participation.[3050]

Generally, under corporate law a shareholder cannot act on behalf of a corporation. All the shareholders can do is elect directors. Directors then make strategic decisions (often not more than 100 or 500 hours' worth) and delegate the daily running to the officers (who are by definition employees). So generally a trust as a shareholder in a corporation has no authority to participate in the business' affairs. TAM 201317010 does not seem to understand this inherent limitation and appears geared toward businesses that are wholly owned by trusts.

Given that the IRS is reading the legislative history in a manner that makes it difficult for a trust to materially participate in its role as a shareholder, one might consider the following if the entity is an S corporation:

- Many states have "close corporation" statutes or other statutes that allow shareholders to directly run a corporation, much like an LLC is run by its members.[3051] They also have built-in buy-sell provisions, some of which might protect a corporation's S election (once in place).

- Consider an LLC or limited partnership taxed as an S corporation,[3052] with an operating agreement or partnership agreement that has distributions following S corporation single-class-of-stock rules rather than capital accounts, and either a limited liability partnership registration in place to protect the general partner (making the partnership an LLLP)[3053] or having the limited partnership do business through an LLC subsidiary. Generally, for an

[3049] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).
[3050] See part II.K.1.a.v What Does Not Count as Participation.
[3051] See fn 1073 and accompanying text regarding close corporation statutes as providing protection against creditors. Such statutes are in the minority. Of the states that do not have close corporation statutes, almost all of them have buried in their corporate law provisions allowing the shareholders to bypass the board of directors and directly run part or all of the business. A chart of states in an article co-authored with Richard Barnes was published March/April 2015 in *Probate & Property*, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/6131013_1.pdf; links supporting this chart were prepared by a summer associate in 2014 and are found in my firm's internal document number 5977514, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/5977514_7.pdf.
[3052] As described in part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, certain regulations might lead one to believe that an S election does not shield LLC owners from self-employment tax; however, those regulations appear to be obsolete. For those who are concerned about those regulations, a limited partnership would be the preferred state law entity, to obtain the self-employment tax exclusion available to limited partners, which is described in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[3053] See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration.

existing corporation, a merger into the new entity (LLLP or the LP's LLC subsidiary) would be required.[3054]

In either case, if all the S corporation stock the trust has is old-and-cold nonvoting stock, do a Code § 1036 tax-free swap for voting stock, giving enough voting stock to constitute adequate and full consideration (using a formula transfer). The holder of the voting stock would file a gift tax return adequately disclosing the transaction as a non-gift.

Also, consider having the entity pay the trust for services rendered managing the business, issuing IRS Form 1099-MISC to the trust.[3055] The trust would report the management income and expense on Schedule C or C-EZ.[3056] Trusts do not pay self-employment tax. After taking a reasonable profit on the payment, the trust would compensate the trustee for services rendered. Unlike most trusts, because the trust is now engaging in a trade or business, the trust would issue IRS Form 1099-MISC to the trustee for those services, and the trustee would report the income in his/her Form 1040, Schedule C, and pay self-employment tax;[3057] however, the IRS

[3054] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[3055] For Thompson Coburn LLP personnel – see document number 5879530.

[3056] For an ESBT, management fee income is not part of the S portion, because it is not a K-1 item. Reg. § 1.641(c)-1(d)(1), (2). The same answer applies to QSSTs. Reg. § 1.1361-1(j)(7), (8).

[3057] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 2134, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles. However, the Rev. Rul. modifies that position when the trustees carry on a trade or business:

> *Example (1). Executor who receives a flat fee for administering the estate*. A, a nonprofessional fiduciary, receives a flat $10,000 for administering the estate of B. B's gross estate is valued at $150,000 and includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which B's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth $150,000 he would have been entitled to $7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received $10,000 instead of $7,500 in commissions, the excess, or $2,500, is regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this $2,500 as earnings from self-employment. The remaining $7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than $7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.
>
> *Example (2). Executrix who receives a special fee for handling the estate's business*. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, $5,125 (based upon a percentage of the value of the assets distributed) and $500, in addition, for the operation of the drugstore. Under these circumstances, only the $500 commission for the operation of the drugstore constitutes earnings from self-employment. The $5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.
>
> *Example (3). Coexecutor who does not participate in the operation of the estate's business*. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D, who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings

did not object when a trust formed its own LLC (disregarded for income tax purposes) to manage the business, which LLC reported on Forms W-2 (instead of Form 1099-MISC) compensation that the LLC paid the trustees.[3058]

Does changing the individual's participation from being a direct employee to serving as a trustee affect that person's material participation as an individual? No – although the IRS takes the position that work a trustee's work as an individual does not count as participation by the trust, work done as a trustee apparently counts towards the trustee's participation as an individual.[3059] Consider, however, any impact on employee benefits.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[3060] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[3061] and a QSST's mandatory income requirement does not do violence to the estate planning goals. However, the trustee's participation will become important again if the stock or business assets are sold.[3062] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity. See part II.D.1 Trust as a Business Entity.

However, if the beneficiaries did not create the trust, the trust will not be considered a business entity merely because the trustee engages in business operations.[3063]

> from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

[3058] *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The court did not mention this nuance, but the facts described somewhere in the petition, reply, and briefs mentioned that Forms W-2 were issued; see http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

[3059] See fn. 2781 in part II.K.1.a.ii Material Participation.

[3060] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[3061] Because a QSST is a grantor trust deemed owned by the beneficiary, the beneficiary's participation, not the trustee's, is what counts. See text accompanying fns. 2124-2125. Although normally participating in owner-type activities is required to avoid the passive loss rules, regulations governing the 3.8% tax do not mention this issue and therefore do not appear to impose that requirement for avoiding the 3.8% tax. See part II.K.1.a.v What Does Not Count as Participation. For more planning tips involving how to meet the participation requirements and qualify for an exclusion from the 3.8% tax, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[3062] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax. This is important only for net investment income tax purposes, as a complete disposition of a passive activity removes the passive loss restrictions for that activity. Code § 469(g).

[3063] I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The last major pre-1997 case, *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), *acq*. 1987-2 C.B. 1, held:

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules

Generally, income retains its character when flowing from a nongrantor trust to a beneficiary.[3064] Therefore, income's character as passive or nonpassive at the trust level also controls at the beneficiary's level.

In support of this, note that private letter rulings have held that passive rental income earned by a pooled income fund was passive income in the hands of its beneficiaries.[3065]

In grouping passive activities, a beneficiary's beneficial interest in a trust's ownership of an activity cannot be grouped; all grouping is done at the trust level.[3066]

Regarding applying the passive loss rules to the beneficiary's share of directly apportionable deductions (such as depreciation, depletion, and amortization), the IRS instructs taxpayers:[3067]

> Any directly apportionable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the estate or trust. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.

> We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)….
>
> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

[3064] See fn. 2133, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and fns. 2590-2591, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

[3065] Letter Rulings 200608002 and 200608003 held:

> … the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Letter Ruling 8806065 took a similar position.

[3066] See fn. 2864.

[3067] 2013 Form 1041 Instructions, page 38, explaining how to prepare line 9 of Schedule K-1 issued to the beneficiaries. The instructions also refer to depletion and amortization. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

> To assist the beneficiary in figuring any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of directly apportionable deductions derived from each trade or business, rental real estate, and other rental activity.

However, some commentators suggest that depreciation deductions flow through to the beneficiaries separately only to the extent allowed after applying the passive loss rules at the trust level.[3068] The best reconciliation I can come up with is the following example: Suppose the trust has $100 rental income before depreciation and $60 depreciation, for $40 net income; therefore, the depreciation is fully deductible under the passive loss rules applied at the trust level. The rental income and depreciation deductions are separately stated on the trust's K-1s to beneficiaries.

On the other hand, a source that CPAs often use for tax preparation states:[3069]

> When net passive income less depreciation results in a net passive loss, a PAL limitation applies at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary and the depreciation allocated to the trust exceeds the passive income, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level if the allocated depreciation exceeds the income at both the trust and beneficiary levels.

It appears that more than one approach might be defensible. Consider the strategic consequences:

- If the beneficiary can deduct the depreciation currently, then separately applying the passive loss rules based on the beneficiary's participation seems beneficial. However, if the deduction does not offset net investment income, query whether it would have been better to deferred the deduction until it can be deducted against NII.

- If the beneficiary cannot deduct the depreciation currently, consider the effect of suspending the passive losses. When can one credit the beneficiary for a disposition of the passive activity, freeing that activity's losses from suspension?[3070] If the trust sells the asset, incurs gain because depreciation reduced the trust's basis in the property, and the gain is trapped inside the trust, then the depreciation deductions (suspended or not) do not offset the gain.[3071]

[3068] Sutton & Howell-Smith, ¶ 15.03 Application of Passive Loss Limitations at the Entity Level, *Federal Income Taxation of Passive Activities* (WG&L) (referring to the position the AICPA took in the late 1980s); Schmolka, "Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)," *N.Y.U. Tax Law Review*, vol. 58, p. 191 (2005).

[3069] Key Issue 7E: Reporting Passive Activity Information to a Beneficiary, *1041 Deskbook* (PPC) (2015). See also Key Issue 7D: Passive Loss Limitations Generally Determined at the Entity Level, *1041 Deskbook* (PPC) (2015).

[3070] Code § 469(g). For more about Code § 469(g), see fn. 2772.

[3071] For further discussion of mismatches along these lines, see Abbin (WTAS), § 811 Real Estate Investment Passive Activity Concerns, *Income Taxation of Fiduciaries and Beneficiaries* (2013), arguing

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules

Electing small business trusts have a special tax regime that divides the trust into a grantor trust portion, a nongrantor trust S corporation portion, and a nongrantor trust non-S corporation portion.[3072]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[3073] allow an individual and a C corporation that the individual owns to combine their participation even though they are separate taxpayers.[3074]

Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purpose other than administratively,[3075] they would not aggregate their income and loss in determining allowable passive losses and then disaggregate their income and loss in determining taxable income. Given uncertainty regarding how ESBTs treat net operating losses (NOLs),[3076] it's a good thing that this separate treatment applies.

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling

Because grantor trusts are ignored for income tax purposes,[3077] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[3078]

A grantor can count her work in a business for only that part of the year in which she is treated as owning an interest in the business.[3079] If, when grantor trust status terminates, she has not yet worked sufficient hours in the current year (and does not qualify for participation based on participation in prior years),[3080] then consider making sure she keeps at least some ownership in the business after turning off grantor trust status, so that she can count the hours she works later that year. If necessary, the trustee might divide the trust and leave a small portion of the trust as a grantor trust.

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Losses

If an interest in the activity is transferred by reason of the death of the taxpayer, losses generally are allowed to the extent such losses are greater than the excess (if any) of the basis of such

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that passive loss rules limit the extent to which a trust passes depreciation deductions to the beneficiaries.

[3072] See part III.A.3.e.ii.(b) ESBT Income Taxation.

[3073] See part II.K.1.b Grouping Activities.

[3074] Reg. § 1.469-4(a), (d)(5)(ii).

[3075] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 5650.

[3076] See fn. 5657.

[3077] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

[3078] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.

[3079] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[3080] See part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules, especially part II.K.1.a.ii Material Participation.

property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[3081] Let's turn this recitation of the Code's rule into common sense: Suspended losses reduce basis, but without the person incurring the losses receiving a benefit from that lost basis. If the owner disposes of the interest during life in a taxable disposition, the suspended losses are allowed, and the tax system has broken even. If the owner dies holding the interest, then the question is what it takes to get the basis restored on account of the suspended losses. To the extent that there is a basis step-up, the suspended losses have not caused a tax detriment, so those losses do not need to be taken to make up for lost basis; therefore, the losses are disallowed to that extent. However, if the suspended losses exceed the basis step-up, then the excess losses should be allowed.

The corollary is that losses are allowed on the decedent's final income tax return to the extent that the transferee does not receive a basis step-up at death, which would make beneficiary grantor trusts[3082] (including QSSTs),[3083] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[3084] That also might apply to irrevocable grantor trusts taxed to the settlor[3085] - "might" because the statute requires that the interest be "transferred by reason of the death of the taxpayer;" arguably the grantor's death would qualify, but for trust deemed owned by settlor legally the transfer to the trust preceded the deemed owner's death. So, in the latter case, the trust might consider selling the interest to an otherwise identical nongrantor trust – triggering the losses and increasing the basis – to make sure that the benefits of the losses offset their detriment (in that the losses reduced basis).

Code § 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to inject some fairness, added to the basis of the partnership interest.

Suppose an estate is terminating, using fractional pick-and-choose funding. At first, a Code § 469(j)(12) basis increase in the partnership interest might not appear to generate a Code § 743 basis step-up because, lacking a pecuniary aspect, there is no sale or exchange, and therefore the transfer is not "by sale or exchange or upon the death of a partner." Perhaps the termination of the estate might be attributed to the partner's death? This seems uncertain, however, because the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem. On the other hand, a trust's or estate's distribution of a partnership interest probably does trigger Code § 743 basis adjustments, so a Code § 743 adjustment seems to be available after all.[3086] For more thoughts on planning for Code § 469(j)(12) and evaluating its impact, see Sutton & Howell-Smith, ¶15.07. Treatment of Suspended Passive Losses Upon Distribution of Activity by an Estate or Trust, *Federal Income Taxation of Passive Activities* (WG&L).

[3081] Code § 469(g)(2), reproduced in part II.K.1.j Complete Disposition of Passive Activity.
[3082] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
[3083] See part III.A.3.e QSSTs and ESBTs.
[3084] FSA 200106018.
[3085] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[3086] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good

II.K.3.a. Why Being Passive Can Be Good

Particularly when significant business interests are passed to the next generation, being passive can have good results, if the business has a significant net loss.

Suppose the taxpayer has a relatively modest income, other than what the business generates. Deducting a net loss will offset income in the lower tax brackets. This is especially true if the loss is so large that it generates a net operating loss (NOL) carryover under Code § 172.[3087] Another concern is the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses.[3088]

However, in profitable years, the business income might be taxed in the highest tax bracket. The owner might save more taxes by offsetting the income in a later, high-tax-bracket year, than by deducting the loss in the lower tax brackets.

If and to the extent that the loss is passive and the taxpayer does not have passive income against which to offset it, the loss is suspended and carried forward.[3089] Thus, instead of offsetting income in lower brackets in the year in which the loss is generated, it offsets income in a later year that would otherwise push the taxpayer into a higher bracket.

Furthermore, after 2017 tax reform, NOLs may offset only up to 80% of taxable income,[3090] whereas suspended passive losses can offset 100% of any income from that activity or passive income from any other activity.

Being passive does cause income to constitute net investment income (NII)[3091] subject to the 3.8% tax on net investment income.[3092] However, for taxpayers who have income below the NII thresholds,[3093] that impact might be small or none. If the NII tax impact is significant, compare (a) the possible income tax savings if income and loss years tend to fluctuate significantly, to (b) the extra cost of NII tax; I am not suggesting that being passive will usually be better – merely that one should consider it when planning. Furthermore, suspended passive losses that offset passive income will also offset income that generally would otherwise be subject to the NII tax.

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year

One might increase planning flexibility in the planning described in part II.K.3.a Why Being Passive Can Be Good by engaging in significant participation (more than 100 hours)[3094] rather

[3087] See part II.G.4.l.iii Code § 172 Net Operating Loss Deduction.
[3088] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5657.
[3089] See the introduction to part II.K.1 Passive Loss Rules Generally.
[3090] See part II.G.4.l.iii Code § 172 Net Operating Loss Deduction.
[3091] See part II.I.8 Application of 3.8% Tax to Business Income.
[3092] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[3093] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[3094] See part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 2981-2984.

than material participation (more than 500 hours).[3095] If suspending the loss becomes important and one sees the loss coming (or perhaps is experiencing losses and expects them next year), one might cut back one's work.

Material participation might be difficult to impossible to turn off:

- One might have worked too many hours in the year before one realizes that being passive is desirable.

- One might have worked too many hours in a prior year to turn it off.

    - An individual is deemed to materially participate if the individual materially participated in the activity (determined without regard to this sentence) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.[3096]

    - An individual is deemed to materially participate if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.[3097]

Suppose an activity is passive when it generates losses and active when it generates income. The suspended passive losses offset active income from the same activity,[3098] and the active income avoids the 3.8% NII tax.[3099]

Furthermore:

- After 2017 tax reform, net operating losses (NOLs) offset only 80% of taxable income,[3100] whereas suspended passive losses can offset 100% of taxable income when released.

- Also see part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

If one is leaning toward using significant participation instead of material participation, consider:

- If the taxpayer stops working in the business and continues to generate business income, material participation may keep the income nonpassive for as long as five years (longer for some businesses) after the taxpayer stops working, whereas significant participation does not carry over like that. For material participation, see part II.K.1.a.ii Material Participation.[3101]

- Part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

[3095] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 2786) is usually what people consider, it is not the only way to materially participate.
[3096] See part II.K.1.a.ii Material Participation, especially fn. 2792.
[3097] See part II.K.1.a.ii Material Participation, especially fn. 2793.
[3098] See part II.K.1.k Former Passive Activities.
[3099] See part II.I.8 Application of 3.8% Tax to Business Income.
[3100] See part II.G.4.l.iii Code § 172 Net Operating Loss Deduction.
[3101] Especially fns 2792 (five years) and 2793 (three years in a personal service activity leads to permanent nonpassive status).

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

III.A.3.e.i.(a). QSSTs Generally

After determining a trust's eligibility for its beneficiary to make a "qualified subchapter S trust" (QSST) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. A beneficiary may make a protective QSST election.[5581]

A QSST may have only one beneficiary[5582] (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its income[5583] must be

[5581] See Reg. § 1.1361-1(k)(1), Example (2), part (iii), reproduced in the text accompanying fn 5526 in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

[5582] Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. § 1.1361-1(j)(2)(iv). On the other hand, Letter Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 5584 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 2418, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient. However, the Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting; for details on decanting by mere amendment, see fn. 2717, found in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 5589) confirms that result.

[5583] All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under

distributed currently to that beneficiary[5584] while the trust[5585] holds S stock.[5586] The income distribution rule is that all income either actually is distributed each year or is required to be

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Code § 1361(d)(3)(B) was not required to be distributed. Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2).

If the income may be used to discharge the beneficiary's parent's support obligation, actual (not mere potential) use for that purpose may ruin the trust's qualification. Reg. 1.1361-1(j)(2)(ii)(B), "Legal obligation to support," provides:

> If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See § 1.677(b)-1 for rules on the treatment of trusts for support and § 1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.

Reg. § 1.1361-1(j)(2)(ii)(C) provides an example illustrating Reg. 1.1361-1(j)(2)(ii)(B):

> *Example*. F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

However, if the distribution is caught within the first 2½ months of the year, consider converting the trust to an ESBT. See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

[5584] Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity, and Letter Rulings 8831020, 9001010, and 9140055 approved distributions to custodial accounts under the Uniform Transfers to Minors Act (the latter also approved distributions to "a court-appointed guardian or conservator of the beneficiary"). This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

[5585] In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate in the shares of stock to give rise to a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

distributed each year;[5587] inadvertent termination relief may be available if the income is not distributed and catch-up distributions are made.[5588] Special rules apply to an inter vivos QTIP or another trust for a spouse.[5589] If a QSST cases to meet any of the requirements of

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[5586] Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[5587] Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.i.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

[5588] Letter Ruling 201710001.

[5589] Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

> (i) *Transfers to QTIP trust.* On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.
>
> (ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.
>
> (iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 5496); therefore, when drafting a trust for a

Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day on which that requirement ceases to be met.[5590] If such a trust ceases to meet the income distribution requirement of Reg. § 1.1361-1(j)(1)(i), but continues to meet all of the requirements Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet that income distribution requirement. See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation[5591] and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

Reg. § 1.1361-1(k)(1), Example (4) illustrates the income distribution rule (before the number of shareholder limitation was increased from 75 to 100):

(i) *QSST when terms do not require current distribution of income*. Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently*. Assume the same facts as in paragraph (i) of this Example 4, except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus*. Assume the same facts as in paragraph (i) of this Example 4, except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as

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spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.h How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see fn. 5582.
Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. See part III.B.2.h.viii Code § 682 Limitations on Grantor Trust Treatment, the result of which is that, if distributions are made after separation, the trust no longer qualifies as a wholly owned grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made (but note that Code § 682 is being repealed by 2017 tax reform). For the interaction of divorce with Chapter 14, see parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and III.B.7.d Code § 2702 Overview, especially the text accompanying fns. 6863-6868.

[5590] Reg. § 1.1361-1(j)(5).

[5591] Especially fn 6379 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

Reg. § 1.1361-1(k)(1), Example (7) illustrates the effect of a remote possibility[5592] that principal may be distributed to someone other than the current income beneficiary and curing that defect:

> QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A)(ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of § 1.1001-2(c) of the regulations.

[5592] Using the latest mortality tables that had issued, on July 5, 2019 a 13-year-old had a 99.5% chance of reaching age 21. I don't know why Code § 673(a) was chosen, because the facts below do not appear to satisfy Code § 673(a), which provides that, subject to subsection (b) when the beneficiary is a minor descendant, "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."
See fn 5597, which reproduces the holding of Rev. Rul. 93-31 regarding a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[5593] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law[5594] or the governing instrument.[5595] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[5596]

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[5597] For example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the

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[5593] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

[5594] See part II.J.8.c.i.(a) Power to Adjust.

[5595] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 2532-2537 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[5596] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act. For form language that might facilitate this allocation, see fn. 2532, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[5597] Code § 1361(d)(3); see Letter Ruling 201119005, discussed in fn 5611 in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies. Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a.ii Separate Share Rule), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).

See the text accompanying fn 5592 for an example in the regulations about what happens when the remote possibility is cured.

trust.[5598] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion;[5599] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues. On a separate but related note, suppose a QSST holds investments (such as partnerships) that generate taxable income without necessarily generating trust accounting income. Can the nongrantor trust portion of the QSST take an income distribution deduction with respect to the distributions to the beneficiary of trust accounting income derived from S corporation? The QSST regulations[5600] do not address it, but the grantor trust regulations provide some support for my preliminary view that the nongrantor trust portion cannot get credit for those distributions.[5601]

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[5602] (although the trust still needs to get its own tax ID).[5603] However, when the

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[5598] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[5599] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[5600] Reg. § 1.1361-1(j).

[5601] Reg. § 1.671-3(a)(2) provides:

> If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

"Items" refers to "items of income, deduction, and credit against tax attributable to or included in that portion," so I can't say with absolute certainty what the answer is. However, I think that the "better" answer is that distributions from the trust of S corporation trust accounting income would be attributable to the grantor trust portion. This is consistent with the IRS' general approach in CCA 201327009, discussed in the text accompanying fns 5724-5726 in part III.A.3.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST.

[5602] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[5603] Reg. § 1.671-4(b)(6)(iii).

QSST sells the stock, the trust itself is taxable on any gain on the sale,[5604] including any gain the corporation incurs after adopting a plan of complete liquidation[5605] or from the deemed asset sale resulting from a Code § 338(h)(10) election.[5606] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[5607]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[5608]

See part II.A.2.d Estate Planning Strategies Available Only for S Corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[5609]

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[5610]

[5604] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[5605] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[5606] Letter Rulings 9828006, 199920007, and 201232003.

[5607] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.

[5608] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.

[5609] See part II.Q.7.c S corporations Owned by a Trust Benefitting Charity, especially the text accompanying fn. 4525.

[5610] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[5611]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[5612] at the trust's presumably higher income tax rates.[5613] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share[5614] of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[5615] drafting to address this issue would be advisable:

[5611] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2). Code § 1361(d)(2)(B)(ii) provides:

> Elections with respect to successive income beneficiaries. If there is an election under this paragraph with respect to any beneficiary, an election under this paragraph shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election.

Letter Ruling 201119005 held that, when the QSST beneficiary died, separate shares were created that qualified as QSSTs, without any QSST election needing to be affirmatively made wuith respect to the remaindermen, in the following scenario:

> Upon B's death, Trust's assets were divided into two shares. The income from one share is required to be paid to C and the income from the other share is required to be paid to D. During the life of each of C and D (the income beneficiaries), the income and principal from one beneficiary's share can only be paid to that income beneficiary. Neither income beneficiary has a claim against the income and principal of the other beneficiary's share. Since Date 4, the income from each share of Trust has been distributed to the income beneficiary of that share. Neither beneficiary has affirmatively refused to consent to the QSST election made for Trust on Date 3.

For separate share treatment for QSSTs, see fn 5597 in part III.A.3.e.i.(a) QSSTs Generally.

[5612] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

[5613] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.

[5614] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[5615] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[5616] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Income Tax Issues Regarding Bequeathing

[5616] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

S Corporation Stock and Partnership Interests, which addresses timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

III.A.3.e.ii. ESBTs

III.A.3.e.ii.(a). Qualification as an ESBT

After determining eligibility to make an electing small business trust (ESBT) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. Make sure the election correctly refers to the date shares were transferred to the trust that is selected as the effective date.[5617]

To qualify to make an ESBT election,[5618] the trust cannot have as a beneficiary any person other than an individual, an estate, a charity within certain definitions;[5619] if a potential current beneficiary of an ESBT is not an eligible shareholder of an S corporation, the S election terminates.[5620] "Beneficiary" includes a person who has a present, remainder, or reversionary interest in the trust.[5621] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a Code § 170(c)(2) or (3) organization.[5622] In all other situations, any person who has a beneficial interest in a "distributee trust" is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[5623] A "distributee trust" is a trust that receives or may

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[5617] Letter Ruling 201941006 granted inadvertent termination relief as of Date 3 in the following situation:

> On Date 2, Trust 1 acquired shares in A. Trust 1 qualified under § 1362(c)(2)(A)(v) as an eligible S corporation shareholder and timely filed an ESBT election effective Date 2. A represents that on Date 3, under the laws of State Trust 1 merged with and into Trust 2, with Trust 2 surviving. As a result of the merger, the shares of A owned by Trust 1 were transferred to Trust 2 as of Date 3.
>
> On Date 4, the trustee of Trust 2 filed an election under § 1362(c)(2)(A)(v) to be treated as an ESBT effective Date 5. The ESBT election incorrectly stated that the shares of A owned by Trust 1 prior to the merger were transferred to Trust 2 on Date 5, when the shares were actually transferred on Date 3. A represents that Trust 2 intended the ESBT election to be effective as of Date 3. As a result, A's S corporation election terminated on Date 3 because Trust 2 was an ineligible shareholder.

See parts II.J.18.b Trust Mergers and II.J.18.c Decanting, the latter being relevant because a decanting may be a trust merger treated as a mere continuation of the original trust.

[5618] Code § 1361(e)(1)(A)(iii) authorizes the election.

[5619] Code § 1361(e)(1)(A)(i). Permitted charities include an organization described in Code § 170(c)(2), (3), (4), or (5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a Code § 170(c)(1) organization. As described in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, 2017 tax reform allowed a nonresident alien (NRA) to be a beneficiary. In exchange, any part of the trust that the NRA is deemed to own is taxed as a nongrantor S portion; see fns 148-149.

[5620] Reg. § 1.1361-1(m)(5)(iii), which provides further:

> For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

[5621] Reg. § 1.1361-1(m)(1)(ii)(A).

[5622] Reg. § 1.1361-1(m)(1)(ii)(B).

[5623] Reg. § 1.1361-1(m)(1)(ii)(B).

receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[5624]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary ("PCB") of the ESBT portion.[5625] Generally, a PCB is any person who at any time during the taxable year is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust;[5626] the deemed owner of a grantor trust is also a PCB.[5627] A potential trap applies when an ESBT terminates in favor of trusts (the "downstream trusts"). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[5628] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[5629] A trust that is not yet funded not currently a distributee trust.[5630]

[5624] Reg. § 1.1361-1(m)(1)(ii)(B).

[5625] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.

[5626] Code § 1361(e)(2). Reg. § 1.1361-1(m)(4)(i) provides:

> *Generally*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust. An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

Reg. § 1.1361-1(m)(4)(iii) further provides:

> *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

Reg. § 1.1361-1(m)(4)(v) also provides:

> *Contingent distributions*. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

For the effect of a power of appointment, see fn 5641.

[5627] Reg. § 1.1361-1(m)(4)(ii) provides:

> *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

[5628] Reg. § 1.1361-1(m)(4)(iv)(A).

[5629] Reg. § 1.1361-1(m)(4)(iv)(A).

(2) If the distributee trust qualifies a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the persons who would be its PCBs if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[5631] However, if the distributee trust is a former grantor trust[5632] or is a testamentary trust,[5633] in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[5634]

(3) If the distributee trust is not a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[5635] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[5636] and the distributee trust's

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[5630] Reg. § 1.1361-1(m)(4)(iv)(A). Letter Rulings 200816012 and 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a non-resident alien is not permitted to be a PCB of an ESBT under the Code and Regs. (I do not know why the rulings cited Reg. § 1.1361-1(m)(4)(iv) instead of Reg. § 1.1361-1(m)(4)(v). I wonder whether that is a typo.) However, starting in 2018, a nonresident alien may be a beneficiary of an ESBT. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fns 146-136.

[5631] Reg. § 1.1361-1(m)(4)(iv)(C).

[5632] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

[5633] See part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.

[5634] Reg. § 1.1361-1(m)(4)(iv)(C).

[5635] Reg. § 1.1361-1(m)(4)(iv)(B).

[5636] Reg. § 1.1361-1(m)(4)(iv)(D) provides:

> For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

Letter Ruling 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

Reg. § 1.1361-1(m)(8)(vi), Example 6, provides:

> (A) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).
>
> (B) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.
>
> (C) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in Example 6 in paragraph (m)(8)(vi)(A) of this section except that Trust-2 is a trust treated as

PCBs would count as PCBs of the trust that does hold the S stock.[5637] Another option is for the main trust to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[5638]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[5639]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period,[5640] and the regulations now reflect this change.[5641] If

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owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

[5637] Reg. § 1.1361-1(m)(4)(iv)(B) provides:

If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

See Reg. § 1.1361-1(m)(8)(vi), Example 6, reproduced in fn. 5636.

[5638] Reg. § 1.1361-1(m)(8)(v), Example 5, provides:

Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

[5639] Code § 1361(c)(2)(B)(v).

[5640] Code § 1361(e)(2).

[5641] Reg. § 1.1361-1(m)(4)(vi)(A) provides:

(A) *Powers of appointment*. A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ``general power of appointment'' for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible

a distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation shareholders;[5642] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[5643]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[5644] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[5645]

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to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ``power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of "power of appointment" for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment*. If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

[5642] Reg. § 1.1361-1(m)(4)(iv)(B).

[5643] Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

[5644] Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election, *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015).

Letter Ruling 201834007 ruled:

A is causing A's grantor trust to transfer the shares of X stock to the Trust pursuant to the divorce Decree, and the amount of the liabilities assumed plus the liabilities that the property transferred is subject to does not exceed the adjusted basis of the property transferred.

Accordingly, based on the facts submitted and representations made, provided that the transfer of the shares of X stock to the Trust occurs within six years of the entry of final judgment and the terms of the Trust as executed by A and B remain materially identical to those submitted, we conclude that § 1041(a) applies and A and B will not recognize any gain or loss on the transfer of the shares of X stock from A's grantor trust to the Trust.

Further, § 1041(b) applies such that the transfer is treated as a gift under § 1041(b). As such, B's acquisition of B's lifetime distribution rights in the Trust for consideration is not a purchase within § 1361(e) because the sale is not governed by § 1012(a). Accordingly, B's acquisition of B's distribution rights will not disqualify Trust from being an ESBT.

Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.

If an ESBT transfers stock to a qualified voting trust,[5646] the ESBT continues to be treated as the owner for purposes of reporting income and the current beneficiaries of the ESBT continue to be treated as the shareholders for purposes of determining whether the corporation remains eligible to be taxed as an S corporation.[5647]

A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT, and the last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.[5648] A trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock; but, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation,

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> ....
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

[5645] Reg. § 1.1361-1(m)(1)(iii) provides:

> *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

T.D. 8994 (5/13/2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines purchase as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[5646] See part III.A.3.b.iv A Trust Created Primarily to Exercise the Voting Power of Stock Transferred to It.

[5647] Letter Ruling 201837012.

[5648] Reg. § 1.1361-1(m)(5)(i).

the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.[5649]

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of subtitle A of the Code.[5650] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[5651] The grantor trust rules trump this treatment;[5652] but, to the extent a nonresident alien is a deemed owner, that portion is reallocated to the nongrantor S portion.[5653] However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[5654]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[5655] Very few deductions are allowed against this income, and the income distribution deduction is not available;[5656] the IRS has taken the position that net operating losses (NOLs) are not allowable deductions,[5657] but capital loss carryforwards appear to be allowable.[5658]

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[5659] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[5660] Note that the $10,000 limit on state income tax

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[5649] Reg. § 1.1361-1(m)(5)(ii).
[5650] Code § 641(c); Reg. § 1.641(c)-1(a).
[5651] Reg. § 1.641(c)-1(a).
[5652] Reg. § 1.641(c)-1(a).
[5653] See fns 148-149 in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
[5654] Reg. § 1.641(c)-1(a).
[5655] Code § 641(c)(1); Reg. § 1.641(c)-1(e).
[5656] Code § 641(c)(2).
[5657] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).
Making a Code § 645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, since estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under Code § 1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii) if a Code § 645 election is in place and therefore can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a Code § 645 election.
See also the text accompanying fn. 5666 for how to avoid the ESBT generating an NOL when it has significant losses from its S corporation stock; this generally requires advance planning.
[5658] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.
[5659] Reg. § 1.641(c)-1(d)(4)(i), which is specifically authorized by Code § 641(c)(2)(C)(iii).
[5660] Reg. § 1.641(c)-1(h).

deductions[5661] would apply separately to the S portion and the non-S portion,[5662] allowing the trust to deduct up to $20,000 in state income tax.

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction. The charitable deduction applies only the charitable contributions passing through a K-1 from the S corporation to the trust and not to contributions made by the trust.[5663] Effective for tax years beginning after December 31, 2017, an ESBT's contribution deduction does not apply Code § 642(c) but rather uses the Code § 170 limits based on the rules that apply to individuals,[5664] which means that the charitable deduction generally is based on the fair market of property donated, in contrast to the Code § 642(c) deduction being limited to the property's adjusted basis.[5665] For other differences between Code §§ 170 and 642(c), see part II.J.4.c Charitable Distributions.

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules. In light of the IRS' position on NOLs for ESBTs,[5666] consider whether the trustee should be passive, as discussed in part II.K.3 NOL vs.

5661 For the $10,000 limit, see the text accompanying fn 2306 in part II.J.3.d Who Benefits Most from Deductions. Because Reg. § 1.641(c)-1(d)(4)(i).says that these taxes are "taken into account," rather than "deducted," the regulation does not appear to provide an independent basis for a deduction.

5662 See fns 5650-5651 in this part III.A.3.e.ii.(b).

5663 The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

Code § 512(e)(1)(B)(i) provides all S corporation K-1 income is per se unrelated business income, so Code § 681 and Reg. § 1.681(a)-2(a) would apply the individual contribution limits, rather than the unlimited Code § 642(c), to such deductions. For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

5664 Code § 641(c)(2)(E) provides:

> (i) Section 642(c) shall not apply.
> (ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

The Senate report adopting this rule said:

> The Senate amendment provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

5665 See fn 4509 in part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income.

5666 See fn. 5657.

Suspended Passive Loss - Being Passive Can Be Good (and note that an ESBT avoiding NOLs might be at the cost of incurring the 3.8% tax on net investment income).[5667]

Regarding the Code § 199A deduction, which generally is 20% of qualified business income, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction, especially part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[5668]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or

- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the ESBT into two separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

[5667] See part II.I 3.8% Tax on Excess Net Investment Income (NII), especially parts II.I.8 Application of 3.8% Tax to Business Income and II.J.14 Application of 3.8% NII Tax to ESBTs.
[5668] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 2658-2659.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust rules,[5669] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[5670]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[5671] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[5672] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[5673] A QSST's income is not subject to the 3.8% NII tax if the beneficiary is active in the business[5674] or has income below the threshold;[5675] however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[5676] Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[5677] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[5678] If the trustee of an irrevocable grantor trust makes an

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[5669] Code §§ 2056(b)(1) and 2523(b).
[5670] Code § 651.
[5671] Code § 1(e)(2).
[5672] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 2675 (which also refers to an example in the proposed regulations) and the accompanying text.
[5673] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[5674] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 2124.
[5675] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[5676] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[5677] See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 2267-2268.
[5678] See text accompanying fns. 5610-5611.

ESBT election as a protective measure,[5679] the trust's ESBT taxation continues after death,[5680] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[5681]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).[5682] For inside basis step-up opportunities,[5683] see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[5684]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[5685] A better solution is a trust taxable to its beneficiary under Code § 678.[5686] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[5687]

[5679] A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c). T.D. 8994 (5/13/2002) includes the government's response to the idea that a protective ESBT election should be available:

> One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

[5680] Reg. § 1.1361-1(m)(8)(iv), Example 4.

[5681] part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 5655-5658 for ESBT taxation.

[5682] For a comparison of ESBTs and QSSTs, see text accompanying fn. 4647.

[5683] Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations explains such issues.

[5684] See part II.H.8.a.ii State Income Tax Disconnect.

[5685] Reg. § 1.641(c)-1(d)(4)(ii) provides, (ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).

[5686] See fn 5481.

[5687] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.

III.A.3.e.iv. Flexible Trust Design When Holding S Corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[5688] But for this process, Reg. § 1.1361-1(m)(6) provides:

  > An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[5689]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[5690] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

In making these elections, consider part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

[5688] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[5689] See fn. 5587.
[5690] Letter Ruling 201122003.

Note that toggling only affects whether income distributions to that beneficiary may or must be mandatory or discretionary; the beneficiary must remain the trust's sole beneficiary of income[5691] and principal[5692] during the beneficiary's life.[5693] Thus, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[5694] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[5695]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[5696] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[5697] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets.[5698] If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[5699] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[5700]

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[5701]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Every dollar of ESBT income is taxed at 37% federal income tax and 3.8% tax on net investment income ("NII").[5702] The beneficiaries' federal income tax brackets might be

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[5691] Code § 1361(d)(3)(A)(i).
[5692] Code § 1361(d)(3)(A)(ii).
[5693] Rev. Rul. 93-31 provides that even a remote possibility of these conditions not being met would disqualify the trust from being a QSST. See fn 5597 in part III.A.3.e.i.(a) QSSTs Generally.
[5694] See text accompanying fns. 5640-5641.
[5695] See fm. 5582.
[5696] See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[5697] See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 2124 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).
[5698] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[5699] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[5700] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.
[5701] See text accompanying fn. 5678.
[5702] See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% NII Tax to ESBTs.

significantly lower,[5703] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[5704]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[5705] in taxable income, so the accumulation strategy would have additional income tax costs.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

[5703] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.
[5704] Reg. § 1.67-2T(b)(1).
[5705] $12,750 in 2019 per Rev. Proc. 2018-57, § 3.01, Table 5; presumably higher in future years.

- If centralized management is a concern:

  - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[5706] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

  - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[5707] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[5708] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[5709]

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[5710]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

[5706] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).

[5707] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 5604-5606, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.

[5708] Section 501 of the Uniform Principal & Income Act.

[5709] See text accompanying fn. 5704 and Code § 1366(a)(1)(A).

[5710] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.
- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.
- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.
- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[5711] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[5712]
- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[5713] A sale to an irrevocable grantor trust is a powerful estate planning technique.[5714] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.[5715]

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[5716]

Beneficiary grantor trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[5717] might at some point take a position inconsistent with its many past favorable private

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[5711] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse any individual who was the spouse of the grantor at the time of the creation of such power or interest. Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income is paid, credited, or required to be distributed and therefore taxed to the former spouse.

[5712] See fn. 5589, noting the contrast between paragraphs (ii) and (iii) within Example (10).

[5713] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

[5714] See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[5715] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

[5716] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

[5717] Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of

letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[5718]

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's selling or distributing the stock is attributable to the trust, not the beneficiary,[5719] but does not discuss the consequences of the trust buying S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[5720] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is buying stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[5721]

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appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

[5718] Code § 1361(d)(1)(B) provides, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made.

[5719] For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 5604-5606.

[5720] T.D. 8600.

[5721] This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 6097.

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[5722]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[5723] The IRS has taken the position that, when the QSST buys stock from a

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The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned:

> A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13, reproduced in fn 3957 in part II.Q.4.b.i Transfer for Value Rule Generally, reaffirmed this concept, and it should be applied to the sale to a QSST as well.

[5722] Letter Rulings 200441013, 200441014, and 200441015.

[5723] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 5685 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.

Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income. Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book

third party using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore is deductible by the beneficiary.[5724] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[5725]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[5726]

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

- Inability to Divide S corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[5727] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[5728] Thus, distributing marketable securities to family members so that they go their

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> value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

[5724] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[5725] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering interest expense and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

[5726] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

[5727] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.

[5728] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[5729]

However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[5730] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[5731] or a sale of stock combined with a Code § 338(h)(10) election;[5732] either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[5733]

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[5734]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that the beneficiary's failure to compel the trustee to compel a distribution from the S corporation constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions, so the IRS should view any distributions within than range as sufficient.[5735] If distributions were below this range, the IRS would argue that the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e) that appears to protect such a small lapse is calculated in a way that does not provide much protection.[5736]

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

[5729] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[5730] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[5731] See fn. 5605, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 4458, found within part II.Q.7.a.vii Corporate Liquidation.
[5732] See fn. 5606, found within part III.A.3.e.i.(a) QSSTs Generally.
[5733] In addition to the citations within fns. 5731 and 5732, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[5734] Reg. § 1.1361-1(j)(8); see fns. 5604-5606.
[5735] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 2531.
[5736] See fn 2406 in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

Consider who pays income tax for the year in which the beneficiary dies.[5737] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death.[5738] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[5739] Furthermore, the partnership could later divide in a variety of ways on a tax-free basis,[5740] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[5741]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

See also parts II.A.2.d.ii Estate Planning and Income Tax Disadvantages of S Corporations, II.A.2.d.iii Which Type of Entity for Which Situation? and III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

[5737] See part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

[5738] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 4680.

[5739] Distributing in stages would tend to alleviate the concerns described in fn 4680.

[5740] See part II.Q.8 Exiting From or Dividing a Partnership.

[5741] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[5742] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to pay to the beneficiary.[5743] Private letter rulings have readily accepted this theory for mandatory income trusts;[5744] this theory should apply to a discretionary income trust.[5745]

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note (as used in this part III.A.3.e.vi.(c), the "adjustment amount").[5746] Thus, although note payments complete the sale (the obligation

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[5742] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

[5743] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[5744] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs. CCA 201327009 did not expressly consider this issue; however, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[5745] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[5746] See fn. 5743.

to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary:

- Worst Case Scenario – Simplistic view. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the adjustment amount to the beneficiary are fully paid. However, if the adjustment amount is not expected to paid made for a while, consider that the possible inclusion of the adjustment amount in the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed.

- Actual Law – Not So Bad? The trust's obligation is to transfer to income principal equal to the adjustment amount. This means that, when the trust receives cash generally classified as principal, it must reclassify that cash as income, to the extent of the adjustment amount. That principal receipt might never happen during the beneficiary's life, and the trust might never be required to pay the beneficiary.

Consider the following ways to repay this additional obligation, if it exists:

1. Suppose the trust is a discretionary income trust. Perhaps an independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[5747] but might be possible using a *Clayton*-QTIP plan).[5748] After the note is repaid, the independent trustee might turn off the mandatory income obligation. If the beneficiary never needs the income under the standards provided by the trust, the trust might accumulate funds thereafter and never pay cash equal to the full adjustment amount. However, the IRS might argue that such a modification undermines the point of recharacterizing the principal as income,[5749] so consider a compromise: Instead of the trustee accumulating income under the discretionary standards and perhaps never paying the adjustment amount, the trustee and beneficiary come to the following agreement: The trustee agrees to pay future income to the beneficiary to the extent of the adjustment amount, notwithstanding the fact that the trustee has determined that the beneficiary would not receive income under the trust's new distribution standards. That income is payable until the earlier of the beneficiary's death or amounts equal to the adjustment amount have been paid. The trustee might sign a revocable letter directing the company to pay the beneficiary directly any distributions of income (up to the adjustment amount) that normally would have gone to the trust.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested

[5747] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[5748] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 5764.
[5749] Reg. § 1.643(b)-1 provides, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially the text accompanying fn. 2530.

S corporation taxable income).[5750] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[5751] or being used to determine a distribution[5752] should cause the capital gain to be taxed to the beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements between principal and income?[5753] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows: The IRS might argue that stock's value exceeded the sale price; therefore, the IRS might argue, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion. One might consider using a defined value clause,[5754] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right) or a sale. With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift portions.[5755] The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[5756] would make a QSST election unnecessary during the seller's life.

Such a possible Code § 2036 attack may deter using this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[5757] However, if one has an operating business in an S corporation, a preferred partnership is not available[5758] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[5759]

[5750] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[5751] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law.
[5752] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[5753] For flexibility in allocating between income and principal, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
[5754] See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[5755] See part III.B.4 Adequate Disclosure on Gift Tax Returns.
[5756] Code § 677.
[5757] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[5758] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.
[5759] If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[5760] who could make a distribution for welfare and then resign.

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[5761] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[5762] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[5763] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[5764]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Grantor Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

[5760] As fn. 6257 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 2334).

[5761] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.

[5762] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.

[5763] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.

[5764] See fn. 5748.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary grantor trust.[5765] However, in either case, be sure to consider exit strategies upon the client's death, as described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.

[5765] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.