BESSEMER TRUST

ACTEC 2016 Summer Meeting Musings (Including Fiduciary Income Tax "Bootcamp")

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This summary reflects the individual observations of Steve Akers from the seminars at the 2016 Summer Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Introduction

Some of my observations from the 2016 ACTEC Summer Meeting Seminars in Boston, Massachusetts on June 16-18, 2016 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-32 come from the "Stand Alone" program titled "Boot Camp on Fiduciary Income Tax." Items 33-69 come from a seminar titled—"The Hats ACTEC Fellows Now Wear and May Wear in the Future."

Items 1-27 are observations from comments by George L. Cushing, Gregory V. Gadarian, David A. Handler, Prof. Jeffrey N. Pennell, and Melissa J. Willms about fiduciary income tax and estate administration issues. The written materials include a 230 page outstanding technical resource, Chapter 5 of CASNER & PENNELL, ESTATE PLANNING.

1. Overview of Taxation of Trusts

a. **Subchapter J**. Subchapter J is divided into five subparts: (A) General rules and definitions; (B) simple trust rules (these can largely be ignored because the rules that apply to simple trusts are also in subpart (C), but the regulations under subpart (B) are important because some of those provisions are adopted for purposes of subpart (C), *e.g.*, Treas. Reg. §1.662(b)-1); (C) complex trust rules; (D) throwback rules (which are now irrelevant except for foreign trusts); and (E) grantor trust rules.

The general approach of Subchapter J historically was to punish taxpayers. A concern existed that multiple trusts were being used to create separate taxpayers to take advantage of the bottom tax brackets. The rules are crafted generally to push income out to the settlor of a grantor trust and to beneficiaries of a nongrantor trust. Because of the ultra-compressed tax brackets for trusts that now exist (a trust or estate reaches the maximum tax bracket at a mere $12,400 of income in 2016), these rules are now generally favorable to taxpayers by causing much of the trust income to be taxed at beneficiaries' or the grantor's individual rates.

b. **Brief Overview Summary of Taxation of Nongrantor Trusts**. The taxation of trusts is sometimes referred to as conduit taxation (somewhat like for partnerships or Sub S corporations) but that is not entirely true. Flow-through income results from trust distributions and is not automatic.

Any distribution from an estate, whether of income or principal, will generally "carry out" the income of the estate to the beneficiary to the extent of the estate's distributable net income (DNI). §661 (deduction to estate); §662 (income to beneficiary). DNI is the taxable income of the estate with certain modifications. §643(a). If the distributions exceed the amount of DNI, the DNI is carried out proportionately to the beneficiaries who receive distributions (under "tier" rules, the income is allocated proportionally to the recipients of mandatory income distributions,

and then allocated to charitable beneficiaries, and then to non-charitable beneficiaries receiving discretionary distributions). The character of income in DNI (ordinary dividends, qualified dividends, tax exempt income, etc.) is also carried out proportionately.

Important timing differences can exist for estates (and for trusts that make the election under §645 to be taxed as part of the estate). Unlike for individuals, trusts and some other entities, estates may have a taxable year separate from the calendar year. For example, this can result in a delay of when income tax must be paid on estate income that is taxed to a beneficiary.

c. **Brief Overview Summary of Taxation of Grantor Trusts**. The income and deductions of grantor trusts are generally reported directly to the settlor of the trust (or the deemed owner of a trust subject to §678).

d. **Types of Trusts and Entities Subject to Trust Taxation**. Trusts and estates generally are subject to the fiduciary income tax rules for trusts under Subchapter J. But that is not always the case.

- A trust may sometimes be regarded as an association taxable as a partnership or corporation. Factors in determining whether beneficiaries will be considered as associates in a joint enterprise for profit are: (1) whether the trust relationship was created by or continues as a result of volitional activity of the beneficiaries; (2) whether the beneficiaries, as beneficiaries, influence the management activities of the trust; and (3) whether the interests of the beneficiaries are freely transferable. *See* PLR 8842043.
- Bankruptcy estates are not taxable under Subchapter J.
- Custodianships and guardianships typically are ignored for income tax purposes, and the income is taxed directly to the ward.
- Entities for which administration has been improperly prolonged are disregarded.

e. **Audit Frequency**. From a brief hand-survey of the audience, only about 10 participants have ever participated in a trust income tax audit. The IRS will be careful about unbundling expenses under §67, but other than that, there is no sense that the IRS is auditing trusts.

f. **"Income" in Subchapter J Generally Means Fiduciary Accounting Income**. For most purposes, the term "income" (when not modified by some other term, such as gross, taxable, or distributable net) means fiduciary accounting income as determined under state law. §643(b). However, the term "income" means taxable income for grantor trust purposes. Treas. Reg. §1.671-2(b) (penultimate sentence).

2. Simple Trusts vs. Complex Trusts

a. **Distinguishing Simple and Complex Trusts**. A simple trust must satisfy three requirements: (1) the trust must require that all fiduciary accounting income be distributed; (2) the trust does not provide for any charitable distributions or set asides; and (3) during the current year, the trust makes no distribution of corpus. Otherwise, the trust is a complex trust. A trust can be a simple trust in some years and a complex

trust in other years; for example, a trust that would otherwise be a simple trust will be a complex trust in any year in which it makes a corpus distribution.

To satisfy having a mandatory income requirement, the trust does not have to identify the beneficiary receiving the income. Furthermore, there is an anti-tracing rule; the trustee must merely be required to distribute the *amount* of the fiduciary accounting income, not the actual dollars constituting the fiduciary accounting income.

b. **Effects of Simple vs. Complex Trust Treatment**. Whether a trust is a simple or complex trust makes very little difference. The income is taxed to beneficiaries regardless of whether it is actually distributed, but that rule applies both to simple trust and to complex trusts that have a mandatory income requirement. As a practical matter, the most important reason for knowing whether a trust is a simple or complex trust is that a box must be checked at the beginning of Film 1041 indicating whether the trust is a simple or complex trust.

Only two differences exist in the treatment of simple and complex trusts. (1) The deduction (in lieu of a personal exemption) is $300 annually for any trust that is required to distribute all of its income currently and $100 annually for all other trusts. Therefore, the $300 deduction applies to all simple trusts, but also applies to complex trusts that mandate the current distribution of all income. (2) A technical difference is that taxable extraordinary or stock-on-stock dividends that are allocated to corpus under the instrument or local law and are not currently distributed are excluded from DNI for simple trusts but not for complex trusts, §643(a)(4).

3. Taxable Income

As for individuals and other entities, a trust's taxable income is its gross income less deductions. One of the special deductions for a trust is the "income distribution deduction" (available up to the amount of the trust's distributable net income, or DNI).

Some of the differences in determining a trust's taxable income, as compared to an individual's taxable income, are as follows.

- A trust or estate has a deduction in lieu of a personal exemption ($600 for estates, $300 for trusts required to distribute all income, and $100 for other trusts). This deduction is not subject to the phase-out rules that apply to an individual's personal exemption under §151(d)(3).
- The 2% floor on miscellaneous itemized deductions under §67 applies to trusts and estates only with respect to "costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate." §67(e). This has resulted in a tortured litigation history, culminating in the Supreme Court *Knight* case and the issuance of detailed regulations. (See Item 27.)
- Different charitable deduction rules apply for trusts and estates; there are no percentage limitations, a deduction is allowed only for amounts of gross income distributed to charity (§642(c)(1)), and a "set-aside" deduction is allowed for amounts of gross income that are permanently set aside for charity even though the income has not actually been distributed to charity during the current taxable year (§642(c)(2)).

- Special rules apply to S Corporation income for electing small business trusts (ESBTs).
- Certain items claimed as administrative expense deductions on the federal estate tax return cannot also be deducted on the estate's income tax return. §213(c). Most estate administration expenses can be deducted on either the estate income tax return or the estate tax return, but not both returns. (See Item 26.)
- The credit for foreign taxes is allocated among the entity and its beneficiaries, and the credit for political contributions is denied entirely. §642(a).

4. Distributable Net Income (DNI)

a. **Function and Role**. DNI places a limit on the amount of the distributions deduction and on the amount and character of the current income that is attributed to the income beneficiaries.

b. **Computation**. The DNI of a trust or estate is its taxable income, with several modifications.

- The distribution deduction is not allowed. §643(a).
- The deduction in lieu of the personal exemption is not allowed. (In effect, the amount of the deduction is added back to the amount of the trust's taxable income in determining DNI, which increases the amount of income taxable to beneficiaries. Individual beneficiaries do not get the benefit of the trust deduction in lieu of the personal exemption, because the individuals have their own personal exemptions.)
- For simple trusts (but not complex trusts), exclude extraordinary dividends or taxable stock dividends that are allocable to corpus. §643(a)(4).
- Add back the amount of any tax-exempt interest, reduced by any expenses directly associated with tax-exempt income, and reduced by a proportionate part of any indirect expenses (apportioned between tax-exempt and taxable income). §643(a)(5). In effect, this tax-favored income passes through to the beneficiaries as tax-exempt income of the beneficiaries, and any disallowance rules (for example for expenses and interest relating to tax-exempt income that are limited under §265) are applied at the beneficiary level.
- Capital gains are generally excluded. See Item 5 below for a more detailed discussion of the rules regarding capital gains in DNI.

c. **Fiduciary Accounting Income, Taxable Income and DNI**. Fiduciary accounting income, taxable income, and DNI for a year may all be different, and they may be higher or lower than the others, depending on the circumstances.

Fiduciary accounting income could exceed taxable income if deductible expenses were paid from corpus or due to the deduction in lieu of the personal exemption, but fiduciary accounting income could be less than taxable income if taxable items were allocated to corpus, such as net capital gains or certain dividends. Similarly, taxable income could exceed DNI because the distributions deduction is ignored or because net capital gains or taxable dividends are allocated to corpus and excluded in computing DNI, but taxable income could be less than DNI due to tax-exempt interest or the deduction in lieu of the personal exemption, all of which being considered in computing taxable

income but not in determining DNI. Finally, there need be no correlation between fiduciary and accounting income and DNI. [In accompanying footnote: For example, DNI could include taxable income that is not includable in fiduciary accounting income (such as the phantom income generated by discharge of indebtedness attributable to the running of an estate's non-claim statute).] CASNER & PENNELL, ESTATE PLANNING §5.3.4.

5. Capital Gains in DNI

a. **General Rule and Regulatory Exceptions**. Capital gains ordinarily are excluded from DNI (so that capital gains are ordinarily taxed at the estate or trust level). Treas. Reg. §1.643(a)-3(a). However, the regulations provide that capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "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.

Treas. Reg. §1.643(a)-3(b).

Planning possibilities using each of these three exceptions are summarized below.

b. **Exception (1)—Capital Gains Allocated to Income.** One type of capital gains is automatically included in fiduciary accounting income: short-term capital gains generated from mutual funds (see the discussion below quoting Comments to §401 of the Uniform Principal and Income Act). In addition, the proceeds of any sale or exchange may be allocated to income to compensate for the delayed sale of an unproductive or underproductive asset. Uniform Principal and Income Act (1997 Act) §413.

Consider providing in the trust instrument that capital gains are allocated to income (but do not do this for mandatory income trusts—so that the capital gains would not necessarily have to be distributed annually). A few state statutes give this discretion to trustees explicitly (for example, Alaska, Delaware, Kentucky, and Nevada; New York is considering such a statutory provision).

- Consider providing in the trust instrument that the trustee has the *discretion* to allocate capital gains to income; **there is no consistency requirement in Treas. Reg. §1.643(a)-3(a)(1) regarding allocating capital gains to income,** so the trustee could exercise its discretion each year whether to allocate capital gains to income. *See* Reg. §1.643(b)-1 ("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"). Interestingly, the proposed regulation did include the word "consistent," but that was deleted from the final regulation.

- Distributions from flow-through entities are typically treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. Under UPAIA, cash distributions from a flow-through entity with capital gains that are taxed to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.) Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States,* 34 Fed. Cl. 112 (1995).

  An interesting argument is that Schedule K-1 capital gains allocated to a trust from a partnership but that are not distributed will still be included in the trust's DNI. Section 643(a) starts with taxable income in defining DNI and then describes several modifications. Section (a)(3) says that capital gains are excluded from DNI to the extent they are allocated to corpus and are not paid or required to be distributed to a beneficiary or for charitable purposes. If the capital gains are not allocated to corpus, the statute has no provisions removing them from DNI. If the partnership does not make distributions of the capital gain, the trust has no receipts that are characterized as either income or corpus. As long as the K-1 capital gains are not allocable to corpus, they are not excluded from DNI.

- Net short term capital gain from a mutual fund is treated as fiduciary income under the Uniform Principal and Income Act. Comments to Section 401 of the Act include the following:

  > Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

c. **Exception (2)—Capital Gains Allocated to Corpus and Consistently Treated as Part of Distributions**.

- Give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a "deeming" rule. Treas. Reg. §1.643(a)-3(e) Exs. 2-3.

- Trust agreements may specifically grant the trustee the discretion to allocate all or part of realized gains from the sale or exchange of trust assets to income or to principal (within the meaning of Treas. Reg. §1.643-3(b)), or to deem any

discretionary distribution of principal as being made from capital gains realized during the year (within the meaning of Treas. Reg. §1.643(a)-3(e)). See generally Treas. Reg. §1.643(e) Ex. 11.; TAM 8728001; Blattmachr & Gans, *The Final "Income" Regulations: Their Meaning and Importance,* 103 TAX NOTES 891 (2004).

- Some state statutes explicitly give the trustee the authority to consider discretionary distributions to a beneficiary as being made from capital gains realized during the year. *E.g.* ALASKA STAT. §13.36.109(29); N.C. GEN. STAT. §36C-8-816(16).
- The consistency requirement is emphasized in the regulations. Treas. Reg. §1.643(a)-3(e) Exs. 2, 12, 13. How a trust changes its position to start deeming that capital gains are included in distributions is not clear. *See* TAMs 8506005 & 8105028; Treas. Regs. §§1.643(a)-3(d) Ex. (1) (last sentence) & 1.643(a)-3(e) Ex.(2). *See generally* Sloan, Harris, & Cushing, *When Income Isn't "Income" – The Impact of the New Proposed Regulations Under Section 643*, 94 J. TAX'N 325 (2001). This is especially problematic because historically, capital gains typically have not been treated by trustees as being included in distributions to cause them to be included in DNI.

d. **Exception (3)—Capital Gains Allocated to Corpus But Actually Distributed or Considered in Determining Amount to be Distributed**.

- No provision in the regulation requires that this authority be exercised consistently. *See* Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA,* TRUSTS & ESTATES 23 (March 2013)(suggesting that the trustee "make a record, before the distribution if possible, of the decision to do so") .
- As an example, a trustee may study the trust income and income tax brackets of the trust and its beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions, it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been "utilized by the fiduciary in determining the amount that is distributed" thus satisfying exception (3).
- However, the examples in the regulations for Exception (3) are rather narrow and do not include an example with that rationale.

e. **Example Clause.** An example clause (provided by Greg Gadarian) giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee (other than a Trustee who is also a qualified beneficiary, and other than the Grantor) may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income; or (2) if such gains are allocated to principal, to the extent they are distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary, or treated consistently on the trust's books, records, and tax returns as part of a distribution to the trust beneficiary. (From Greg Gadarian)

6. Allocation of Trust Income

a. **General Conduit Treatment**. Generally speaking, a conduit-type taxation approach applies; to the extent that trust distributions are made, the income is taxed to the beneficiaries, up to the amount of the trust's DNI. §§651-652, 661-662.

b. **Character of Income**. The character of trust income that is distributed to beneficiaries is preserved. §652(b) & 662(b). The various classes of income are allocated proportionately to beneficiaries receiving distributions, and the items of deduction entering into the computation of DNI are allocated among the various classes of income.

   If the instrument directs that a specific category of income will be distributed, that direction is respected. §§652(b) & 662(b) (allocation of specific class of income recognized only to the extent "the terms of the trust specifically allocate different classes of income to different beneficiaries"); *see e.g.,* Treas. Reg. §1.652(b)-2(b)(3). The allocation of specific class of income must be mandated; an allocation pursuant to trustee discretion would not be recognized. Similarly, a direction to pay half the income to A, or $10,000 of income to A to be satisfied first with a specific class of income to the extent available would not be a recognized allocation. Also, a direction to pay the income equally to A and B, with a direction to pay the tax exempt income to pay A and, to the extent necessary, to pay other assets to B to equalize the amounts distributed to A and B, would not be recognized because the payment of tax exempt income to A does not have independent economic effect. The allocation of a specific class of income must be such that the trustee can have discretion to alter the amounts passing to A and B only by controlling the investment of tax corpus in a way that produces certain classes of income (such as tax exempt income).

   The net investment income rules generally preserve this same character passthrough approach. Treas. Reg. §1.1411-3.

c. **AMT**. A trust has its own AMT exemption and computes and AMT DNI, each for special AMT accounting purposes. For a discussion of the AMT effects of trusts, see CASNER & PENNELL, ESTATE PLANNING §5.4.1. n.13.

d. **Timing**. The inclusion in a beneficiary's income occurs in the year of the trust that ends within or with the beneficiary's taxable year. In effect, the beneficiary is deemed to receive trust income that is allocated to the beneficiary as of the last day of the taxable year of the trust or estate. §§652(c) & 662(c). For example, if an estate has a taxable year ending January 31, any estate income for the estate year from February 1, 2015-January 31, 2016 that is allocated to a beneficiary is deemed to be included in the beneficiary's 2016 taxable year.

e. **65-Day Rule**. Under the 65-day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b). (For a non-leap year, this is March 6.) An estate's or trust's taxable income may not be determined by the end of the taxable year, and the 65-day rule can be helpful in planning distributions to carry out income to multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level (with its very low $12,400 threshold in 2016 for the top rates and §1411 tax).

f. **Tier Rules**. The term "tier" is not used in the Code or Regulations, but is generally used to refer to the distinctions in §661(a)(1)-(2) for amounts of income required to be distributed currently (first tier) and other amounts properly paid, accredited, or required to be distributed (second tier). Distributions first carry out income up to the amount of DNI to mandatory income distributees. Any excess DNI is allocated proportionately among the discretionary income recipients.

   Charitable distributions effectively constitute an intermediate tier falling between the first and second tiers. (This is attributable to the parenthetical in §662(a)(1) that is absent from §662(a)(2), such that the §642(c) charitable distribution deduction is considered in determining the DNI remaining to be carried out to second tier beneficiaries but is ignored in determining the amount of DNI available to be carried out to first tier beneficiaries. The effect is as if DNI were carried out to charity because DNI that is carried out to second tier beneficiaries is reduced by virtue of the smaller amount of taxable income caused by the §642(c) deduction.) In effect, DNI passes initially to first tier beneficiaries, then to charitable distributions, then to second tier beneficiaries, until exhausted.

g. **Specific Bequests.** Payments of specific bequests are excluded from the general rule that distributions carry out estate income to beneficiaries. This exception applies to a bequest of a specific sum of money or specific property and which is paid or credited all at once or in not more than 3 installments. §663(a)(1). In order to qualify for this exception, the amount of money or the identity of specific property must be ascertainable under the terms of the will as of the date of death. Treas. Reg. §1.663(a)-1(b). For example, a marital deduction formula pecuniary bequest is not covered by this exception (because the amount of the bequest depends upon the amount of administration expenses and elections made by the executor.)

   Distributions in satisfaction of an elective share do not qualify for the specific bequest exception (so the spouse receives an allocation of estate income, up to the amount of DNI allocated to the spouse).

   Observe that *failing* to satisfy the specific bequest exception may be tax advantageous, to facilitate "carrying out" the estate income to the beneficiaries rather than having the income taxed in the estate at high income tax brackets.

h. **Separate Share Rule**. Substantially independent and separately administered shares of a single trust or of an estate will be treated as separate trusts or estates for DNI allocation purposes. §663(c). Accordingly, distributions will carry out DNI to a beneficiary only up to the beneficiary's entitlement to income from that separate share.

   The separate share rule has long applied for trusts but became applicable to (and mandatory) for estates of decedents dying after 8-5-97. The general purpose is to provide a more equitable result for estate beneficiaries, by limiting the amount of DNI that is carried out as taxable income for a particular beneficiary to that beneficiary's pro rata share of such income that the beneficiary is entitled to receive from the estate. While this purpose is laudable, the application of the rule can be difficult, especially in estates with difficult-to-value assets.

   The general effect of the separate share rule is to limit the amount of DNI that is carried out to each beneficiary (which is taxable to the beneficiary, § 662(a), and deductible to

the estate, § 661(a)) to the DNI that is allocable to each beneficiary's separate share. The rule only limits the amount of DNI carried out with distributions that are made. It does not create a "flow-through" system to allocate taxable income to beneficiaries who do not receive distributions. For example, if an estate makes distributions to only one of two equal beneficiaries in year one, the separate share rule would limit the DNI carried out to that one beneficiary to his or her share of the estate's income. The remaining income would be taxed to the estate. State laws (not the separate share rules) would then determine if the income tax paid by the estate would be charged solely against the remaining beneficiary's share of the income, or whether it would be charged against the estate generally—which would be inequitable to the beneficiary who received the distribution and had to pay income tax with respect to his or her share of the income.

Final regulations for the estate separate share rule added a number of new provisions, including provisions addressing (1) a clarification of when separate shares exist, (2) a surviving spouse's elective share (the separate share rule generally applies to distributions in satisfaction of a surviving spouse's elective share, which results in the surviving spouse being taxed on the estate's income only to the extent of the surviving spouse's right to share in the estate's income under state law, but technical gaps remain in the treatment of certain elective share situations under the regulations), (3) treatment of revocable trusts, (4) pecuniary formula bequests, (5) the need to adjust returns when the relative percentages of the separate shares are changed by audit, (6) the treatment of partnership and S corporation flow-through items, (7) the allocation of IRD among separate shares, and (8) addressing the treatment of interest on elective shares and pecuniary bequests.

The separate share rule applies to almost all types of bequests from estates. This can present a huge practical problem for estates with assets that are difficult to value. For example, in a formula marital deduction will, the respective values of the marital and credit shelter trust shares depend on the values of assets in the estate. If the executor initially uses values that end up years later being changed in an estate tax audit, the estate and beneficiaries may have filed incorrect income tax returns in those intervening years. The preamble does not suggest any de minimus exception, and would seem to require the filing of amended returns by the estate and all beneficiaries who received distributions carrying out DNI when the relative amounts of the respective shares are adjusted due to audit revaluations. Return preparers will probably take a pragmatic approach and not file amended returns where the cost of filing the returns will approximate the amount of dollars shifted in process. However, realize that the regulations and the IRS comments to the regulations do not provide any comfort, other than "a loose 'reasonable and equitable' allocation, valuation and calculation standard that ostensibly provides some flexibility to fiduciaries in making the requisite computations." CASNER & PENNELL, ESTATE PLANNING §5.4.3.

A hand-survey suggests that participants are often not applying the separate share rule to estates, and the IRS does not seem to be going after those situations. Try to make pro rata distributions and that avoids the separate share rule issues.

i. **Interest on Funding Pecuniary Bequests**. The Uniform Principal and Income Act provides that pecuniary bequests payable to trusts and nonpecuniary bequests share in estate income attributable to the bequest, but recognizes that most states grant interest at a statutory rate for pecuniary bequests not in trust that are not funded by a

particular time (often one year after the date of death). The IRS maintains that interest on funding pecuniary bequests is not included in the estate's DNI that is carried out to the beneficiary, and is not deductible by the estate as a distribution deduction under §661 or other sections. However, it is interest income to the beneficiary. The overall effect is to create taxable income to the family. As a result, there may be an emerging trend for estate planning instruments to allocate estate income to pecuniary bequests, rather than paying interest on pecuniary bequests. Some state statutes adopt that position; the Pennsylvania principal and income statute provides that the pecuniary beneficiary is entitled to *income* at the rate of 5%, thus providing an argument that the payment is entitled to a DNI distribution deduction.

The preamble to the separate share final regulations makes clear that interest on pecuniary bequests is not subject to the §§661-662 rules (*i.e.*, it does not carry out DNI to the beneficiary and is not deductible by the estate.) The preamble also observes the analogous position taken in the proposed regulations and retained in the final regulations with respect to elective shares that do not share in estate income but receive interest. Treas. Reg. 1.663(c)-5 Ex. 7.

One district court case has held that interest paid on specific bequests was not deductible. *Schwan v. United States*, 91 264 F. Supp.2d 887 (D. S.D. 2003). The court reasoned that the interest expense was not deductible under §212 because it was not necessary for the estate to incur the interest charges. An investment interest deduction under §163 was not allowed because the interest was not tied to debt incurred for an investment.

j. **Distributions in Kind**.

Basis. The basis of in-kind property received by a trust or estate beneficiary is the trust or estate's basis in the property prior to the distribution adjusted for any gain or loss recognized by the trust or estate on the distribution. §643(e)(1).

DNI Carryout. In-kind distributions generally carry out DNI equal to the lesser of the asset's fair market value or basis. §643(e)(2). If an in-kind distribution does not cause a realization of gain or loss by the trust or estate, the beneficiary receives assets with a built-in income tax liability. Limiting the DNI carryout to the lesser of fair market value or basis keeps the beneficiary from unfairly being treated as receiving estate income *and* having to pay gain on the later sale of the asset.

Distribution of Appreciated or Depreciated Property in Satisfaction of Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. A pecuniary bequest or amount is one that has a fixed or definite dollar amount. Treas. Reg. §1.661(a)-2(f); *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940). *See also Suisman v. Eaton*, 15 F. Supp. 113 (D.C. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936); Rev. Rul. 82-4. Regulations take a similar position if a trust distributes property in kind in satisfaction of its requirement to distribute currently all of the income of the trust. Treas. Reg. §§1.651(a)-2(d), 1.661 (a)-2(f). If a specific bequest is funded in-kind, producing gain under the rule described above, the gain would not be included in the estate or trust's DNI for income tax purposes. Rev. Rul. 68-392, 1968-2 C.B. 284 (trusts); §663(a)(1)(estates); *see* Treas. Reg. 1.663(c)-5 Ex. 4.

The extension of §§267 and 1239 to estates in 1997 did not extend to a sale or exchange that is in satisfaction of a pecuniary bequest. §267(b)(13). Therefore, a distribution of a depreciated asset to a beneficiary in satisfaction of a pecuniary bequest can still qualify for a loss deduction. Furthermore, a distribution of an appreciated asset that is a depreciable capital gain asset in satisfaction of a pecuniary bequest will not be treated as causing the recognition of ordinary rather than capital gain income. §§267(b) & 1239(b).

Elective Share. A distribution of appreciated property in satisfaction of an elective share right also triggers gain to the estate, but the distribution does not satisfy the specific bequest exception, so income is carried out to the recipient.

Election to Recognize Gain on In-Kind Distributions. An in-kind distribution generally does not result in any gain recognition by the estate or trust (unless it is in satisfaction of a pecuniary bequest, as discussed above). However, a fiduciary may elect to treat a non-realization distribution as if it was a sale or exchange, intentionally recognizing gain. §643(e)(3). This has the effect of shifting gain from the distributee (who would otherwise recognize the gain when the property is subsequently sold by the distributee) to the trust or estate. The election applies to all distributions made during the taxable year. §643(e)(3)(B). Planning considerations for whether the election should be made include whether the entity or distributee would pay tax in a lower bracket or has available losses to offset any gain. In addition, the election is often made in the last year of the estate or trust to make sure that all beneficiaries are treated fairly and all beneficiaries receive assets with a basis equal to the fair market value.

k. **Year of Termination.** If an estate or trust in any year has deductions exceeding income, the excess deductions are generally lost, except to the extent they qualify as net operating loss or capital loss carryovers. An exception exists in the last taxable year of the estate or trust, in which case any net operating loss carryover, capital loss carryover or deductions (not including the personal exemption deduction or the charitable deduction) in excess of gross income for the year may be utilized by the beneficiaries succeeding to the estate or trust property. §642(h)(1)-(2). (A beneficiary is not entitled to carryback any losses received from the trust or estate, even if the estate had no preceding taxable years eligible for carryback.) Whether any unused AMT credit carryover in the final year is also carried out to beneficiaries is not clear. One commentator suggests that it should be. ZARITSKY & LANE, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS (3d ed. 2001 ¶2.14[3].)

The character of any such deduction or carryover is the same as it was for the trust or estate. Therefore, deductions allocable to tax-exempt income similarly are disallowed to the beneficiary, and the number of years for carryforwards is the same as if the entity had not terminated.

To avoid wasting the ability to deduct administration expenses, the best practice is to pay a substantial part of the expenses in the year of termination (to the extent that is possible with service providers). This will take careful planning to assure that the estate is terminated in that year and that all of the assets are distributed in time.

Optimal planning would be to pay enough expenses each year to fully offset the trust or estate's gross income. Being able to use the deductions to offset the trust or estate's income is generally preferable to leaving the deductions to be carried out to

the beneficiaries because *each* beneficiary will have to first offset any deductions by his or her own 2% limitation on miscellaneous itemized deductions under §67 and his or her own 3% floor on itemized deductions under §68.

What is the year of termination, for example if the trust retains sufficient assets to pay for the preparation of its income tax return? Guidance suggests that if 95% of the assets have been distributed and the remaining 5% are in a fund that produces no income, the trust will be treated as if it has terminated.

7. Charitable Deduction

a. **Payable From Gross Income Pursuant to Governing Instrument.** The charitable deduction percentage limitations that apply under §170 to individuals do not apply to trusts or estates. Section 642(c)(1) provides that an estate or trust may take a charitable deduction (not subject to percentage limitations that apply to charitable gifts by individuals) for "any amount of the *gross income*, without limitation, which *pursuant to* the terms of the governing instrument is, during the taxable year, paid for a [charitable] purpose." (emphasis added) As an example of the gross income tracing requirement, income in respect of a decedent (IRD) qualifies for the deduction, but the right to receive IRD does not. Furthermore, the executor or trustee may elect to treat a contribution made in one taxable year as having been made in the prior taxable year. §642(c)(1).

A 2015 case addressed, for the first time, whether a trust could receive a charitable deduction for the full fair market value of appreciated property, rather than just the basis of such property. *Green v. United States*, 144 F. Supp.3d 1254 (W.D. Okla. 2015), *related case,* 117 AFTR 2d 2016-700 (W.D. Okla. 2016). While §642(c) limits the trust charitable deduction to "any amount of gross income… paid," the court reasoned that section does not require the distribution to be made in the same year in which the gross income was realized, and that the property had been purchased with the proceeds of income distributed from a partnership.

The "pursuant to" requirement is satisfied by a beneficiary's exercise of a non-general inter vivos power of appointment, even if the instrument merely authorized the exercise of the power in favor of charity and did not mandate a charitable bequest. *See, e.g.,* Ltr. Rul. 200906008.

b. **Ordering Rules**. To avoid the DNI allocation rules that normally allocate a pro rata share of every type of income to distributions, some draftsmen have attempted to specify that distributions to charity follow a worst-in, first-out (WIFO) approach, specifying that distributions must be made from various categories of income (to satisfy the gross income requirement), and that the types of income that would otherwise generate the most tax for the trust or individual beneficiaries will be distributed to charity. However, regulations provide that an ordering provision (for example, a charitable lead trust specifying that the lead charitable distributions be made first from income, then capital gains, then tax-exempt income and finally followed by corpus) is valid only "to the extent such provision has economic effect independent of income tax consequences." Treas. Reg. §§1.642(c)-3(b)(2) and 1.643(a)-5(b). Interestingly, in the reverse situation, for charitable remainder trusts the

statute mandates a WIFO approach for determining the type of income distributed to the current non-charitable beneficiaries of the charitable remainder trust. §664(b). The net investment income tax regulations similarly apply a WIFO approach.

c. **No Distributions Deduction If Charitable Distribution Does Not Qualify for Charitable Deduction.** The IRS position, which so far has been upheld by the courts, is that a distributions deduction is not allowable for charitable distributions, and that §642(c) is the only available source of the deduction for charitable distributions. *E.g. Crown Income Charitable Fund v. Commissioner,* 98 T.C. 327 (1992), *aff'd*, 8 F.3d 871 (7th Cir. 1993); *Mott v. United States*, 462 F.2d 512, 518 (Ct. Cl. 1972); Treas. Reg. §1.663(a)-2 (second sentence). Prof. Pennell thinks this position is ripe for challenge, and the issue should merely be to avoid getting both a charitable and distributions deduction for the same distribution.

d. **Charitable Set Aside Deduction**. An estate or trust may also be entitled to an income tax charitable deduction for amounts of gross income that are permanently set aside for charity even though the income has not actually been distributed to charity during the current taxable year. §642(c)(2). The regulations provide that an amount is not "permanently set aside" for a charitable purpose "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." Treas. Reg. §1.642(c)-2(d). Two cases in 2015 denied a charitable set aside deduction because of the possibility that some portion of the funds might be used for litigation expenses or used for purposes other than passing to charity. *Belmont v. Commissioner*, 144 T.C. 84 (2015); *Estate of DiMarco v. Commissioner*, T.C. Memo. 2015-184.

8. Equitable Adjustments

a. **Description**. Equitable adjustments under state law may arise in a variety of circumstances to satisfy a fiduciary duty of impartiality to beneficiaries. For example, the executor can decide whether to deduct most types of administration expenses for estate tax or income tax purposes. The choice may favor one beneficiary to the detriment of another. An "equitable adjustment" may be required under state law (*see In re Estate of Warms*, 140 N.Y.S.2d 169 (Surr. Ct. 1955) (hence this is sometimes referred to as a "*Warms* adjustment")), even if the manner in which the adjustment should be made to treat to beneficiaries fairly is not clear.

Examples include deductions for expenses that are deductible on *either* the estate income tax return or the estate tax return under §642(g) (which benefits some beneficiaries to the detriment of others), or treating capital gain as part of DNI (which increases the income tax of the income beneficiaries to the benefit of the remainder beneficiaries).

b. **Mandating Exercise or Non-Exercise**. Prof. Pennell prefers that an instrument mandate that an adjustment either be made or not made. He believes that giving the fiduciary the discretion to make an adjustment puts the fiduciary in a very difficult position – the fiduciary would not know whether to adjust, and if so, how to make the adjustment.

Be particularly wary if a marital deduction is involved. Making a *Warms* adjustment by shifting income or corpus away from the surviving spouse could endanger some or all of the marital deduction.

For an excellent listing of resources regarding the fiduciary and tax effects of equitable adjustments, see CASNER & PENNELL, ESTATE PLANNING §5.8.4, at n.51-52.

9. Income in Respect of a Decedent

a. **Description.** Income in respect of a decedent (IRD) is, generally speaking, income that was earned before the decedent's death, but that was received after his death. (As discussed below, in order to prevent a cash basis taxpayer from receiving such items tax-free, the Code provides that IRD is taxed upon receipt by the estate or other beneficiary. §691(a)(1).)

The scope of what constitutes IRD is not in the statute, but substantial jurisprudence provides guidance. The Tax Court summarized a four-part test to determine if a transaction is sufficiently complete prior to the decedent's death to conclude that it had been "earned" before death and that the proceeds would be IRD: (1) the decedent entered into a legally significant transaction; (2) the decedent performed all of the substantive tasks required; (3) no economically significant contingencies that might disrupt the transaction existed; and (4) the decedent would have received the proceeds but for the decedent's death. *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), *aff'g*, 74 T.C. 630 (1980).

Common sources of IRD include salary, IRAs (but not Roth IRAs), pensions, the share of S Corporation and partnership earnings earned before death, accrued interest, accrued dividends, accrued rents, accrued royalties, and payments on installment notes (capital gain to the extent that each payment would have been capital gain had the decedent still been alive).

b. **Income Inclusion; No Basis Adjustment.** No basis adjustment is allowed under §1014(c), and upon receipt, the proceeds will be income to the recipient. §691(a). The character and holding period of the item are the same as if the decedent was still alive to receive it.

The person who receives the IRD reports the taxable income, whether that is (i) the decedent's estate, (ii) a person who acquires the right to receive the IRD separate from the estate, or (iii) a person who acquires the right to the IRD by bequest, devise, or inheritance if the amount is received after a distribution by the decedent's estate of such right.

c. **Effect of Distribution of Right to IRD from Estate to Legatee.** Distribution from the estate of the right to IRD to a legatee generally does not accelerate the income (unless, as discussed in subparagraph d below, the distribution is in satisfaction of a pecuniary bequest). The distribution should carry out DNI under the general rules that govern distributions. However, §643(e) limits the amount of DNI carried out by distribution of any property in kind (presumably including a right to receive IRD) to the lesser of basis or fair market value of distributed asset. Because the basis of most items of IRD is zero, the amount of DNI carried out normally is zero. Accordingly, if an

item of IRD is distributed by an estate to a beneficiary, the distribution effectively does not carry out DNI to the beneficiary. Several cases have held that a distribution of IRD (before recognized by the estate) "is treated as a neutral event, and is not subject to the distribution rules of Secs. 661 and 662." *Dean Estate v. Commissioner*, T.C. Memo. 1983-276. *See also Rollert Residuary Trust v. Commissioner*, 752 F.2d 1128 (6th Cir. 1985). (In those cases the IRD asset had a zero basis.) A distribution of an IRD item with basis, such as an installment note, probably would carry out DNI to the extent of the basis. *Cf*. Rev. Rul. 68-195, 1968-1 C.B. 305 (distribution of right to receive future payments under §736(a) is not *property distributed in kind* for purposes of the deduction provisions of section 661(a)). When the actual IRD amount is received by the beneficiary, it will be taxed to him or her at that time.

d. **Transfer of Right to IRD Causing Acceleration.** If the estate or beneficiary transfers the right to receive the IRD item before receipt, the estate or beneficiary is treated as having received the fair market value of the right at the time of the transfer. §691(a)(2).

A distribution of a right to receive IRD in satisfaction of a fixed sum of money bequest will likely cause tax on the IRD to be accelerated. Treas. Reg. § 1.691(a)-4(b)(2) says that if the right to receive IRD is transferred to a *specific* or *residuary* legatee, only the legatee includes the IRD in income. An implied connotation is that transferring IRD in satisfaction of a *pecuniary* bequest does not carry out the income tax burden to the legatee; if not, the distribution would seem to be treated as a transfer or sale of an IRD item under Treas. Reg. § 1.691(a)-4(a), which would trigger the income. *See* Treas. Reg. §1.661(a)-2(f) & 1.1014-4(a)(3); Ltr. Rul. 9507008 (funding pecuniary charitable gift in revocable trust with Series E bonds causes trust to recognize income equal to previously unreported gain). A formula marital deduction bequest is not deemed to be a bequest of a "specific sum of money" for purposes of §663(a)(1).

Accordingly a distribution of a right to receive IRD in satisfaction of a formula pecuniary bequest causes income recognition to the estate, which would cause a basis increase in the amount of income realized by the acceleration, so that the DNI carried out to the recipient would equal such realization amount. Treas. Reg. §1.663(a)-1(b)(1). The effect is that the estate's income recognition is offset by its distribution deduction, and the recipient realizes the income from the estate distribution, but does not have any subsequent income recognition when the IRD is actually received, because its basis would have been increased by the acceleration realization event. The result is simply to accelerate the tax year in which the IRD is taxed, but not to alter the taxpayer who would incur the tax liability, which is appropriate for policy reasons.

The acceleration problem does not occur if IRD is distributed in satisfaction of a percentage bequest where the executor had the right to make distributions in cash or in kind and to allocate assets to a particular beneficiary. Letter Rul. 200234019. Furthermore, allocating an item of IRD in satisfaction of a portion of a residuary bequest does not trigger acceleration. Ltr. Ruls. 200652028 (trustee's exercise of discretion under non pro rata funding authority to distribute IRA in satisfaction of residuary distribution of trust not a deemed transfer within the meaning of §691(a)(2)); 200633009 (assignment of IRA to charity to satisfy residual bequest where estate was beneficiary of the IRA not a transfer with the meaning of §691(a)(2)); 200526010;

200520004; 200452004 (assignment of IRAs and deferred annuity contracts by executors of decedent's estate to charity in satisfaction of its share of residuary estate will not cause estate or any of its beneficiaries to have any taxable income or cause estate to include any amount in its distributable net income).

e. **Income Tax Deduction for Federal Estate Tax Attributable to IRD**. The recipient of the IRD amount, when paid, is allowed an income tax deduction for the federal estate tax attributable to the IRD. §691(c). (The beneficiary is entitled to the §691(c) deduction for the year that the IRD income is received by the beneficiary, even if the estate tax has not yet been paid. Field Service Advice 200011023.) This mitigates double taxation (estate tax and income tax) on the same IRD item. The §691(c) deduction achieves a result roughly comparable to the decedent having paid an income tax on the item and deducting that income tax from the gross estate for estate tax purposes, if the income tax bracket of the recipient is the same as that of decedent.

A complete offset of the double tax does not result because the §691(c) deduction is only allowed for the federal estate tax—but not the state estate or inheritance taxes—attributable to the income in respect of decedent items. The fact that state estate taxes are deductible under §2058 does not remove the double tax with respect to state estate tax on income in respect of a decedent. (Indeed, the overall tax cost of IRD is even higher than before because the state estate tax on the IRD is merely a deduction rather than a credit for federal estate tax purposes, and the state tax is not considered in the §691 deduction.) In some cases, recognizing the IRD income before death will result in lower overall taxes. *See* Blattmachr & Gans, *Planning for IRD After Elimination of the State Death Tax Credit*, 33 EST. PL. 3 (March 2006).

The estate tax is computed on the net value of the IRD (IRD amount minus deductions in respect of the decedent). The estate tax attributable to the IRD is calculated using an incremental and not an average tax approach (this is done by recomputing the estate tax as though the net value of the IRD had not been included in the gross estate.) Treas. Reg. §1.691(c)-1(a). The person who receives the IRD is the person entitled to the §691(c) deduction, whether (1) that person receives a distribution of the right to the IRD from the estate prior to its receipt, or (2) the estate receives the IRD payment, which is then distributed to a beneficiary carrying out DNI including the IRD amount. Treas. Reg. §1.691(c)-2.

DNI and the distributions deductions are calculated without regard to the §691(c) deduction, and the §691(c) deduction is then apportioned between the estate and the beneficiaries. Treas. Reg. §1.691(c)-2. The beneficiaries deduct the §691(c) deduction allocable to them on their separate returns. The part, if any, of the §691(c) deduction apportioned to the estate is deducted by the estate in computing its taxable income (even though it does not reduce DNI).

f. **Bequests to Charity or Spouse.** Leaving IRD to charity or a spouse may be preferable to leaving it to other beneficiaries.

- To the extent the distribution to charity of the right to receive IRD does not accelerate the income and is not a gain or loss realization event, there will be no

income tax consequences to the estate or its beneficiaries and charity should be exempt from income tax on income as it is received.

- The allocation of a right to receive IRD to a marital deduction bequest may be desirable, because inclusion of a right to receive IRD in the marital deduction bequest should not affect the amount of the allowable marital deduction, and the income tax liability will reduce the amount subject to estate tax when the surviving spouse subsequently dies (and if a bypass trust is created, it will not have to bear the income tax liability when the IRD item is received).

10. Deductions in Respect of the Decedent

"Deductions in respect of the decedent" are deductions for payments that would have reduced the decedent's taxable income if the decedent had paid them during life. In that event, the decedent would have received an income tax deduction, and the amount would have been removed from the decedent's gross estate for estate tax purposes. To replicate this result, deductions for these types of expenses can be deducted both on the estate's fiduciary income tax return and on the estate tax return. §642(g) (last sentence). A common example is property taxes that accrue as of January 1 each year but are often not paid until December (or even into the following calendar year).

11. Grantor Trusts—Overview

a. **Subpart E.** Subpart E of Subchapter J includes §§671-679, which provide exceptions to the general rule of §641 taxing income of a trust to the trust or its beneficiaries.

b. **Historical Purpose.** The grantor trust rules prevent the use of multiple trusts for purposes of "riding the lower brackets" numerous times—the income of all grantor trusts is included on the grantor's individual return.

c. **General Effects–Reported on Grantor's Tax Return**. The income, deductions, and credits of a grantor trust are reportable on the grantor's individual income tax return. §671. The statute does not specifically refer to gains or losses, and whether the grantor can claim losses is not totally clear. Losses are considered along with gains in determining the trust's "income" but that does not necessarily mean the grantor would be treated as the owner of excess losses. *See* Treas. Reg. 1.671-3(a)(1) ("If a grantor … is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) …"); CASNER & PENNELL, ESTATE PLANNING §§5.11n.7, 5.11.8.2, 5.11.9 (excess deductions reduce income allocable to corpus, but excess losses not necessarily available to grantor). Sections 672-677 and 679 identify certain trusts as grantor trusts, generally on the basis of the interests or powers retained by the grantor or grantor's spouse. Powers that may trigger the grantor trust rules may be retained either by the grantor or by someone else who is not a beneficiary who is adversely affected by the exercise of the power. Section 678 identifies certain trusts as grantor trusts as to the beneficiary of the trust.

d. **General Effects–Sales Between Trust and Grantor**. No capital gain or loss should be recognized on sales between the trust and the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent grantor is treated as owner of trust, the trust will not be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor). In that ruling, the I.R.S. indicated that it would not follow *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) to the extent it would require a different result. *See* Rev. Rul. 2007-13, 2007-11, I.R.B. 684 (Situation 1 reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts).

e. **General Effects–Miscellaneous**.

Income Tax Reporting. A grantor trust either must file a Form 1041, or follow the alternate reporting procedures described in Treas. Reg. §1.671-4(b)(2). If the trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the grantor for inclusion on the grantor's Form 1040. The grantor trust box on the Form 1041 should be checked.

In some circumstances, no Form 1041 need be filed (and the trustee of the trust does not need to obtain a taxpayer identification number). Under Regulation § 1.671-4(b), if the trust (1) is a grantor trust, all of which is treated as owned by one grantor or one other person, (2) if the grantor or other person who is treated as the owner of the trust provides to the trustee a completed Form W-9, and (3) if the trustee gives the grantor's (or other person's) name and taxpayer identification number to all payors to the trust during the taxable year, the trust need not file a Form 1041, and the items of income will be reported directly to the grantor. Treas. Reg. §1.671-4(b)(1), 4(b)(2)(i), and 4(b)(2)(ii)(B). Furthermore, if the grantor is also the trustee or co-trustee, the trust is not required to give a reporting information statement to the grantor. Treas. Reg. § 1.671-4(b)(2)(ii). If the conditions described above are satisfied, the grantor trust does not need to obtain a taxpayer identification number until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor or another person, or until the first taxable year of the trust for which the trustee no longer reports pursuant to Regulation § 1.671-4(b)(2)(i)(A). Treas. Reg. § 301.6109-1(a)(2)(i).

Gift Tax Effects of Grantor's Payment of Income Tax on Trust Income. Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1)

Income Tax Reimbursement Provision. Revenue Ruling 2004-64 also provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under §2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation. (Situation 2). In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the

grantor's creditors to reach the trust under applicable state law. (Situation 3). Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. *E.g.*, TEX. PROP. CODE §112.035(d).

Other Miscellaneous Effects.

- Grantor trusts (as to both income and corpus) can be S corporation shareholders. §1361(c)(2)(A)(i).
- The §121 gain exclusion for the sale of a principal residence applies if the residence is owned by the resident's grantor trust. Rev. Rul. 85-45.
- For net investment income tax purposes, the grantor's threshold applies, and material participation (for purposes of the material participation in active business exception) is based on participation by the grantor.

A *proposal* in the President's budget proposal (beginning in the proposal for the 2014 fiscal year) would cause the portion of the grantor trust attributable to a purchase of assets from the grantor to be in the grantor's estate for estate tax purposes or to be treated as a gift when the grantor trust status ends during the grantor's life.

12. Grantor Trusts—Definitions

a. **Income**. "Income" means "taxable income" for purposes of subpart E (grantor trusts), and for the rest of the Subchapter J regarding fiduciary income tax, "income" means fiduciary accounting income.

b. **Adverse Party**. An adverse party is a person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of a power held by that person. §672(a). "Substantial" is not defined in the statute, but the regulations say "substantial" is based on the relative value of the interest. (Example: a power of appointment over $1 would generally not be substantial, but it would be if the trust only has $2.) Mickey Davis summarizes the concept as a realization that in a battle between blood and money, money wins—the focus is on who has something to lose when a power is exercised.

c. **Nonadverse Party**. The Code defines a nonadverse party as a party that is not an adverse party. §672(b).

d. **Related or Subordinate Party.** This term includes certain objectively defined relatives (grantor's spouse if living with the grantor, father, mother, issue, or sibling) and certain "subordinate" parties (employee, corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant for voting control, or a subordinate employee of a corporation in which the grantor is an executive). §672(c).

e. **Spousal Unity Rule.** After March 1, 1986, the grantor is deemed to hold any power or interest held by "any individual who was the spouse of the grantor at the time of the creation of such power or interest," or who subsequently became the grantor's spouse as to periods after becoming the grantor's spouse. §672(e)(1). An individual who is legally separated from his spouse under a divorce decree (or other separate maintenance order) "shall not be considered as married." §672(e)(2). Section 672(e)

does not cease to operate following the divorce of the grantor and the spouse who was married to the grantor when the power or interest was created. However, the extent to which a subsequent *divorce* cuts off the spousal unity rule as to that prior spouse is not clear. Section 672(e)(2) does not say that §672(e)(1) no longer applies following a divorce; it merely says the persons are not considered as married.

> Curiously, §672(e) does not indicate whether spousal unity ends when the marriage does, §672(e)(1)(B) making it clear only that marriage when the interest or power was *created* is not required if they subsequently get married. In addition, §682 overrides the special unity rule following a divorce or legal separation, but only to the extent the spouse is *entitled to income* from the trust, and not otherwise. Thus, it does not turn off grantor trust status attributable to powers … And it might not apply with respect to discretionary income or capital gains that are allocable to corpus and are not distributed currently to the spouse [citing Treas. Reg. §1.682(a)-1(a)(1)(i)]…. [Section] 7701(a)(17) limits the definition of husband and wife as including a former spouse only for specified purposes. Arguably the failure to include §672(e) in that list is indicative of an intent that former spouses not be subject to §672(e). If that was true, however, quaere why Congress made it explicit that §§674(c) and 675(3) (last sentences) are applicable only "for periods during which an individual is the spouse of the grantor" but no specific provision otherwise establishes that a §672(e) or §677(a) capital gain problem can be divorced. CASNER & PENNELL, ESTATE PLANNING §5.11.1 n. 36.

See the discussion below regarding the applicability of §677 following divorce.

13. Overview of Grantor Trust Triggers-Powers or Interests

a. **Section 673–Right of Reversion.** The grantor is treated as the owner of any portion of a trust if trust income or principal ultimately reverts to the grantor and if the value of the reversionary interest at the time the trust is created exceeds 5% of the trust's value (assuming the maximum exercise of discretion in favor of the grantor). §673. A reversion that takes effect only if minor lineal descendants predecease the grantor before age 21 will not cause the trust to be a grantor trust (but that would not help avoid estate inclusion). §673(b). Section 673 is not typically used to create a grantor trust intentionally because the reversion would likely cause estate inclusion under §2037 (which is tested as of the moment of death, not just at the creation of the trust).

b. **Section 674–Power to Control Beneficial Enjoyment**. The general rule is essentially that a trust is a grantor trust if the grantor or anyone other than an adverse party has any control over distributions. §674(a). A number of important exceptions to the general rule are in §674(b).

c. **Section 675–Administrative Powers.** The grantor is treated as the owner of any portion of a trust over which certain administrative powers are held. Some of the powers that trigger grantor trust status must be held by the grantor or a nonadverse party (the power to deal for less than full consideration and the power to borrow without adequate interest or security, §675(1)-(2)), while other powers could be held by any person in a nonfiduciary capacity, §675(4). In addition, actual borrowing of trust funds by the grantor or grantor's spouse can trigger grantor trust status. §675(3).

d. **Section 676–Power to Revoke**. The grantor is treated as the owner of any portion of the trust if the grantor or a nonadverse party has the power to revest title to that portion in the grantor, but this rule does not apply during any period that §673 would apply if the power were a reversionary interest (applying the same 5% actuarial test

and the exception for minor descendants). §676(a)-(b). The trust instrument should state specifically whether it is a revocable or irrevocable trust (under a minority position, applied in Texas, a trust is revocable unless it specifically provides that it is irrevocable).

e. **Section 677–Income for Benefit of Grantor**. The grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, *is*, or in the discretion of the grantor or nonadverse party, *may be* (1) distributed or accumulated for future distribution to the grantor or the grantor's spouse, §677(a)(1)-(2), or (2) applied to the payment of premiums for life insurance policies on the life of the grantor or the grantor's spouse, §677(a)(3).

f. **Section 678–Person Other Than Grantor Treated as Substantial Owner**. A person other than the grantor is treated as the owner of any portion of the trust over which the person has the sole power to vest the corpus or the income in the power holder, §678(a). If the grantor would also be treated as the owner under §§673-677, those provisions will override §678. §678(b).

14. Grantor Trust Trigger—Section 674 Power to Control Beneficial Enjoyment

a. **General Rule, §674(a)**. Section 674(a) provides broadly that the grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the corpus or income is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party.

b. **Exception–Powers Permitted to Be Held by Anyone, §674(b)**. Certain powers may be held by anyone as trustee without creating a grantor trust. These exceptions are extremely detailed. One speaker comments that his "summary notes" about these exceptions are the Code itself. If the planner wants a trust to be a grantor trust under the general rule of §674(a), the trust provisions must be navigated very carefully so that *none* of these exceptions apply.

§674(b)(1) – power to apply income to support of a dependent (referring to §677(b)).

§674(b)(2) – power affecting beneficial enjoyment only after occurrence of an event if there is less than a 5% probability that the event will occur.

§674(b)(3) – testamentary power.

§674(b)(4) – power to allocate among charities.

§674(b)(5) – power to distribute corpus that is limited by a reasonably definite standard *or* if the trust has separate shares (but not including a power to add beneficiaries other than to provide for after-born children).

§674(b)(6) – power to distribute or accumulate income if the income must ultimately pass to specifically identified beneficiaries, unless a beneficiary does not survive a date of distribution that reasonably could have been expected to occur during the beneficiary's lifetime and the assets then pass to other designated takers whose shares have been irrevocably specified (but not including a power to add beneficiaries other than to provide for after-born children).

§674(b)(7) – power to distribute or withhold income only during the disability of the beneficiary or before the beneficiary reaches age 21 (but not including a power to add beneficiaries other than to provide for after-born children).

§674(b)(8) – power to allocate receipts and disbursements between income and corpus.

c. **Exception–Certain Powers of Independent Trustees, §674(c)**. A power that is exercisable solely by the trustee, none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor, to distribute or accumulate income or corpus (even if no reasonably definite distribution standard exists) is an exception that will avoid the general rule of §674(a). This exception does not apply to a power to add beneficiaries other than to provide for after-born children.

d. **Exception–Power to Allocate Income Limited by a Standard, §674(d)**. A power to make or withhold distributions of income held by the trustee, other than the grantor or grantor's spouse, if the power is limited by reasonably definite external standard, will avoid the general rule of §674(a). This exception does not apply to a power to add beneficiaries other than to provide for after-born children.

e. **Exception to the Exception–Power to Add Beneficiaries**. The provisions for many of those exceptions provide that the exceptions will not apply if "any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children". *E.g.*, I.R.C. §§ 674(b)(5), 674(b)(6), 674(b)(7), 674(c), 674(d). If such a power to add beneficiaries exists, the exceptions provided in §§674(b), (c), and (d) will not apply, so the general rule in §674(a) provided for grantor trust treatment would apply.

Who Should Hold the Power? No limitation on who can hold the power applies as far as whether the power will result in grantor trust status. As long as a nonadverse party holds a power over dispositions, the person who holds the power to add beneficiaries does not have to be a nonadverse party.

- The *grantor* should not hold the power to add beneficiaries because that retained power would cause the transfer to result in an incomplete gift. Treas. Reg. 25.2511-2(c), (f). In addition, the assets may be included in the grantor's estate under §§2036(a)(2) or 2038.
- The power could be held by the *grantor's spouse* without risking estate inclusion as long as no property is contributed to the trust by the spouse and as long as the spouse is not controlled by the grantor. (However, a successor holder of the power should be provided or else the death of the spouse could cause a termination of grantor trust status.)
- The power to add beneficiaries should not be held by a *beneficiary*. An exercise of the power by a beneficiary might result in a deemed gift.
- If a *trustee* holds the power to add beneficiaries, query whether fiduciary principles would place any constraint on the ability of the trustee to add a beneficiary?

Class of Beneficiaries That May Be Added. The statute states that the power to add beneficiaries "to provide for after-born or after-adopted children" would not cause grantor trust status. No other limitations are listed regarding the permissible class of added beneficiaries. Various cases and rulings have recognized grantor trust status where a power exists to add charities as beneficiaries. See e*.g., Madorin v. Commissioner*, 84 T.C. 667 (1985). The permissible classes of additional beneficiaries could be limited in any manner desired by the grantor. For example, the power could be given to add members of a specific group, such as nieces and nephews, spouses of children, or more remote relatives. However, it is not clear that a power to "add" persons who are already contingent remote beneficiaries would be treated as a power to "add" beneficiaries that would trigger grantor trust treatment. "Adding" beneficiaries in that situation arguably just elevates their beneficiary status, but really does not "add" them as beneficiaries.

Power of Appointment. A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status. *See* Letter Ruling 9643013 (trustee for one trust and grantor's spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor's descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the §674(c) exception did not apply).

Checks and Balances. Because of the very broad power granted to an individual to add beneficiaries, the grantor may feel more comfortable with a "checks and balances" system to assure that various individuals concur with the addition. An approach used by some planners to provide "checks and balances" is to give someone other than the trustee the power to add beneficiaries, but to provide that the trustee would make the decision of when to make distributions to the new beneficiaries, the same as for all trust beneficiaries.

f. **Inter Vivos Limited Power of Appointment.** Giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment over all of the trust assets, at least during the grantor's lifetime, is one way of creating a grantor trust as to the entire trust (income and corpus). The third party must be a nonadverse party (so a beneficiary cannot hold the power). Because the person is not a trustee, the exception in §674(c) would not apply. [Consider using a related or subordinate party if there is any concern that the power may be deemed to be held in a fiduciary capacity; in that event, § 674(c) still would not apply.] Because no standard exists, the exception in §674(d) would not apply. The testamentary power of appointment exception in §674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in Section 674 would apply, so the general rule of §674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset. Provide a succession of power holders during the grantor's lifetime—so that the trust will continue as a grantor trust if the initial power holder dies before the grantor.

15. Grantor Trust Trigger—Section 675 Administrative Powers

a. **General Statutory Rules.** The grantor is treated as the owner of any portion of a trust over which certain administrative powers are held:

- Power of the grantor or a nonadverse person to allow the grantor to deal with trust assets for less than full and adequate consideration, §675(1);
- Power of the grantor or a nonadverse party to allow the grantor to borrow trust assets without adequate security or interest (but not including a general lending power to make loans to any person), §675(2);
- Actual borrowing of trust funds by the grantor (other than a loan for adequate interest and security made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor), §675(3);
- General powers of administration exercisable by any person in a nonfiduciary capacity to (A) vote stock in a corporation of which the holdings of the grantor trust is significant to voting control, (B) control the investment of trust funds to the extent the funds consist of stocks of corporations in which the holdings of the grantor and trust are significant to voting control, or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value, §675(4).

Professor Pennell remarks that none of the administrative powers in §675 "make a lick of sense," except that they were just designed to hurt taxpayers when trusts were viewed as abusive attempts to reduce income taxes; Congress was overreaching with these rules, and they are being used against the government now that grantor trusts are used strategically by taxpayers. He observes that even the numbering of §675 does not make sense (with its sub-paragraphs being numbered (1). (2), etc. instead of (a), (b), etc. like the rest of the Code).

b. **Actual Borrowing of Trust Funds.**

Actual Borrowing Required. Under §675(3), if the grantor has (directly or indirectly) *actually* borrowed corpus or income from the trust and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated as a grantor trust. Grantor trust treatment will not result if the loan provides for adequate interest or security and if the loan is made by a trustee other than a related or subordinate party. Under the statute, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status. This raises practical issues for assets other than cash. For example, how does a grantor "borrow" real estate or stock of a closely held company or marketable securities? (But some panelists were not concerned with the concept of borrowing such assets.)

Grantor Trust Status if Loan Outstanding Any Time During the Year. The statutory language suggests that grantor trust status depends upon whether a loan is outstanding at the beginning of a taxable year. Under that interpretation, if borrowing occurs during year one, but is repaid before year two, grantor trust status would not exist in either year one or year two. However, the IRS interprets §675(3) as imposing grantor trust status if the loan to the grantor has been outstanding *any* time during the year. Rev. Rul. 86-82, 1986-1 C. B. 253, following *Mau v. United States*, 355 F. Supp.

909 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/2015 and repaid on 1/2/2016, the grantor would be treated as owning the trust for all of 2015 and 2016 under Revenue Ruling 86-82. The intriguing possibility of just making a loan on December 30 of a year to make the trust a grantor trust for the entire year creates great flexibility. That may be used in year-end planning (but the possibility exists that the IRS might take the position at some point that this is an abusive strategy, despite the outstanding Revenue Ruling and case support).

Repurchase of Asset For a Note. Most attorneys overlook that Revenue Ruling 85-13, 1985-1 C.B. 184 (which concluded that transactions between a grantor and his or her grantor trust do not result in gain recognition) says that a nongrantor trust can be converted into a grantor trust by having the grantor just buy back all of the trust assets for a note (if it was an unsecured note with inadequate interest), and the grantor trust treatment is effective even as to that sale. Whether the amount of the borrowing impacts the portion of the trust that is treated as a grantor trust is unresolved. (See the following paragraph.) However, the Second Circuit held that such a purchase of trust assets for a note caused the trust to be a grantor trust as to future transactions, but the purchase transaction itself resulted in gain recognition. *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984).

Unclear as To Portion of Trust Treated as Grantor Trust. It is not clear whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus which could have been borrowed if some borrowing occurs. *Compare Bennett v. Commissioner*, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; held that grantor was taxable on portion of current year's income which the principal of the loan at the beginning of the year bears to the total trust income from the trust inception) *with Benson v. Commissioner*, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; held that grantor should be taxed on all trust income). Unless the grantor borrows the entire corpus, there can be no assurance that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

Fiduciary Duty Concerns. Some attorneys have questioned how a trustee can loan trust assets and receive no adequate security without breaching its fiduciary duty. A simple answer is that the trust instrument may authorize the trustee to do so, but would that be treated as a retained beneficial interest? It should not, because the trustee has the discretionary power to make the loan and there is no retained right by the grantor. Furthermore, whether making a loan without adequate security is a breach of fiduciary duty goes to the reasonableness of the transaction; unsecured loans are often made in the commercial world (based on the creditworthiness of the borrower). Determining the value of a note received by the trust would consider a variety of factors, including the stated interest rate, the creditworthiness of the borrower, and the extent of any collateral.

c. **Substitution Power**. Substitution powers, referenced in §675(4)(C), are addressed in the following Item 16. (This is addressed in its own separate item because this is the most popular trigger power used to create grantor trust status.)

16. Grantor Trust Trigger—Substitution Power

a. **Statutory Provision**. Section 675(4) lists several general powers of administration, which, if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment. One of those powers, listed in § 675(4)(C), is "a power to reacquire the trust corpus by substituting other property of an equivalent value."

b. **Grantor Trust as to Both Corpus and Income**. Even though §675(4)C) refers to a power to reacquire "trust corpus," this power causes the grantor to be treated as the owner of trust corpus and income (including ordinary income not allocable to corpus). Treas. Reg. § 1.671-3(b)(3).

c. **Nonfiduciary Capacity Determination**. The regulations provide that "the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." Treas. Reg. §1.675-1(b)(4). The IRS typically takes the position in rulings that whether the grantor holds the power in a nonfiduciary capacity for purposes of §675 is a *question of fact* to be determined by the district director after returns have been filed.

d. **Trustee or Adverse Party Should Not Hold Power**. Because grantor trust status depends upon the power being held in a "nonfiduciary" capacity, the power of substitution should not be held by the trustee. Similarly, a trustee's approval or consent should not be required. Regulation §1.675-1(b)(4) provides that if a power is exercisable by a person "as trustee," there is a rebuttable presumption that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Similarly, a trustee's approval or consent should not be required (or else the requirement in the initial sentence of §675(4) will not be satisfied.)

   The power should not be held by an adverse party. Even though several clauses of §675 require that a power be exercisable by a nonadverse party (§675(1) & (2)), §675(4), which deals with general powers of administration, merely refers to powers held "by any person" without requiring that the power be held by a nonadverse party. However, Regulation §1.675-1(b)(4) refers to powers of administration held in a nonfiduciary capacity "by any nonadverse party." Despite the clear contradiction of the statute, it is possible that the regulation might be upheld under the broad deference standard for upholding regulations. Accordingly, the substitution power should not be held by a trust beneficiary.

e. **Estate Inclusion Can Be Avoided; Revenue Ruling 2008-22**. Prior to the issuance of Revenue Ruling 2008-22, planners were wary of using substitution powers as a grantor trust trigger, for fear that a substitution power held by the grantor would cause estate inclusion. Revenue Ruling 2008-22, 2008-16 IRB 796, provides very helpful guidance, indicating that a grantor non-fiduciary substitution generally will *not* trigger estate inclusion under §§2036 or 2038. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, "the trustee has a fiduciary duty to prevent the exercise of the power." The ruling reasons that (1) the

trustee "has a fiduciary obligation to ensure that the assets exchanged are of equivalent value," and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee's power to reinvest assets and the trustee's duty of impartiality regarding the beneficiaries.

With respect to the shifting of benefits limitation, the ruling provides several safe harbors:

> A substitution power cannot be exercised in a manner that can shift benefits if:
>
> (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus AND a duty of impartiality with respect to the trust beneficiaries *[Observe, state law would generally impose both of these duties unless the trust instrument negates these duties]*; OR
>
> (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

Rev. Rul. 2011-28 is a follow-up to Revenue Ruling 2008-22; it clarifies that a nonfiduciary substitution power generally will not trigger estate inclusion with respect to life insurance under §2042.

Third Party Substitution Powers. Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power "exercisable in a nonfiduciary capacity by *any person*"); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by "*any* nonadverse party"). However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to <u>re</u>acquire the property. The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status. Similarly, Rev. Proc. 2008-45 uses the same approach for the sample inter vivos CLUT grantor trust form. Several private letter rulings have held (apparently incorrectly and inadvertently) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power. *E.g.*¸PLRs 201216034, 9311021.

17. Grantor Trust Trigger Power—Income For Benefit of Grantor, §677

a. **Overview of Statutory Provision**. The grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, *is*, or in the discretion of the grantor or nonadverse party, *may be* (1) distributed or

accumulated for future distribution to the grantor or the grantor's spouse, §677(a)(1)-(2), or (2) applied to the payment of premiums for life insurance policies on the life of the grantor or the grantor's spouse, §677(a)(3).

b. **Income and Corpus.** The literal language of §677(a) would suggest that income and corpus of the trust would be treated as a grantor trust.

(a) General Rule.—The grantor shall be treated as the owner of *any portion of a trust…whose income…is, or…may be*

(1) distributed to the grantor or grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse …. (emphasis added)

A trust treated as a grantor trust under §677(a)(1), however, is only a grantor trust as to the income. An example in the Regulations very specifically indicates that the §677(a)(1) power only results in the grantor being treated as the owner of the income portion of the trust and not the corpus where the grantor was entitled to the trust income for life, with remainder passing to another unrelated person. Treas. Reg. §1.677(a)-1(g), Ex. 1.

If §677(a)(2) applies and accumulated income (even including capital gains that are allocated to corpus) may later be distributed to the grantor or the grantor's spouse, the trust is a grantor trust as to the entire trust, including the capital gains. Treas. Reg. §1.677(a)-1(g) Ex.2.

c. **Support Exception.** Section 677(b) provides that grantor trust treatment will not result under §677 (or any other provision) merely because the income could be used to provide for the support or maintenance of a beneficiary (other than the grantor's spouse) that the grantor is legally obligated to support, unless it is actually used for the beneficiary's support or maintenance. Professor Pennell points out that the "actually used" exception to the exception "does not require distributions that 'discharge' the obligation of support or maintenance, [but only that] the distributions were for the support or maintenance of someone the grantor was obliged to support or maintain." *Stone v. Commissioner*, 54 T.C.M. 462 (1987), a*ff'd in unpublished opinion* (9th Cir. 1988) ("[t]he legal obligation required [by §677(b)] seems to be a general one towards the beneficiary, not a specific obligation to expend particular amounts on particular expenses connected with the person to whom the obligation is owed").

d. **Impact of Divorce; "Divorce Trusts."** Sections 674(c) and 675(3) specifically provide that they do not apply to a power held by or a loan made to a grantor's spouse following a divorce from the grantor. Section 677 does not have such a specific statutory exception following divorce, but Treas. Reg. §1.677(a)-1(b)(2) indicates that the provisions in §677(a) regarding income payable to the grantor's spouse apply "solely during the period of the marriage of the grantor to a beneficiary."

While the regulation to §677 indicates that it will not apply to possible distributions to an ex-spouse following a divorce, there is uncertainty in light of the subsequently enacted spousal unity rule in §672(e) treating the grantor as holding any power *or*

interest held by the grantor's spouse at the creation of the power or interest. To the extent that the spouse's beneficial interest is an "interest," §672(e) would seem to continue to apply as long as the interest arose when the spouse was married to the grantor.

> Section 672(e)'s test is administered at the time the interest is created. It contains no mechanism for a later retesting to take into account a change in marital status.
>
> It is probable that I.R.C. §672(e) operates to extend the application of I.R.C. §677(a) to periods after the divorce… [I]f trust income is or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), I.R.C. §677(a) treats the grantor as the deemed owner. If the spouse's status as a mandatory or discretionary recipient of trust income is a trust "interest" within the meaning of I.R.C. §672(e), then that status would continue to be attributed to the grantor after a divorce and would result in grantor trust status. [Footnote 185 adds this clarification: …the power to distribute to the former spouse is treated as the power to distribute to the grantor [under §672(e)]. That is what is reached by I.R.C. §677 after divorce.]
>
> …
>
> The result … seems inappropriate.
>
> Carlyn McCaffrey & John McCaffrey, *Tax and Estate Planning for Divorce – Selected Issues* (Oct. 2015).

Section 682 is also relevant. Section 682 provides that if spouses are divorced, the income that either of them receives or is entitled to receive from a trust will be included in that spouse's income and will not be included in the gross income of the other spouse even though the amount would be otherwise be included in the other spouse's income. In the context of grantor trusts, this generally prevents the grantor from being taxed on the grantor trust's income that may be distributed to the grantor's spouse following a divorce. However, this likely applies to income but not the accumulated capital gains. (Some uncertainty exists as to the treatment of capital gains. No definition of "income of any trust" appears in §682 and whether that refers to trust accounting income [which is the case under §643(b) for purposes of §§641-668] or to taxable income [which is the case under Treas. Reg. §1.671-2(b) for purposes of the grantor trust rules in §§671-679] is unclear. If it refers to trust accounting income, capital gains would not be taxed to the ex-spouse, but to the grantor under the general grantor trust rules. If it refers to taxable income, capital gains would be taxed to the transferee ex-spouse to the extent of distributions to the ex-spouse.)

e. **Spousal Access Lifetime Trusts**. Trusts may provide that the grantor's spouse is a discretionary beneficiary as a way to being able to access trust funds in the unlikely event the spouse should ever need distributions from the trust. However, the parties should be aware that including this provision will cause the trust to be a grantor trust under §677.

If the spouse is included as a potential beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift from the spouse may result (unless the relinquishment is a qualified

disclaimer within nine months of the creation of the interest.) A possible planning strategy would be to give an independent party the power to remove the spouse as a discretionary beneficiary.

f. **Estate Tax Inclusion Risk if Grantor is Discretionary Beneficiary**. If the grantor, rather than the grantor's spouse, is a discretionary beneficiary, there is a likelihood that the trust assets would be included in the grantor's estate under §2036 unless the trust is formed in a state which has adopted a Domestic Asset Protection Trust statute (where a settlor can be a discretionary beneficiary without subjecting the trust assets to the settlor's creditors.) Even in such a "self-settled trust" state, however, if the trustee actually makes distributions to the grantor, a concern may arise under §2036 as to whether there was an implied agreement about distributions to the grantor, which could trigger §2036 inclusion even apart from creditors rights.

g. **Payment of Life Insurance Premiums**. The grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. §677(a)(3); *see generally* Andrew Katzenberg, *Unlocking the Trapdoor of IRC Section 677(a)(3)*, TRUSTS & ESTATES 31 (April 2016). The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. §1.677(a)-1(b)(2). However, despite the very broad wording of §677(a)(3), cases have imposed restrictions on grantor trust status merely because of the *power* to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. *Corning v. Commissioner*, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. *E.g.*, *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq*. 1944 C.B. 29.

18. Person Other Than Grantor Treated as Substantial Owner ("Pseudo-Grantor Trusts"), §678

a. **Statute**.

Current Power, §678(a)(1). Section 678(a)(1) provides that an individual shall be treated as the owner of any portion of a trust with respect to which the individual has a power, exercisable solely by himself, to vest the corpus or income from the trust in himself. Such a person could be a beneficiary serving as the sole trustee, or could be someone (even if not a trust beneficiary) who has the power to withdraw assets from the trust. For example, this provision could apply to all Crummey power holders, even though some of them may not be trust beneficiaries and may not be expected to exercise the withdrawal power.

Following Release of Power, §678(a)(2). After the power has been "partially released or otherwise modified" so that the person no longer holds the power to withdraw the trust corpus or income, §678(a)(2) treats the person as the continuing owner if the power holder has interests or powers that would cause §§671-677 to

apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust, but §677 may apply only as to trust income and not trust corpus if accumulated income does not ultimately pass to the beneficiary).

Support Obligations, §678(a)(3). If a person has a power as trustee or co-trustee to apply income to the support or maintenance of a dependent, §678(c) limits grantor trust exposure to that person to the amount of actual distributions. This limitation, to the amount actually distributed, applies only as to income and as to a person's power as a fiduciary. If any such support distributions are actually made, the power holder is taxed under Sections 661-662—based on an allocation of DNI—rather than being treated as the owner of a portion of the trust. §678(c).

Disclaimer, §678(a)(4). Section 678 does not apply if the power holder renounces or disclaims the power within a reasonable time after the holder first became aware of its existence. §678(d).

b. **Ascertainable Standard Exception Is Uncertain**. There is no ascertainable standard in the statutory language of §678. Whether the beneficiary-sole trustee will be taxed on trust income under §678 if the trustee's discretion is subject to an ascertainable standard is unclear. Perhaps not, under the theory that the statutory language requires that the trustee be able to vest the corpus or income in himself "solely by himself," and the trustee is not making a determination "solely by himself" if he is making a distribution decision based on whether ascertainable standards are satisfied. The legislative history states that §678 would treat a person as an owner of the trust "if he has an *unrestricted power* to take the trust principal or income." S. Rep. No.1622, 83d Cong., 2d Sess. 87 (1954) (emphasis added).

The reference to an unrestricted power is consistent with case law under a predecessor provision to §678. *See Funk v. Commissioner,* 185 F.2d 127 (3d Cir. 1950) (trustee's power to distribute income to herself for her "needs" did not cause trust income to be taxed to trustee as owner); *Smither v. U.S.*, 108 F. Supp. 772 (S.D. Tex. 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953) (power to distribute income for support, maintenance, comfort and enjoyment; beneficiary-trustee not taxed on trust income as owner).

In addition, there is one reported case that has addressed this issue after the adoption of §678, and it adopts an ascertainable exception approach. *U.S. v. DeBonchamps*, 278 F.2d 127, 130 (9th Cir. 1960) (held that grantor trust rules applied to determine tax effects of holder of life estate; life tenant did not have unrestricted power under state law to distribute corpus to self, but only for "needs, maintenance and comfort"; held that undistributed capital gains not taxed to life tenant).

Private rulings from the IRS have been inconsistent. *Compare* Ltr. Rul. 8211057 (trustee-beneficiary with discretionary principal interest for "support, welfare and maintenance" taxable on income under §678) *with* Ltr. Rul. 9227037 (trustee-beneficiary with discretionary principal interest for "health, support and maintenance" held not taxable under §678). *See also* Ltr. Rul. 8939012 (trustee-beneficiary not taxable as owner of trust under §678; however exact distribution standard not clearly set forth in ruling).

What should be the correct approach? Professor Pennell believes that, from a policy standpoint, an ascertainable standard exception should apply to be consistent with the "reasonably definite standard" exception in §674(b)(5)(A).

c. **Overview of Other Applications of §678**. Possible applications of §678, other than situations in which a beneficiary is the sole trustee, are for:

- Crummey Trusts;
- §2503(c) trusts; and
- Trusts in which a beneficiary has a "five or five" withdrawal power (sometimes referred to as a "Creeping 678 Trust," because each year's 5 or 5 power would cause an increasing portion of the trust to be a grantor trust as to the power holder).

d. **Crummey Trusts.** The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under §678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. *See e.g.*, Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.

In Ltr. Rul. 201216034 the beneficiary had a non-fiduciary substitution power, and the ruling reasoned that the existence of the non-fiduciary substitution power constituted the requisite retained interest or power that would cause §675 to apply if the power were held by the grantor. That ruling, like many of the other rulings issued by the IRS acknowledging that §678 applies to the trust, involved a trust that held S corporation stock, and the ruling held that the trust was a qualified shareholder of the S corporation, because it is a grantor trust. (The ruling appears to be wrong — because the existence of the beneficiary's non-fiduciary substitution power causes the trust to be a grantor trust as to the original grantor (and §678(b) makes clear that the trust is not treated as owned by the power holder under §678(a) if the original grantor is treated as the owner).

Lapse vs. Release Issue. The IRS's position under §678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "partial release or modification" of a withdrawal power. This arguably is not the same as the mere *lapse* of a withdrawal power. A "release" seems to require an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. (Sections 2041b)(2) and the 2514(e) provide that "the lapse of a power … shall be considered a release of a power.") However, the statute refers to a "partial release;" is a lapse a partial release? The IRS position has been clear since the early 1980s. A number of private letter rulings view the lapse as a release, and since no "five or five" exception exists in the income tax statute, the beneficiary whose Crummey withdrawal rights have lapsed is treated as the partial owner of the trust.

Portion Issue. A further complication is that under §678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in

Treas. Reg. §1.671-2(e)(6) Ex. 4. In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under §678. However, the term "portion" might refer to the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust has appreciated to $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey power holder as the owner of a trust owning S stock, the trust would no longer be a wholly grantor trust if any growth occurred in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust that is attributable to the power holder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

Observe that this causes a complex reporting nightmare. A trust might include 20 Crummey powerholders, each of whom is treated as owning a portion of the trust. The IRS has issued no published rulings regarding this issue. It apparently does not know what to do about the issue either. (There are no reported cases where the IRS has gone after Crummey powerholders for not reporting trust income.)

e. **Section 2503(c) Trusts.** At age 21, the beneficiary of a §2503(c) trust has the right to withdraw all assets. Therefore, at age 21, the trust may become a §678 trust, with the beneficiary being treated as the owner. (Arizona and Michigan have recently revised their statutes to provide creditor protection, despite the beneficiary's ability to withdraw all of the trust assets at age 21. Most states that have statutes protecting Crummey powerholders from creditors' claims limit the protection to withdrawal amounts within the gift tax annual exclusion amount.)

f. **Creeping 678 Trust**. One of the panelists routinely uses this approach. The beneficiary is given a right to withdraw the greater of $5,000 or 5% of the trust corpus (a "five or five" power), which lapses at the end of the current year. For example, assume that a trust has $1 million (and for simplicity, assume that the assets do not appreciate in value). At the end of year one when the five or five power lapses, the trust would be a §678 trust as to 5% and an ordinary trust (subject to the DNI distribution rules of §§661-662) as to 95%. In year two, the beneficiary's 5% withdrawal causes an additional 5% of the ordinary trust portion (*i.e.*, 5% of $95%, or 4.75%) to be subject to section 678. Accordingly, in year two, the trust is a §678 trust as to 5% + 4.75%, or 9.75%. Over a period of years, an increasing portion of the trust becomes a §678 trust. Some panelists view that process as being overly

complicated. However, one panelist uses it in order to cause an increasing portion of the trust to be a grantor trust as to the beneficiary.

g. **Grantor Trust Treatment as to Original Grantor Overrides §678**. Section 678(b) generally provides that if grantor trust status is conferred on the grantor under §§673-677 and on a beneficiary under §678, the grantor trust status on the original grantor will prevail. However, §678(b) literally applies only as to "a power over *income*" and a withdrawal power is typically a power to withdraw *corpus*. The 1954 Committee Reports make apparent that the language of §678(b) contains a drafting error and that it was intended to apply to a power over income *and corpus*, similar to §678(a)(1). The committee reports relating to §§671 through 678 include the following statement:

> A person other than the grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income … unless the grantor himself is deemed taxable because of such a power." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954).

Despite arguments from the literal statutory language (the exception in §678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a §678 power attributable to a person holding a Crummey withdrawal right that lapses. *E.g.*, PLRs 200730011, 200603040, 200606006, 200011054; 9309023; 9321050.

In any event, the IRS can change its position from that taken in prior PLRs. If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power when structuring a grantor trust.

h. **"BDIT."** The "Beneficiary Defective Inheritor's Trust" (sometimes referred to as "BDIT") is a trust created by a "nominal" third party with a nominal amount (typically $5,000) that is designed to be a grantor trust as to the beneficiary under §678 based on the beneficiary's withdrawal power. The withdrawal power typically lapses gift and estate tax free under §§2514(e) and 2041(a)(2). The beneficiary might later sell assets to the trust to build its value. Because the beneficiary never makes any gifts to the trust, the beneficiary could be the trustee and a beneficiary of the trust (subject to an ascertainable standard relating to the beneficiary's health, education, support, or maintenance).

If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under § 678. See the discussion in subparagraph d above regarding Crummey Trusts.

For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The beneficiary would be treated as the owner of the entire trust for income tax purposes under § 678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary's estate, the beneficiary could serve as the trustee of the trust, and the trust should not

be subject to the beneficiary's creditors if it contains a spendthrift clause (which is made clear in some state statutes). Furthermore, the trust could give the client a broad limited testamentary power of appointment. In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors.

Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee might then be able to divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.] The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as with other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments.

For an excellent discussion of planning considerations, see Stuart Horwitz & Jason Damicone, *BDIT: New Twist on Trust Design Provides Superior Results*, ESTATE PLANNING 3 (July 2014); Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013); Jonathan Blattmachr & Howard Zaritsky, *Is the BDIT Ready for Primetime?,* 24 PROBATE PRACTICE REPORTER 1 (September 2012); Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")* (2008).

Does it work? The IRS has expressed its concern in two ways.

- The IRS added the "sale to a BDIT" transaction to its "no-ruling" list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to §§678, 2035, 2036, 2037, 2038, and 2042). (Professor Pennell remarks that the IRS's adding an issue to the no-ruling list means they hate something but do not know why or how to attack it under current authorities.)

- In addition, the sale to grantor trust legislative proposal specifically refers to the "deemed owner under the grantor trust rules," which undoubtedly is a reference to trusts treated as being owned by the beneficiary under §678.

This is the IRS's "shot across the bow" suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work. Possible IRS attacks include (1) whether a leveraged sale to the trust supported by third-party guarantees is a bona fide sale and note from the trust or whether the sale constitutes a deemed gift in some manner by the trust owner-beneficiary, and (2) whether the portion rules may prevent the trust from being a wholly grantor trust as to the beneficiary. For example, Professor Pennell suggests a possible "portion rule" argument, for which there is *no* guidance, is that the withdrawal amount would be compared to the total value in the trust *after* the sale to determine the portion of the trust that is a §678 trust. (If $5,000 has been contributed to the trust for each of 10 years to accumulate $50,000 in the trust, and the beneficiary then sells assets worth $50 million to the trust, is the trust a §678 trust as to all of the trust, because all gifts to the trust have been subject to withdrawal powers, or as to $50,000/$50,050,000 (or .0999%)?) Does it matter that the trust has been in existence for 10 years and is an "old and cold" trust? If the trust is not a wholly grantor trust as to the beneficiary, the sale transaction may be an income recognition event to the extent of the sale to the nongrantor trust portion.

i. **QSST**. Trusts that can be qualified shareholders of S corporations include grantor trusts, qualified Subchapter S trusts (QSSTs), and electing small business trusts (ESBTs). The QSST must have only one income beneficiary, and all fiduciary accounting income must be distributed to the beneficiary at least annually. The beneficiary makes an election to treat the trust as a QSST, which has the effect for purposes of §678 of treating the beneficiary as the owner of that portion of the trust consisting of S corporation stock. §1361(d)(1)(A). *See* Reg. §1.1361-1(j)(8) (while income beneficiary is treated as owner under §678 of the portion of the trust that consists of S corporation stock for which the QSST election is made, gain or loss on the sale or other disposition of the stock by the trust will be attributed to the trust and not the income beneficiary). That regulation supersedes Rev. Rul. 92-84 with respect to a sale of QSST stock *by* the QSST, but the principles of Rev. Rul. 92-84 appear to support disregarding for income tax purposes a sale of QSST stock from the beneficiary *to* the QSST. *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, Part III.A.e.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST (printed 9/21/2016) (available by emailing author at **sgorin@thompsoncoburn.com**).

19. Dividing Partial Grantor Trust into Two Trusts, One of Which Is Fully Grantor Trust

A frequently recurring issue is how to treat a trust that is only partially a grantor trust. For administrative convenience, could the trust be divided into two trusts, one of which is fully an ordinary trust (subject to the §§661-662 DNI distribution rules) and one of which is a wholly grantor trust? For example, if a trust is created with community property, after one spouse dies, could the trust be divided into two equal separate trusts, one of which would

be a wholly grantor trust as to the surviving spouse? Some panelists take that approach. Others are concerned over the lack of authority for this position, analogizing to the GST rules that do not recognize a division of a trust (into separate GST exempt and non-exempt trusts) unless the severance is a qualified severance made pursuant to specific statutory and regulatory authorization.

20. Grantor Trust Portion Rules

a. **General Description**. Under the grantor trust rules, the grantor is treated as the owner of a portion of a trust as to which a particular interest or power causes grantor trust treatment. The various grantor trust triggers vary as to the portion of the trust that is affected. Little authority exists as to the portion rules. For example, the Ferguson, Freeland and Ascher treatise on the Federal Income Taxation of Estates, Trusts, and Beneficiaries summarizes that the cases regarding the application of the portion rule to §675(3) are in hopeless disarray. The portion rules are discussed in Treas. Reg. §1.671-3.

   Planning with grantor trusts requires a "3-D" analysis. (1) Does a grantor trust trigger apply? (2) Does that particular power or interest avoid estate inclusion for the grantor? (3) Does the trigger cause grantor trust treatment as to the entire trust or only as to the trust income or trust corpus or other specific portion of the trust?

b. **Entire Trust.** The entire trust may be treated as a grantor trust under some of the triggers, including:

   - §673 reversion power;
   - §676 revocation power;
   - §674(a), if the grantor or nonadverse party has unrestricted powers over income and corpus and none of the exceptions in §674(b)-(d) apply;
   - §677(a)(2), if the trust remainder (including accumulated income) passes to the grantor or the grantor's spouse; and
   - §675(4)(C), if the swap power applies to all trust assets.

c. **Ordinary Income**. The trust is a grantor trust only as to fiduciary accounting income (not including corpus) under some triggers, including:

   - §674(a), if the grantor or nonadverse party has unrestricted powers over income and none of the exceptions in §674(b)-(d) apply (including the absence of a reasonably definite external standard over income distributions under §674(d)), or if an exception applies only under §674(b)(5) regarding a power to distribute corpus; and
   - §677(a)(1) income interest for the grantor or grantor's spouse (but a standard limiting distributions may limit the portion to that amount of corpus needed to generate the income needed for those purposes, *see* Rev. Rul. 56-484).

d. **Corpus.** A trust that is a grantor trust only as to corpus is possible. An example would be a reversion that escapes §673 but not §677(a)(2). A trust that is a grantor trust only as to corpus, however, would be rather unusual. For example, even if a trustee has a

power over corpus alone, that can affect the enjoyment of current income as well because income would flow with corpus to any distributee.

e. **Fractional Portion.** The trust may be a grantor trust as to a fraction of the income or corpus (for example, a §677(a)(1) right to receive one-half of the trust income, or a §673 reversion of half the corpus).

An interest or power stated as a specific dollar amount must be converted to a fraction of the trust, using the dollar amount as the numerator and the value of the trust at the beginning of the taxable year as the denominator. Treas. Reg. §1.671-3(a)(2). If an interest or power is a stated dollar amount *of income,* the amount of corpus required to produce that amount of income must be identified and that amount of corpus is used as the numerator of the fraction. Treas. Reg. §1.671-3(c).

An example in which a fractional portion of the trust may be a grantor trust arises with a loan of less than all of the trust assets to the grantor or grantor's spouse without adequate interest or adequate security. §675(3). The law is unclear as to the portion of the trust that becomes a grantor trust. *See* FERGUSON, FREELAND, & ASCHER, FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND BENEFICIARIES §10.13[B] (3d ed. 2011) (the loan cases "constitute a highly problematic body of law. They are badly inconsistent among themselves. Taken together, they create horrible distinctions based in part on whether loans come from income or corpus. They also often point in different directions.") Professor Pennell believes that the proper approach is a fractional approach, with the numerator being the amount of the debt and the denominator being the income for the year (not the size of the trust corpus). Accordingly, if the grantor borrows the full amount of trust income, the trust should be a grantor trust as to all of the income.

21. Grantor Trust Toggling

a. **Desirability of Flexibility**. A grantor may be concerned with being liable for what could potentially be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Having the flexibility to "turn off" the grantor trust status can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to "toggle" grantor trust status could be achieved.

Despite the very helpful flexibility afforded by building in toggling features, some panelists do not mention toggling to clients when structuring grantor trusts, for fear the clients would want to go overboard in "turning off" and "turning on" grantor trust status repeatedly.

b. **Toggle Arrangement Using §674**. The power of the trustee, more than half of whom are related or subordinate parties, to make discretionary distributions not covered by a reasonably external standard will result in grantor trust treatment as to the entire corpus and income of the trust. See Item 14.a-d above. A third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause more than half of the co-trustees to be related or subordinate parties (if grantor trust status was desired) or that would cause no more than one-half of the trustees to be related or subordinate parties (if grantor trust status

was not desired.) The grantor should not hold the power to remove and replace successor trustees unless any such successor must be someone who is not a related or subordinate party in order to meet the "safe harbor" provided in Revenue Ruling 95-58.

Using this trustee removal mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee. If the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, it would be difficult to determine whether the next successor should be a related or subordinate party or not at the time that the trust agreement was prepared.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries.

c. **Toggle Arrangement Using Loans, §675(3).** Loaning all of the trust assets to the grantor or grantor's spouse causes grantor trust status for the entire year. Having the grantor (or grantor's spouse) repay the loan before the next year leaves the flexibility of being able to cause the trust to be a grantor trust in the following year (by the grantor's borrowing the trust assets at some point during the year) or not be a grantor trust (by not borrowing the trust assets). As discussed above in Item 15.b, the IRS position appears to be that the person could wait until the last several days of the year to make this decision.

d. **Toggle Arrangement Using Substitution Power, §675(4)(C).** Grantor trust status could be toggled by giving someone other than the grantor the right to cancel and reinstate a power of substitution under §675(4)(C).

e. **Toggle Arrangement Using Borrowing Power, §675(2).** Either the trustee or the grantor could be given the authority to relinquish the trustee's power to make loans to the grantor without requiring adequate security. Someone other than the grantor could be given the power to reinstate the power to loan without adequate security. To provide additional checks and balances, different persons could be given the authority to terminate and reinstitute the power to lend without adequate security.

f. **Toggle Arrangement Using Power to Add Beneficiaries**. The person who is given the authority to add beneficiaries could also be given the authority to relinquish the right to add beneficiaries. If a potential toggle is desired, another party could be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she likely would be treated as never having relinquished the authority to add beneficiaries.) Even if different persons are used, some commentators are concerned that the IRS may view the two persons together as still holding the power. Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Sales to Grantor Trusts*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 395, 437 (April 2016) ("The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a 'protector'), that probably only means that the trustee and the protector together still have the power.").

g. **If Grantor Can Release Trigger Power, Only Give Third Person Power to Reinstate It (And in a Subsequent Year)**. If the grantor has the right to relinquish a power that causes grantor trust status but has the right to reacquire that power, the relinquishment would not be given effect. The regulations provide specifically that if the grantor has a power broad enough to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under §675, he will be treated as the owner of the portion from the trust's inception. Treas. Reg. §1.675-1(a). Therefore, at a minimum, if the grantor has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power (to toggle back "on" the grantor trust status). Furthermore, the grantor's retention of the right to toggle grantor trust status might arguably constitute a §2036(a)(2) estate inclusion power or arguably result in an incomplete gift.

   To be conservative, provide that the reinstatement power could only be exercised in a *subsequent* taxable year, to help clarify that the trust is not a grantor trust in the year (or for the balance of the year) in which the relevant power is relinquished.

h. **Adverse v. Nonadverse Party Holding Power to Relinquish and Reinstate the Grantor Trust Power**. Many of the grantor trust powers must be exercisable by a nonadverse party in order to result in grantor trust status. However, the power to relinquish or reinstate a grantor trust power could be held by either an adverse party or a nonadverse party. (Nonadverse party status is only important for the person who holds the grantor trust power, and has no relevance to a person who has the authority to relinquish or reinstate that power.) An example of this is Letter Ruling 9010065, where the grantor's descendants (who were beneficiaries of the trust and, therefore, adverse parties) held the power to terminate the trustee's grantor trust power.

   A possible (rather unlikely) concern is whether a trust beneficiary might be deemed to make a gift to the grantor in any year in which the beneficiary toggles off grantor trust status (by relieving the grantor of the obligation of paying income taxes on trust income).

i. **Spouse Holding Power to Relinquish or Reacquire Grantor Trust Powers**. The grantor's spouse could have the power to exercise the grantor trust power directly, or could be authorized to relinquish the grantor trust power. (This may be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor's spouse.) However, beware of §672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes. Accordingly, if the grantor's spouse is given the power to relinquish *and* to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

j. **Using Different Persons May Provide Helpful Checks and Balances**. The powers used to result in grantor trust status may be very "powerful" powers. Giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers. Letter Ruling 9010065 illustrates an intricate checks and balances system. In that ruling, an unrelated trustee could add a qualified charity (which would cause grantor

trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer's spouse (but if the spouse were not living, with the approval of the taxpayer's brother). Other parties (a majority of the taxpayer's adult descendants) were given the power to cut off grantor trust status by terminating the trustee's authority to designate additional beneficiaries.

k. **Consideration from Grantor for Terminating Grantor Trust Status**? If the grantor trust status of the trust is terminated, the grantor is benefited by being relieved of the substantial income tax liability. Could the grantor pay consideration to the trust in return for the termination of the grantor trust status by the trust or other third person on behalf of the trust, without being treated as having made an additional taxable gift to the trust? If so, this could help relieve fiduciary concerns for the trustee's termination of the grantor trust treatment if that were desirable for some reason (for example, if having a grantor trust subjects the trust to state income that otherwise could be avoided), even though doing so would subject the trust to federal income taxation.

l. **Notice 2007-73 Identifies Certain "Toggling" Grantor Trusts as Transactions of Interest**. Notice 2007-73 identifies two rather complicated series of transactions involving grantor trusts. In each, a grantor trust would be formed that creates a unitrust interest and a noncontingent remainder interest for the grantor. The noncontingent remainder interest would cause grantor trust status. A substitution power would arise at a stated date in the future. The grantor would give the unitrust interest, and after certain transactions, would sell the retained remainder interest (which allegedly would remove grantor trust status). The institution of the substitution power at the later date would allegedly reinstate grantor trust status for the trust. Later, the grantor would purchase the unitrust interest. The goal of the scenarios is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain. The Notice states that "transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest" that require disclosure. Therefore, the Notice addresses the complicated transactions described in the two scenarios, and does not appear to apply to "garden variety" grantor trusts (even though grantor trust status has been toggled). The Notice states explicitly that merely terminating grantor trust status does not invoke the Notice:

> The transactions in this notice, as described above, do not include the situation where a trust's grantor trust status is terminated, unless there is also a subsequent toggling back to the trust's original status for income tax purposes.

m. **"Hogs Get Slaughtered."** Do not toggle the grantor trust status on and off various times. That would have the appearance of the existence of an understanding that the grantor trust status will be toggled at the whim of the grantor.

n. **Income Tax Effects of Toggling Off Grantor Trust Status**. A change in the grantor trust status of a trust may cause unexpected income tax consequences. For an excellent review of potential income tax effects, see Peebles, *Mysteries of the Blinking Trust*, TR. & ESTS. 16 (Sept. 2008) (addressing issues involving pass-through entities, estimated payments, suspended losses and deductions, basis, and carryovers).

Terminating grantor trust status during the grantor's life while any part of an installment note from a sale to grantor trust transaction is still unpaid would apparently result in gain recognition, with the remaining amount of the note being treated as the amount realized by the grantor, and gain would be recognized to the extent the debt amount exceeded the basis of the asset. *See Madorin v. Commissioner,* 84 T.C. 667 (1985); Treas. Reg. §1.1001-2(c), Ex.5; Rev. Rul. 77-402. (The trust presumably would receive an adjustment in its basis equal to the amount of any gain recognized.)

Chief Counsel Advice 200923024 suggests that toggling will not necessarily trigger income recognition.

o. **Grantor Trust Conversion During a Year**. If a nongrantor trust is converted into a grantor trust, as of what date does it become a grantor trust? Generally, the trust does not become a grantor trust for the entire year, but only for a fraction of the year. However, for some triggers (such as borrowing from the trust), the trust would become a grantor trust for the entire year.

22. Sales to Grantor Trusts; Income Tax Effect if Grantor Dies Before Note from Sale Transaction Is Repaid

a. **Overview.** If the grantor sells assets to a grantor trust for a note, the grantor trust is "disregarded" for income tax purposes; as long as the trust is a grantor trust, the grantor is treated as selling the assets to himself and paying himself with the note payments. Rev. Rul. 85-13 (to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor). No gain or loss is recognized, and the basis of the asset remains unchanged. If the grantor dies before the note is paid, the IRS may argue that gain recognition is triggered at the grantor's death. The income tax effect on the trust if the grantor dies before the note is paid in full has been hotly debated among commentators. *See* Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 161-64 (2000); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Cantrell, *Gain Is Realized At Death,* TR. & ESTS. 20 (Feb. 2010); Gans & Blattmachr, *No Gain at Death*, TR. & ESTS. 34 (Feb. 2010).

b. **Possible Result – Deferral of Gain Recognition**. As opposed to immediate gain recognition, the better view would seem to be that, at a minimum, gain recognition is deferred under §453 until the obligation is satisfied after the grantor's death. Under that approach, the recipient of installment payments would treat the payments as income and presumably, the trustee would increase the trust's basis in a portion of the sold asset to reflect any gain actually recognized.

c. **Possible Result – No Gain Recognition.** The Manning and Hesch article cited above provides a detailed analysis for the authors' position that income should not be realized as payments are made on the note after the grantor's death. That position has been adopted by various subsequent commentators, and has been gaining acceptance by planners. Indeed, the IRS made this interesting observation in CCA

200923024, in finding that a conversion from nongrantor to grantor status is not necessarily a taxable event:

> We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner ***which is generally not treated as an income tax event.*** (emphasis added)

The arguments in the Manning and Hesch article include the following.

- No transfer to the trust occurs for income tax purposes until the grantor's death (because transactions between the grantor and the trust are ignored for income tax purposes).
- No rule treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance such as an unpaid installment note. *See* Rev. Rul. 73-183, 1973-1 C.B. 364. However, the property does not receive a step-up in basis because the property itself is not included in the decedent's estate. (A further refinement of the no-income recognition position is that the trust assets should receive a basis adjustment at the grantor's death under §1014 even though the assets are not included the grantor's gross estate, because §1014 applies to "property acquired from a decedent," not just property included in a grantor's gross estate. See below.)
- The note itself is included in the decedent's estate, and Manning and Hesch argue that the note should be entitled to a step-up in the basis. A step-up in basis is precluded only if the note constitutes income in respect of a decedent ("IRD") under §691. They argue that the note should not be treated as IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount." §691(a)(3). The decedent would not have recognized income if the note were paid during life (under Rev. Rul. 85-13), so the note should not be IRD.
- This position is supported by the provisions of §§691(a)(4) & (5), which provide rules for obligations "reportable by the decedent on the installment method under section 453." The installment sale to the grantor trust was a nonevent for income tax purposes, and therefore there was nothing to report under §453.
- This position does not contradict the policy behind §691, because the income tax result is exactly the same as if the note had been paid before the grantor's death – no realization in either event.
- If the unpaid portion of the note were subject to income tax following the grantor's death, double taxation would result. The sold property, which is excluded from the grantor's estate, does not receive a stepped-up basis—so ultimately there will be an income tax payable when that property is sold.

One possible planning approach where the grantor does not expect to survive the note term is for the trust to borrow funds from a third-party lender to pay the note before the grantor's death, or if that is not possible, for the grantor to make a loan to the trust and use the loan proceeds to pay the installment note before the grantor's death.

d. **Basis Adjustment at Death for Trust Assets**? Another issue is whether the trust assets should receive a basis adjustment at the grantor's death under §1014. One of the new items on the 2015-2016 Treasury/IRS Priority Guidance Plan is the basis of grantor trust assets following the grantor's death under §1014. Some commentators take the position that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of §1014, and that a basis step-up should be available even though the assets are not included in the grantor's gross estate. Section 1014(b)(9) is the "included in the decedent's gross estate" subsection, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). (An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person; property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.) The Blattmachr, Gans & Jacobson article reasons "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death." Up until the grantor's death, the assets have been treated as being owned by the grantor for income tax purposes.

The IRS added to its "no-ruling" list in 2015 that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37; *see* Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA Daily Tax Report (June 19, 2015) (noting that tax attorney Alan Lederman observes that private rulings are conflicting; PLR 201245006 concludes that a basis step-up would be available for the grantor trust assets at the grantor's death but CCA 200937028 reasons that "since the decedent transferred the property into the trust," no basis step-up arises under §1014). For a discussion of those rulings, see Aucutt, ed., *Recent Developments 2015*, 50TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶102.3 (2016).

23. Other Uses and Benefits of Grantor Trusts

Examples of other uses of grantor trusts include the following.

- Avoiding transfer for value issues for gift/sale of life insurance policy, Rev. Rul. 2007-13 (Situation 1 of ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts);
- Selling trust assets back to grantor to obtain basis step-up at the grantor's death;
- Paying rent to a post-QPRT grantor trust;

- Possible avoidance of net investment income tax if the trust owns S corporation stock and the grantor materially participates in the business;
- Pre-death transfers of loss assets to a grantor trust preserves the high basis that would otherwise be adjusted at the grantor's death if the grantor owned the asset directly;
- Grantor continues to pay income tax on trust earnings, allowing the trust assets to grow faster (and consuming assets of grantor that would otherwise be subject to estate tax at the grantor's death);
- Leverages estate and gift exemption;
- Leverages GST tax exemption;
- Qualifies as permitted S corporation shareholder; and
- Gain exclusion under §121 for the sale of a principal residence applies if the residence is owned by the resident's grantor trust, Rev. Rul. 85-45.

24. Fiscal Year Selection

A decedent's estate may elect a non-calendar fiscal year as long as the first year does not exceed 12 months and the year ends on the last day of the calendar month. § 441(e); Treas. Reg. § 1.441-1T(b). The estate selects its fiscal year by filing the estate's initial Form 1041 with the selected year-end. Treas. Reg. §1.441-1(c)(1). (There is no requirement that the election be made on a timely filed return. Noting the fiscal year on the Form SS-4 is not sufficient to select the fiscal year; that can only be done on the initial Form 1041 for the estate.)

Considerations in the selection of a non-calendar fiscal year include (1) deferring payment of income tax by the estate, (2) deferring beneficiaries' income tax on distributions, by allowing them to report the income in a taxable year after when the distribution was received in certain circumstances, (3) using an initial short year to split income into two separate years, and (4) if death occurs near the end of a calendar year, to allow additional time to generate deductions (for example, payment of fees) and to minimize the number of estate income tax returns required to be filed.

Trusts generally cannot select a fiscal year. One of the advantages of making the §645 election (discussed in Item 25 immediately below) is that a qualified revocable trust can take advantage of the estate's fiscal year if a fiscal year selection is advisable.

25. Treating Qualified Revocable Trusts as Part of Probate Estate for Income Tax Purposes, §645

a. **Overview**. The Taxpayer Relief Act of 1997 permits the executor of an estate and the trustee of a "qualified revocable trust" (QRT) to treat the trust as part of the estate (and not as a separate trust) for income tax purposes for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date." This change was made as the culmination of a long-term planning project generally to treat estates and revocable trusts in a similar manner for income tax purposes.

b. **Maximum Election Period; Procedures for Making Election**. The election period begins on the date of the decedent's death and terminates on the earlier of (1) the day on which both the electing trust and related estate, if any, have distributed all of their assets, or (2) the day before the "applicable date." Treas. Reg. § 1.645-1(f)(1). The term "applicable date" means (A) if no estate tax return is required to be filed, the date that is 2 years after the date of the decedent's death, and (B) if an estate tax return is required to be filed, the date that is 6 months after the date of the final determination of the estate tax liability. §645(b)(2). The final regulations provide that the date of the final determination of estate tax liability is the date that is the earlier of six months after the date the closing letter is issued or various other events (one of which is when the period of limitations runs on additional IRS estate tax assessments). *See* Treas. Reg. §1.645-1(f)(2)(ii). Therefore, the §645 election generally will terminate twelve months after issuance of the federal estate tax closing letter.

If an estate tax return is filed to make the portability election for an estate that is not otherwise required to file a return, is the return "required" for purposes of §645? The preamble to the §1411 proposed regulations states that an estate tax return is treated as "required" in that circumstance for purposes of §645.

The election must be made not later than the time prescribed for filing the income tax return for the first taxable year of the estate (including extensions) and, once made, is irrevocable. §645(c); Treas. Reg. §1.645-1(e)(1). Making this election timely is easily overlooked–the due date for the fiscal year return may come earlier than the normal due dates for fiduciary income tax returns. While the fiscal year selection for an estate can be made on a late return as long as it is the initial return that is filed, the §645 election must be made on a timely filed return.

The mechanical procedures for making the election are revised under the final regulations (which apply for decedents dying on or after December 24, 2002). If an executor is appointed, the executor and trustee of the QRT make the election by signing and filing Form 8855. The election form must be filed by the due date (including extensions) for filing the Form 1041 for the first year of the estate (regardless of whether there is sufficient income to require the filing of that return.) Treas. Reg. §1.645-1(c)(1)(i). If there is no executor, the trustee of the QRT (or trustees of multiple QRTs) must file the election form by the due date (including extensions) for the first taxable year of the electing trust. Treas. Reg. §1.645-1(c)(2).

c. **Obtaining TINs and Filing Short Year Return**. The final regulations revise the approach of the proposed regulations by requiring that the QRT obtain a TIN after the death of the deceased owner (whether or not the election will be made and whether or not there is an executor for the estate). The trustee must furnish that number to payors to the trust after the decedent's death. Treas. Reg. §1.645-1(d)(1). The trust is not required to file a short-year return from the date of death to December 31 of that year if a §645 election will be made. However, the final regulations retain the requirement that the Form 1041 be filed for the short taxable year from the date of death to December 31 if the §645 election will not be made or if the trustee and executor are uncertain whether a §645 election will be made (whether or not there is an executor). If the election is not made and if the trust has not filed a timely return, the QRT will be subject to penalties and interest. Treas. Reg. § 1.645-1(d)(2).

d. **Various Tax Effects of Making Election to Treat Revocable Trust as Part of Grantor's Estate**. Some of the income tax benefits that may result from electing to treat a revocable trust as part of the decedent's estate include the following:

- availability of a fiscal year under §644, Treas. Reg. §1.645-1(e)(3)(i) (see Item 24 above);
- no estimated tax obligation for 2 years after the decedent's death, Treas. Reg. §1.645-1(e)(4);
- availability of the permanent set-aside charitable deduction under §642(c)(2), Treas. Reg. §§1.645-1(e)(2)(iv) & (e)(3)(i);
- eligibility to hold S corporation stock without meeting special trust rules (which would permit the trust to hold S corporation stock for a somewhat extended period of time, because if a federal estate tax return is required the §645 election applies until 6 months after the date of the final determination of the estate tax liability), Treas. Reg. §1.645-1(e)(3)(i); *see* Rev. Rul. 76-23 (estate exception applies for the reasonable period of estate administration and applies for entire §6166 deferral period);
- waiver of the §469 passive loss active participation requirement for rental real estate for 2 years after death, which allows using the estate's exemption under §469(j)(4) to use up to $25,000 in losses from rental real estate activities, even if the losses exceed the estate's passive income, Treas. Reg. §1.645-1(e)(3)(i);
- using the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is a simple or a complex trust), Treas. Reg. §1.645-1(e)(2)(ii)(A);
- allowing losses in funding pecuniary bequests under §267(b)(13);
- simplifying the number of returns (and K-1s) if the trust meets the requirements to permit filing only an estate Form 1041 and not a separate trust Form 1041;
- deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven additional months of deferral–which would apply if the grantor were to die in December); and
- tax items of one entity (such as passive activity losses, net operating losses, capital losses, or investment interest) that would otherwise be nondeductible may offset the other entity's corresponding items of income, thus reducing the aggregate current income tax (but complications may arise in allocating the tax benefits and tax amounts between the estate and revocable trust).

One disadvantage of making the §645 election is that the revocable trust will have to give up the benefit of an additional personal exemption and use of the lower income tax brackets that would otherwise be available to the trust. In addition, there may be additional administrative costs. For example, an allocation will have to be made of the benefit or cost of various tax effects between the trust and the estate (because they remain separate legal entities even though merged for income tax purposes).

26. Administrative Expense Deductions; Whether to Deduct Administration Expenses on Income or Estate Tax Return, §642(g)

Administration and casualty losses are deductible in computing the taxable income of the estate, even if those expenses are chargeable to principal under state law. §§165, 212, 641.

a. **Limit on Income Tax Deduction**. Other than "deductions in respect of the decedent" items (as discussed in Item 10 above), administration expenses can be deducted either for income or estate tax purposes, but not both. Section 642(g) implements this limitation by providing that no income tax deduction can be allowed for such expenses unless a statement is filed in duplicate before the limitations period runs on the income tax return waiving the right to deduct those items on the estate tax return (which is a strange process, because if the waiver is not filed by that time, the limitations period will have run on additional assessments of the income tax).

b. **Delay Filing Waiver**. Delay filing the waiver to leave the flexibility of deducting the expense on the estate tax return in case that should turn out to be preferable. In fact, the expense can be deducted on both returns as long as one of the returns is amended so that it is ultimately deducted only one return.

c. **"Hubert" Regulations**.

The IRS has issued final regulations in response to the Supreme Court discussion of the prior regulation in *Hubert v. Commissioner*, 520 U.S. 93 (1997).) Treas. Reg. §§20.2013-4(b)(3), 20.2055-3, & 20.2056(b)-4(d). Fortunately, the regulation recognizes that the payment of certain administration expenses will *not* require a dollar-for-dollar reduction of the marital or charitable deduction (as the IRS had argued in *Hubert* under the prior regulation). However, the regulation has a variety of restrictions and limitations on when the payment of administration expenses will not require a reduction of the marital or charitable deduction. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. However, administration expenses that constitute "estate transmission expenses" and that are deducted on the estate income tax return will require a dollar-for-dollar reduction in the amount of marital or charitable deduction.

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

Estate transmission expenses (which must reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity) are all estate administration expenses that are not estate management expenses. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Treas. Reg. §§20.2055-3(b)(1)(ii) & 20.2056(b)-4(d)(1)(ii).

The marital or charitable deduction must be reduced by the amount of any estate management expenses that are "paid from the marital [or charitable] share but attributable to a property interest not included in the marital [or charitable] share." Treas. Reg. §20.2055-3(b)(4) [charitable share] & §20.2056(b)-4(d)(1)(iii)(4) [marital share].

The marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3) & 20.2056(b)-4(d)(3).

In summary, **estate management expenses** should always be deducted on the income tax return if there is a substantial marital or charitable deduction. Taking an estate tax deduction would not result in any estate tax savings, and would forego getting any income tax savings. On the other hand, for **estate transmission expenses** there is no clear answer. Taking a current income tax deduction will usually increase the estate tax (or under a marital deduction formula clause, may operate to decrease the amount of assets passing to the non-marital share.) However, deducting estate transmission expenses on the income tax return may yield more savings if the surviving spouse's estate may not be subject to estate tax because of future law changes, asset consumption, increases in the estate tax exemption amount, and possible reductions to the estate tax rates in future legislation.

Many planners are now starting to take the position that at the first spouse's death, unless the income tax bracket is very low or unless the parties expect huge appreciation, the family is probably better off deducting transmission expenses on the income tax return rather than the estate tax return. That has the effect of reducing the bequest to the bypass trust. However, the idea is to take the "bird in the hand" income tax savings in light of the uncertainty of the estate tax savings that may be achieved years later with the bypass trust. Another exception might be if the surviving spouse is expected to die in the next several years, and there would not be much appreciation in the bypass trust assets. While many attorneys are tending to take the deduction on the 1041 now and give up on the bypass trust reduction, there is no one answer that fits all.

If the surviving spouse can pay the transmission expenses directly, doing so may give an optimal result. (The spouse would pay expenses under the rationale that much of the advice is to advise the surviving spouse.) That reduces the surviving spouse's taxable estate, but she would not get an immediate income tax deduction – unless it is an expense deductible under §212. (Furthermore, §212 is not a perfect deduction; for example the 2% floor applies.) Similarly, allocating part of fee to the marital trust should be possible.

27. Two Percent AGI Floor Application to Trusts and Estates, §67(e)

a. **Statutory Provision**. Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income (AGI). Under §67(e) the same rules apply to estates and trusts, except that "the 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" are allowed in full. This exception has been analyzed under a two-prong test: (1) costs paid or incurred in connection with the administration of the estate or trust, and (2) which would not have been incurred if the property were not held in such trust or estate.

b. **Case Law; *Knight v. Commissioner*.** Following a tortured history of inconsistent treatment by circuit courts of whether trust investment advisory fees are subject to the 2% floor, the Supreme Court spoke to the issue in *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181 (2008). The Supreme Court held in favor of the government, adopting the "unusual or uncommon" test used by the Fourth and Federal Circuits and concluding generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."

c. **Proposed and Final Regulations**. Regulations regarding the application of §67(e) to trusts, following the Supreme Court's decision in *Knight v. Commissioner*, were finalized on May 9, 2014, with very few changes from revised proposed regulations that were published in response to the *Knight* case. The final regulations apply to any taxable year of any trust or estate that begins on or after January 1, 2015. Accordingly, the regulations apply to returns for trusts and estates that will be filed in 2016.

   Highlights of the final regulations include the following.

   - The allocation of costs of a trust or estate that are subject to the 2% floor is based on whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
   - In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
   - "Commonly or customarily" incurred expenses that are subject to the 2% floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
   - "Ownership costs" that apply to any owner of a property (such as condominium fees, insurance premiums, maintenance and lawn services, etc. [other examples are listed]) are subject to the 2% floor. Expenses that are deductible under §§62(a)(4), 162, or 164(a) may be fully deductible because they would not be miscellaneous itemized deductions subject to §67(e).
   - A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the 2% floor. Costs of preparing all other returns – including gift tax returns (presumably because individuals file gift tax returns) – are subject to the 2% floor.
   - Investment advisory fees for trusts or estates are generally subject to the 2% floor except for certain incremental fees (above what is normally charged to individuals). If an investment advisor charges an extra fee to a trust or estate because of the "usual" need to balance the varying interests of current

beneficiaries and remaindermen, those extra charges *are* subject to the 2% floor. The incremental portion of investment advisory fees not subject to the 2% floor "is limited to the amount of … fees, if any, that exceeds the fees normally charged to an individual investor."

- Bundled fees (such as trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the 2% floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees (discussed in Item 27.d immediately below).

d. **Unbundling Requirement**.

Bundled fees (such as trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the 2% floor and those that are not.

A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the 2% floor. The balance of the bundled fee is *not* subject to the 2%. Treas. Reg. §1.67-4(c)(2). (This exception may seem overly broad as applied to attorneys' and accountants' fees, but the exception is explicit. If attorneys or accountants charge on a project basis rather than on an hourly basis, fees do not need unbundling if none of them relates to investment advisory expenses.)

If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the 2% floor, that portion of the bundled fee will be subject to the 2% floor.

Any reasonable method may be used to allocate the bundled fees. The preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requested comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS was particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice – other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggested it would not use. The Service received only one comment about allocating bundled expenses – stating that no single standard could be applied to multiple trusts or even to the same trust in different years. The final regulations provide three facts that may be considered (among others) in making a "reasonable" allocation:

> Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. Treas. Reg. §1.67-4(c)(4).

Commentators observe that even if the percentage fee that is charged for investment advisory services and trustee fees is about the same, there are big differences between the services required for investment advisory and trustee services.

> There's a huge difference between acting as a trustee and acting as an investment advisor. A trustee has aggregate responsibilities that far transcend those of an investment advisor – including making mandatory and discretionary distributions to beneficiates, addressing the needs of disabled beneficiaries and those in difficult or special circumstances, engaging in tax planning, allocating receipts and disbursements between income and principal according to legal standards and assembling and rendering fiduciary accountings. Charles A. Redd, *Don't Forget to "Unbundle" for Winter!*, TRUSTS & ESTATES 14, 16 (Nov. 2014).

e. **Mutual Fund Investments for Trusts**. In the future, trustees may tend to make investments through mutual funds rather than through common trust funds or by direct investments, because the investment expense of administering a mutual fund is netted out before the taxable income from the fund is determined. Thus, the issue of having a separate expense that is not fully deductible (or that is subject to the alternative minimum tax) does not exist.

f. **AMT Effect of Being Type of Expense Subject to 2% Floor**. Section 63(d) defines "itemized deductions" to mean deductions other than (1) deductions allowed in arriving at AGI and (2) the deduction for personal exemptions. Therefore, if an investment advisory expense "flunks" §67(e), it is an "itemized deduction." Section 67(b) says that "miscellaneous itemized deductions" includes all "itemized deductions" other than 12 specific deductions listed in §67(b), none of which covers investment advisory expenses. In computing alternative minimum taxable income, §56(b)(1)(A) provides (among many other adjustments) that "[n]o deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b)." Therefore, if an investment advisory expense does not come within the §67(e) exception for trusts and estates, all of the expense (not just the amount within 2% of AGI that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

The AMT effect can be much larger than the effect of not being able to deduct expenses that do not exceed 2% of AGI. For example, assume a trust has $100,000 of investment advisory expenses, and $100,000 of AGI. Despite the 2% rule, the trust can still deduct $98,000 for taxable income purposes, resulting in negligible "regular" income tax. However, for AMT purposes, no deduction would be allowed; after reduction for the $22,500 AMT exemption, the 26% tentative AMT tax is roughly $20,000.

The AMT effect is carried through to beneficiaries who receive trust distributions in excess of the trust's taxable income. Although the beneficiary will not have any taxable income if the trust has $100,000 in gross income and $100,000 in deductions, the K-1 to the beneficiary will report the $100,000 as an adjustment that must be added back for AMT purposes on the beneficiary's tax return. Distributions carry out regular taxable income first to the beneficiaries, leaving tax preferences in the trust. If distributions are less than taxable income, the AMT tax preferences stay in the trust. Excess distributions carry out tax preferences to the beneficiaries. Carol Cantrell (Houston, Texas) says that the ideal plan, for AMT purposes, is for the trust to distribute more than its taxable income but less than the AMTI, and to split the

preferences between the trust and the beneficiaries (because each taxpayer has its own AMT exemption). "Distributions are a dynamite cure for both the 2% rule and the AMT."

g. **Effect on Trust Beneficiaries**. If the 2% limitation applies, the effect will be to increase DNI – so there will be a larger hit to beneficiaries of the DNI carryout. A trustee may take the position that the 2% rule does not apply to the payment of certain investment advisory fees because they represent an "incremental cost … beyond what would ordinarily be required for the ordinary taxpayer." If the IRS reverses that position on audit and if that has the effect of disallowing some deductions, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) and who may have to amend tax returns and pay penalties and interest.

h. **Trust Distributions Reduce Trust AGI and Minimize the Impact of §67**. The distribution deduction is subtracted in arriving at the AGI of the trust (and the 2% limit under §67 is based on the AGI). For example, if the trust distributes enough so that the AGI, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, only a $200 deduction is lost even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then the trust would lose the benefit of the $10,000 of administration expenses.

i. **Not Subject to Overall Limit on Itemized Deductions under §68**. Unlike individuals, estates are not also subject to an overall limitation on itemized deductions under section 68, which (for individuals only) generally reduces the overall allowable itemized deductions (even after taking into account the 2% floor on "excess itemized deductions") by the lesser of (1) 3% (2% in 2006-2007 and 1% in 2008-2009) of the excess of AGI over an indexed "applicable amount" or (2) 80% of the itemized deductions. §§68(a), 68(f)(2). The applicable amount was increased beginning in 2013 to $300,000 for a joint return, or $250,000 for a single individual, indexed from 2013. §68(b).

j. **Calculation of 2% Floor is Complicated**. Calculating the 2% floor is an interrelated calculation if the trust pays the beneficiary more than its DNI. Carol Cantrell says: "The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions (AMID), which depend on its AGI. Thus we have a circular calculation that requires an algebraic formula found only in the IRS instructions to Form 1041, p. 17-18."

Items 28-32 are observations from a session by Richard W. Nenno, Minimizing or Eliminating State Income Taxes on Trusts

28. Significance and Opportunity for Planning

a. **State Income Tax Rates Can Be Very High**. State income tax rates are very high in some states. Examples of the highest top-bracket rate jurisdictions are Oregon (9.9%), New York City (12.696%), and California (13.3%). In 2011 (the last year for

which figures are available) 43,310 estates and trusts paid about $218 million of New York income tax; one wonders how much of that could have been saved with proper planning.

b. **No Break for Capital Gains.** Most states have the same rates for capital gains and ordinary income.

c. **Effect of Federal Deduction for State Tax Can Be Minimal**. For federal income tax purposes, a deduction is allowed for the payment of state income taxes. The effect can be minimal however, particularly for a trust that largely has capital gains, because (i) the AMT tax for federal tax purposes can wipe out most of the benefit of the federal deduction, and (ii) the federal income tax rate on capital gains (23.8%) is not substantially larger than the state income tax rate in some states (*e.g.,* 13.3% in California). For example, a nongrantor trust with a California trustee but not California beneficiaries with $1 million of long term capital gain (and no other income) in 2015 would pay $109,422 of California tax on December 31, 2015 and $232,852 of federal income tax on April 15, 2016. If the trust had a Washington trustee (and therefore was not subject to California state tax), the trust would pay zero state income tax and $236,539 of federal income tax. In effect, the deduction of state income tax for federal income tax purposes only reduced the federal income tax by less than $4,000. Moving the trustee to Washington would have resulted in a net tax savings of over $105,000.

   That same example in New York City results in $107,124 of New York state and city tax and $232,939 of federal income tax vs. zero state tax and $236,539 of federal income tax if the trust is structured to avoid state income tax, resulting in a net tax savings of over $100,000 if the trust is structured to avoid state income tax.

d. **Grantor Trusts**. Grantor trusts are not subject to state fiduciary income taxes, but many trusts are not grantor trusts, and grantor trusts become nongrantor trusts after the grantor's death (or if for some other reason the trust loses its grantor trust status). Furthermore, Pennsylvania does not recognize grantor trusts and other states (*e.g.*, Massachusetts) depart from the federal grantor trust rules.

e. **Governing Law Clauses**. Governing law clauses in trust agreements typically have no effect on determining what state income tax system applies to the trust. (They can have an impact in Louisiana, Idaho and North Dakota.)

f. **Opportunity for Planning**. States typically have clear rules as to what causes the trust to be taxable in the state with factors (that vary among the states) based on the residence of the settlor, trustee, and beneficiaries, or where the trust is administered. Some of those factors can be controlled (for example, the trustee can be changed which could change the residence of the trustee or where the trust is administered). Furthermore, basing state income taxation on the residence of the grantor when the trust was created may be questionable on constitutional grounds under the Due Process or Commerce Clauses.

g. **Fiduciary Concerns**. Section 108(b) of the Uniform Trust Code (which has been enacted in 24 of the 31 states that have the Uniform Trust Code) says the trustee has a duty to administer the trust in an appropriate place. Therefore, the trustee arguably has a duty to minimize state income tax. Some cases (including a Missouri case) have

allowed beneficiaries to force a trustee to change the trust's situs under §§108 and 111 of the Uniform Trust Code. (Because of the difficulty, if not impossibility, of continually monitoring the laws of all of the state and city jurisdictions in the country, some attorneys affirmatively negate the §108(b) duty in drafting trust agreements.)

h. **Analysis Approach**. Consider a three-step analysis approach. (1) Identify all state statutes that might potentially apply. (2) Consider whether a state that might potentially tax the trust has personal jurisdiction over the trustee or in rem jurisdiction over the trust assets. (3) Consider whether the state tax may violate the Due Process or Commerce Clauses of the U.S. Constitution (particularly relevant for states that base state income taxation on the residence of the grantor when the trust was created).

29. Brief Overview of State Taxation of Trusts and Estates

The one thing that is consistent across the board regarding the state income taxation of trusts is inconsistency. There is a complex labyrinth of separate rules throughout the 50 states and the District of Columbia. Only 8 states do not tax the income of trusts (Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming). Tennessee will join that list in 2022 (it currently taxes only interest and dividends of trusts). The remaining 43 states (including the District of Columbia) tax trusts based on a variety of factors.

a. **Overview**. The income of grantor trusts is normally taxed to the grantor, distributed ordinary income of a nongrantor trust is generally tax to the recipient, and source income of the trust (*e.g.*, income attributable to real property, tangible personal property, or business activity) usually is taxed by the state where the property is situated or the activity occurs. Therefore, there are tax savings opportunities for accumulated non-source income of nongrantor trusts, particularly their capital gains.

b. **Grantor Trusts**. Grantor trusts are typically taxed to the grantor in his or her state of domicile.

c. **Nongrantor Trusts Approach**. For nongrantor trusts, most states allow a deduction for distributions, and the distributed amounts are taxed to beneficiaries in their states of domicile. The undistributed income of trusts is taxed under a complex scheme of varying rules.

d. **Source Income**. Almost all states will impose their taxes on undistributed income of nongrantor trusts that is from real estate or businesses located in the state. (That can be a difficult determination for businesses which produce income in a variety of states.) Therefore, no matter whether a trust is a "resident trust" or a "nonresident trust," undistributed trust income from real estate and businesses in the state will be taxed by that state.

e. **Distributed Income.** Income that is distributed from nongrantor trusts is taxed to the beneficiaries, based on the state income tax laws of where the beneficiaries are located**.** This can result in higher or lower state taxes, depending on how the state taxes trusts and depending on the individual tax rates in the state in which the beneficiary resides.

f. **Nonsource Undistributed Income of Nongrantor Trusts**. The remaining income of nongrantor trusts is generally taxed based on where the trust is deemed to be a resident—and a wide pattern of residency rules have developed over the years in determining whether a trust is a resident trust or nonresident trust as to a particular state. Relevant factors (that vary among the states) are the residence of the settlor, trustee, and beneficiaries, or where the trust is administered.

g. **Multi-State Taxation**. The various states define "resident trust" in different ways, leading to inconsistent income tax treatment, and sometimes resulting in double (or more) state income taxes imposed on the same income. After going through the steps described above, if two different states impose income tax on the same trust, most states allow some form of credit to the extent that other states impose an income tax on the same trust income (but the form of the credit varies dramatically).

30. Resident v. Nonresident Trusts

Most of the states typically follow one of several patterns to determine whether a trust is a resident trust for that state. Ten states do not specifically define a resident trust. Some states look at various factors in determining whether a trust is a resident trust. In some states, any of several factors will be enough to trigger state taxation and in other states, a trust must meet a combination of factors to impose state taxation. The state statutes vary in their details, and potentially relevant state statutes must be analyzed in detail.

Dick Nenno's written materials include an exhaustive Appendix listing the relevant state statutes in all states and summarizing the factors used in each state.

a. **Overview.** All of the 43 taxing states plus the District of Columbia tax a trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is sometimes referred to as a "founder state trust" (*i.e.*, the trust is a resident trust if the founder of the trust was a resident of the state).

b. **Residency of Decedent Creating Testamentary Trust.** Sixteen states tax a trust solely because the testator lived in the state at death. (Therefore, if a decedent dies in one of those states, any testamentary trusts created by that decedent are forever after taxed by that state.) Other states include the residence of the testator as a factor, in connection with other factors. For example, in New York a testamentary trust created by a New York decedent is a "resident trust" but an exemption treats some resident trusts as "exempt resident trusts" that are not subject to taxation in New York.

c. **Residence of Settlor of Inter Vivos Trust.** Twelve states tax trusts solely because the settlor lived in the state when the trust was created. Some other states consider the residence of the settlor in connection with other factors. Courts in various states have reached varying results as to the constitutionality of these statutes. States that

base taxation solely on the basis of the residence of the settlor when the trust was crated are particularly suspect on constitutional grounds (see Item 31 below).

For residents of the states that base their taxation of trusts solely on the residency of the grantor, state income taxation is still an important issue in the selection of trustee process. If the instrument appoints a trustee from a state that taxes based on administration or trustee residency, issues of dual taxation and multi-state credits arise.

d. **New York Example**. New York has a grantor/testator-resident statute for taxing trusts, treating as a "Resident Trust" any trust of which the testator was a New York resident on the date of death or was a New York resident on the date the inter vivos trust became irrevocable (or when the revocable trust was created if the trust is still revocable). N.Y. TAX LAW §605(b)(3)(B)-(C). Even so, following the *Mercantile-Safe Deposit* and *Taylor v. State Tax Commissioner* cases, the New York Tax Commissioner issued regulations making clear that New York will not tax a trust that has no New York trustees, no New York assets, and no New York source income. N.Y. COMP. CODES R. & REGS. TIT. 20 § 105.23(c). This exemption was subsequently codified. N.Y. TAX LAW § 605(b)(3)(D)(i). A Resident Trust that is exempt from taxation under these exceptions is referred to as an Exempt Resident Trust. Accordingly, the selection of trustee for a trust created by a New York resident is a critical factor for determining if the New York income tax will apply to undistributed income from the trust. For example, if a Delaware bank is named as trustee and trust assets are located in Delaware, the undistributed trust income would not be taxed in New York or Delaware. (If the grantor wants a New York resident to control investments, consider creating a partnership and naming the New York resident as the general partner of the partnership and contribute the partnership interest to the trust with the Delaware trustee.) **This New York approach is mentioned because this approach is also relevant in almost half the states**.

The 2014-2015 New York budget bill made two substantive changes to how New York taxes income. First, New York residents must pay an accumulations distribution tax (which does not include capital gains) when an Exempt Resident Trust later makes distributions to New York residents, and imposes reporting requirements on the trustees of Exempt Resident Trusts. Second, the bill classifies incomplete nongrantor trusts as grantor trusts for New York and New York City income tax purposes

Throwback Rule for Trust Distributions. Even though undistributed income from an Exempt New York Resident Trust in New York is not subject to income tax in the year the income is received by the trust, distributions from the trust to a New York resident beneficiary after 2014 are subject to New York income taxes with respect to certain accumulations of trust income. This "throwback" tax will not apply to income that was accumulated in the trust either (i) before 2014, or (ii) before the beneficiary first became a New York resident. There is no interest charge on the throwback tax. Capital gains are not typically considered income for these purposes (if the capital gains are not included in distributable net income).

California imposes a similar throwback tax. The New York State Bar Association Tax Section had requested that the throwback tax be delayed because of technical problems with the proposal and difficulties of incorporating the federal rules by

reference. *See Throwback Tax in New York Budget Plan Raise Concerns, NYSBA Tax Section Says*, Bloomberg Daily Tax Report (March 11, 2014).

Incomplete Gift Nongrantor Trusts. "Incomplete gift nongrantor trusts" are trusts formed in a state with no income tax (often Delaware or Nevada, in which event they are referred to as "DING" or "NING" trusts) for the benefit of the grantor and other persons. The purpose of the trust is typically to accumulate income in the trust that is not subject to state income taxation in the state where the trust is located and not included in the grantor's income for state income tax purposes. Under the new legislation, such trusts created by New York residents are deemed to be "grantor trusts" for New York income tax purposes, which results in the income being included in the New York grantor's income whether or not the income is distributed to the grantor. This provision is effective for income earned on or after January 1, 2014, but not for trusts that were liquidated before June 1, 2014.

e. **Administration in the State**. Fourteen states impose tax on the basis of administration in the state. (See Item 32.c.(3) for a list of these states.) Five other states apply this factor in combination with other factors. Accordingly, appointing a trustee who would be conducting a significant part of the administration in one of those states would subject the trust to income taxation in that state.

   Of the states that impose tax on this basis, only Oregon and Virginia offer guidance as to what constitutes administration within the state. The other states offer no such guidance.

   What if the trust has co-trustees and only one co-trustee is in the state? A variety of cases in Virginia have considered such situations in which decisions were made for the trust by a committee, some of whom were in Virginia. (For example, if only one of 5 advisors was in Virginia, the cases generally would not allow Virginia to tax the trust on the basis of administration in the state.)

f. **Residency of Trustee**. Seven states impose tax on the basis of the domicile of the trustee (or any co-trustee). (If co-trustees are located in multiple states, the income may be pro-rated. For example, this is the approach in California. CAL. REV. & TAX CODE § 17743.) Obviously, this is a very important fact to consider before appointing a trustee who is a resident of .one of these states.

g. **Residency of Beneficiary**. Only five states impose tax on this basis. An example is California. For example, if no trustee is a resident of California, the trust is taxed on California source income and that portion of non-source income that is to be distributed to resident noncontingent beneficiaries. CAL. REV. & TAX CODE § 17744.) Various other states have similar provisions. While not typically done by fiduciaries, best practices would be for trustees to inquire annually specifically about the residence of all beneficiaries, in case a beneficiary moves to a state that uses this factor, causing the trust to owe income tax in that state.

31. Constitutional Issues

a. **Pre *Quill* (1992) History**. Three older U.S. Supreme Court cases (all before 1947) have addressed constitutional issues of state taxation. *Safe Deposit and Trust*

Company v. Virginia held that the Due Process Clause prohibits a state from taxing a trust based on the residence of beneficiaries. In *Guaranty Trust Co. v. Virginia*, the Court held that Virginia could tax resident beneficiaries on distributions they received from a nonresident trust. *Greenough v. Tax Assessors of Newport* held that the Due Process Clause did not prevent the city of Newport from imposing a personal property tax on a resident trustee of an otherwise nonresident trust.

Eight state cases addressed the state taxation of trusts in the intervening years before the U.S. Supreme Court again spoke on the issue in 1992.

***Mercantile-Safe Deposit & Trust Co. v. Murphy* (New York 1964)** – no income taxation of nonresident inter vivos trust funded during life and by pourover will solely based on domicile of trustor and income beneficiary where there were no New York assets or source income.

McCulloch v. Franchise Tax Board (Calif, 1964) – taxation based on the state of the residence of a co-trustee/beneficiary upheld.

Taylor v. State Tax Commissioner (N.Y. 1981) – no income taxation of nonresident testamentary trust solely based on domicile of testator.

Pennoyer v. Taxation Div. Dir. (N.J.1983) – no income taxation of nonresident testamentary trust based solely on residence of testator.

Potter v. Taxation Div. Dir. (N.J. 1983) – no income taxation of nonresident inter vivos trust funded during life and by pourover will based solely on residence of trustor.

In re Swift (Mo. 1987) – no income taxation of nonresident trust created by deceased domiciliary permitted.

Blue v. Department of Treasury (Mich. 1990) – no income taxation of nonresident trust based solely on domicile of trustor.

Westfall v. Director of Revenue (Mo. 1991) – *Swift* permits income taxation of trust based on residence of testator and in-state source of trust income.

b. ***Quill* (1992).** The U.S. Supreme Court next spoke on the general issue in 1992, *Quill Corporation v. North Dakota. Quill* had nothing to do with the income taxation of trusts. It involved North Dakota's attempt to collect use tax on catalog sales to North Dakota residents. The case held that the Due Process Clause minimum contacts test no longer required that a business have a physical presence in the state whereas the Commerce Clause substantial nexus test continued to require such a presence. Prior to *Quill*, the cases had focused on the Due Process Clause. Following *Quill*, cases also focus on the Commerce Clause. *Quill* has influenced the two state income tax cases that have been decided since 1992.

c. **1992–1997 State Cases.**

District of Columbia v. Chase Manhattan Bank. In 1997, the District of Columbia Court of Appeals held that the Due Process Clause of the Fifth Amendment did not prevent the District from taxing a trust created by the will of a District resident, even though the trustee and most activity occurred elsewhere. The court did not have to consider the Commerce Clause which only applies to the states and not to the District of

Columbia. The case is sometimes cited to uphold the ability of a state to tax a "founder state trust" created by a resident trustor, but that is incorrect. Footnote 11 of the opinion says "we express no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died, and when the trust therefore became irrevocable."

Chase Manhattan Bank v. Gavin. In 1999, the Supreme Court of Connecticut held that the Due Process Clause and the Commerce Clause did not prevent the state from taxing the income of four testamentary trusts and one inter vivos trust created by Connecticut residents. The trusts had no Connecticut trustees, assets, or source income. The sole non-contingent beneficiary of the inter vivos trust was a Connecticut resident. The opinion included a strong dissent.

Commentators have roundly criticized the District of Columbia and Connecticut cases. Nevertheless, they are the law in those two jurisdictions.

d. **Recent State Court Cases**. Four state court cases in 2013 have suggested a shifting trend when state courts address the constitutional issue—finding that Illinois, New Jersey and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created and allowing a North Carolina case regarding this issue to continue by rejecting the state's motion for summary judgment. *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (Dec. 2013)(no Illinois connections with inter vivos trust other than that the settlor was an Illinois resident when the trust was created; "what happened historically with the trust in Illinois has no bearing on the 2006 tax year")(case will not be appealed); *Kassner v. Division of Taxation*, 2013 N.J. Tax LEXIS 1 (January 3, 2013)(mere fact that testator of testamentary trust resided in New Jersey not sufficient authority for New Jersey to tax trust on its out of state income; "source income" allocated to New Jersey from S corporation was subject to New Jersey taxation); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013) (trust's "only presence in Pennsylvania was Settlor's status as a resident in 1959 when he created the Trusts and the residences of the Trusts' discretionary beneficiaries, neither of which provides the necessary substantial nexus with Pennsylvania for the Trusts to be subject on all of their income. Settlor retained no continuing control or power of appointment over the Trusts' property and the in-state beneficiaries are discretionary and have no current or future right to the Trusts' income or assets"); *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 2013 NCBC 9 (2013) (denying state's motion for summary judgment allowing case to continue).

Two of the 2013 cases were addressed further in 2015. *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (N.C. 2015) was the case addressing the substantive unconstitutionality issue, following the court's earlier rejection of the state's motion for summary judgment in 2013. The trustee did not reside in North Carolina and no trust administration activities occurred in North Carolina, but one of the trust beneficiaries of the trust moved to North Carolina in 1997. The court, on summary judgment, determined that the trust through the activities of its trustee had insufficient contacts with North Carolina to support state

taxation of the trust income. The trust sought a determination that the North Carolina statute is unconstitutional on its face, but the opinion merely concluded the statute is unconstitutional as applied to the particular trust. The opinion specifically observes that "the beneficiary's residence in North Carolina, standing alone, is not a sufficient contact by [a trust] with this State to support the imposition of the tax at issue," citing the Due Process Clause and the Commerce Clause of the U.S. Constitution. The case was appealed by the Department of Revenue, but the North Carolina Court of Appeals has affirmed the lower court order refunding all taxes and penalties paid by the trust with interest, finding the state tax unconstitutional on the grounds that the minimum contacts criteria of the Due Process Clause were not satisfied, (N.C. Ct. App. July 5, 2016).

Residuary Trust A u/w/o Kassner v. Director, Division of Taxation, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g* 27 N.J. Tax 68 (N.J. Tax Ct. 2013) is the appellate case affirming the 2013 lower court opinion. The case dealt with trust income in 2006, following the Division of Taxation's change of position in 2011 regarding undistributed income if the trustee was not a New Jersey resident and the trust had no New Jersey assets. The trust's only connection to New Jersey was that it was a shareholder of an S corporation that owned New Jersey assets. The trust paid tax on its portion of the flow through income from the S corporation's New Jersey assets but not on its other income. The court concluded that the announcement in the Division of Taxation's official publication that the trust income would not be taxed under certain circumstances and then changing that position retroactively was fundamentally unfair. The court did not address constitutional issues.

e. **Supreme Court-Credits for State and County Taxes From Other States.** In *Comptroller of the Treasury of Maryland v. Wynne,* 135 S. Ct. 1787 (2015), Maryland residents had taxable income from an S corporation that was sourced in several other states. They paid taxes to those states and sought a credit for the taxes paid against their Maryland state and county income taxes. They received a credit against their state income tax, but not the county level tax. This Supreme Court affirmed the Maryland Court of Appeals finding that the failure to provide the credit at the county level unconstitutionally discriminated against interstate commerce. The failure to provide the credit violates the dormant Commerce Clause by burdening out-of-state business with double taxation.

f. **Summary – Shifting Trend of State Court Cases.** State taxation of a trust based solely on the testator or grantor being a resident of the state is probably unconstitutional. Before these cases beginning in 2013, however, if this issue was litigated before the taxing state's courts, the state would likely find the tax to be constitutional. This recent trend of cases suggests a shift in that result.

32. Planning Considerations Regarding State Income Taxation of Trusts

a. **Practical Tips–A Starting Point**. (1) A state must have jurisdiction over the trustee to collect the tax against the trust. (2) To determine a state's taxing approach, read the instructions to the state fiduciary income tax return available online. (3) Do not plan for state income tax without involving local counsel. (4) State taxation is typically imposed

on accumulated ordinary income and capital gains (but New Hampshire and Tennessee tax interest and dividends only) of the trust.

b. **Filing Position.** If a state taxes a trust based solely on the resident status of the settlor when the trust was created, the tax is likely unconstitutional. The planner must decide between filing returns each year and taking the position on the returns that the trust is not a resident in order to cause a statute of limitations to run (which puts the state taxing authority on notice to audit the return), or not filing with the risk that the state years later could seek taxes, penalties and interest. In light of the recent litigation suggesting a greater likelihood of state courts finding such a state tax to be unconstitutional, be careful with respect to prior year's returns, and not letting the statute of limitations run on requesting refunds.

c. **Planning Considerations for New Trusts**. Consider state income taxation planning at the outset when the trust is being created. It is much easier to avoid state income tax initially than to get a refund.

(1) Testamentary Trusts Created by a Resident. If the state tax is based on a resident testator, try to fit within a "nonresident resident trust" exception (such as New Jersey and New York;--if there are no trustees, assets or source income in that state).

If the trust is a "founder state trust" that does not have a "nonresident resident trust" exception, having the client move to another state before dying is the only way to be sure to avoid tax without a constitutional struggle. The rationale for taxing based on the testator's residency for testamentary trusts is perhaps more likely to be upheld than systems based on the residency of the grantor of an inter vivos trust, because of the use of the state's probate courts in creating the testamentary trust. If the client says that he or she will not move, suggest that the client not create trusts in the will; instead, fund a revocable trust in another state during the person's lifetime and pour over assets under the will to such a revocable trust created in the other state. That approach may enable the estate to avoid income tax that otherwise would be paid on the probate assets.

Because such a state only taxes resident testators, residents of other states can create trusts in a state like this without state income taxation. For example, New York resident-testators may create trusts with New Jersey trustees and assets and not be subject to New Jersey taxation — because the trust was not created by a New Jersey testator or settlor.

(2) Inter Vivos Trust Created by Resident. The planning considerations are much the same as for testamentary trusts, but the chances of winning a constitutional argument are better because the state probate courts may not need to be utilized.

(3) Trust Administered in State. Fourteen states tax trusts based on whether the trust is administered in the state (Colorado, Indiana, Kansas, Louisiana [unless trust instrument designates governing law in another state], Maryland, Minnesota [if first administered in the state before 1996], Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin [inter vivos trusts first administered in the state before 10/29/99]). In addition, Idaho, Iowa, Hawaii, and Utah use this as one of the factors. Take steps to ensure that all administration occurs outside the state in question.

(4) Resident Trustee. Avoid using a trustee who resides in a state that taxes on this basis. Similarly, avoid using "advisors" in that state; they may be treated as fiduciaries and as "trustees" for this purpose.

(5) Resident Beneficiaries. Five states tax trusts based on having resident beneficiaries (California, Georgia, North Carolina, North Dakota and Tennessee; of those, California and Tennessee tax only income attributable to resident beneficiaries). In these states, be careful to make sure that income attributable to nonresident beneficiaries is not taxed unnecessarily. Make sure that accumulated income and capital gains that might ultimately be distributed to nonresident beneficiaries is not taxed prematurely.

d. **Planning for Existing Trusts**. Review all trusts that are paying state income taxes to see if the state taxes can be reduced or avoided. Necessary changes might or might not involve court involvement. Trustees in all states might have a common law duty under §76 of the Restatement (Third) of Trusts to minimize tax. There may be a statutory duty under §7–305 of the Uniform Probate Code (applicable in Alaska, Colorado, Hawaii, and Idaho) and §108(b) of the Uniform Trust Code (a version of which applies in 25 states).

   Taking steps to reduce state income taxation will not impact the tax status of a trust that is grandfathered for GST purposes or to which GST exemption has been allocated.

e. **Reliance on Utilization of Home State Courts Is Misplaced**. Part of the rationale to support the taxation of trusts based on the residence of a testator or settlor of an inter vivos trust is the availability of home state courts to protect the trustee and beneficiaries. However that reliance is misplaced. As a general rule, courts of the state where the trust is being administered should handle issues involving the trust. Indeed, Uniform Probate Code §7-203 (in effect in Colorado, Massachusetts, and Michigan) require the courts of the home state to decline jurisdiction in favor of courts in the state where the trust is being administered). In addition, trust state courts may not have to give full faith and credit to decisions of home state courts.

f. **Source Income**. Nonresident trusts are taxed on source income. Can that be avoided by putting tangible personal property and real property in an LLC or partnership? The best chance of succeeding is if the assets are put in a multiparty entity with various other assets.

g. **DING or NING Trusts**. The Delaware Incomplete Nongrantor ("DING") Trust may be used to avoid state income tax. A grantor may be able to create a nongrantor trust in a state with no state income tax that includes the grantor as a discretionary beneficiary and that would avoid state income taxes on undistributed income. (Such trusts created in Delaware or Nevada are referred to as "DING" or "NING" trusts.) This type of trust may be successful in sheltering investment income of the grantor that would otherwise be taxable to the grantor in the state of the grantor's residence. See Item 30.d above.

The remaining items are from the Summer Seminar about different hats that attorneys wear reflecting alternatives from traditional practice roles.

Items 33-44 are observations from a session by Thomas E. Bator, Nancy E. Dempze, Martin Hall, and Michael J. Puzo about law firms serving as fiduciaries.

33. Attorneys, Not Firms, Serving as Fiduciaries

The law firm itself is not the fiduciary; attorneys serve as fiduciaries with support models developed by law firms to support their efforts. One model is to act through a trust company that is managed by attorneys in the law firm.

34. History

In 1810, a Bostonian set up a very successful textile mill in Boston after learning (secretly from English companies) how to make cloth. It was structured as a corporation to provide an indefinite duration, and the legislature provided that shareholders would have limited liability. Corporate fiduciaries were prohibited from investing in textile stock, so if someone wanted a trust to invest in textile stocks, an individual trust was required. Individual Boston attorneys served as trustees, and law firms developed structures for attorneys to serve as trustees. Eventually, the law developed allowing corporate trustees to invest in textile stocks (under the prudent man standard), but at that point the law firms had a 40-year head start on serving as trustees. This history is summarized in a book, *The Boston Trustee*, by Thomas E. Bator and Heidi A. Seely.

35. Custodial Arrangements

Some firms use a single custodial arrangement, and others use multiple custodians and accommodate clients that already have a custodial platform. The custodial agreement can either be an omnibus account (with internal staff preparing reconciliations among specific trust accounts) or "full disclosed custody arrangements" under which the custodian keeps separate accounts for each trust (and trust disbursements are made directly from the custodian). The trustee must make sure that someone (either the custodian or otherwise) is maintaining principal and income accounts for each trust.

36. Tax Returns

Tax returns may be prepared in-house or by an outside provider (in which event they must still be reviewed in-house). "You might think it is investing that gets clients upset. But what really matters is getting the K-1s out to clients on time."

37. Investments

Boston law firms that serve as trustee typically have some attorneys who perform trustee services as their primary work. (One of the speakers bills only about 200 hours per year; the bulk of his work is serving as a hands-on private trustee.) Some have non-lawyer professionals who provide substantial investment expertise and investment advice to the

attorney-trustees regarding their investment decisions. Some have a number of delegated trusts with outside managers.

The primary models are (1) being a registered investment advisor ("RIA"), (2) having a separate entity owned by partners of the firm that is an RIA, (3) delegating all investment functions, and (4) organizing as a trust company (subject to state regulation) and using one of the foregoing alternatives to provide investment services.

38. Registered Investment Advisor

Subject to certain exceptions and thresholds, the Investment Advisers Act of 1940 requires all "investment advisers" to register with the SEC.

A registrant is required to file an exhaustive disclosure statement, comply with detailed rules concerning all aspects of the investment activity, and undergo examinations by the regulating authority. RIAs are subject to strict regulations and oversight by the SEC (if managing over $100 million) or state regulators (if managing under $100 million). Many firms steadfastly avoid being an RIA. RIAs are subject to inspections ("they are big deals and scary; they can put you in orange jumpsuits"). Advantages of being an RIA include that the firm can manage money beyond just serving as trustee (the RIA often provides investment advice for outside individual trustees) and can advertise.

If the advisor does not have to be registered, it is still subject to certain SEC rules. Advisors managing over $100 million must file Form 13F with the SEC.

An "investment adviser" does not include a lawyer "whose performance of such services is solely incidental to the practice of his profession." 15 U.S.C. §80b-2(a)(11)(B). An attorney must satisfy three factors to be exempt from registration requirements under the "solely incidental" test: (1) the attorney does not hold himself out to the public as providing investment advisory services, (2) the investment advisory services rendered are in connection with and reasonably related to the lawyer's contract to provide legal services, and (3) the charge for such services is based on the same factors as determine the lawyer's usual charges (for example, billing at an hourly rate). The last factor is the most difficult to satisfy for law firms. There are several exceptions, including a "small firm exception" that has fewer than 15 advisor clients. A 1945 case, *In re Loring* (11 S.E.C. 885 (July 20, 1942)), granted an exception to a professional trustee (who was not a practicing attorney), noting that the applicant did not hold himself out as being engaged in the business of giving advice to others as to securities, but gave advice "solely incidental to his activity as professional trustee." That decision has been favorably cited in several court cases, but the SEC has tried to limit its scope. The SEC has directly addressed the question of whether a lawyer acting as trustee of a trust would be an investment adviser under the "solely incidental" exception given that the lawyer, as trustee, possesses legal title to the assets of the trust:

> It is the Division's position that a lawyer receiving any compensation for acting as a trustee, who gives investment advice to the trust with respect to specific securities and whose activities are not incidental to his or her legal practice, is an investment adviser under the Investment Advisers Act of 1940.
>
> *Clare H. Springs*, SEC No-Action Letter, 1990 WL 286952 (Sept. 13, 1990).

A few lawyers and law firms have formed separate affiliated organizations that have registered as investment advisers under the 1940 Act. Using an affiliated entity, which is essentially a law firm's private trust company, "has recently become a trend among law firms seeking to relieve themselves of regulatory involvement while maintaining trustee relationships with their clients. In Boston, for instance, three of the largest local law firms own and operate affiliated entities of that sort." *Guide for ACTEC Fellows Serving as Trustees,* 26 ACTEC NOTES 313, at 321 (2001).

39. Distributions

Some individual attorney-trustees make their own distribution decisions, and some firms use distribution committees to provide consistency across the firm (and to provide cover for hard decisions). One of the panelists is at a firm at which each trustee makes distribution decisions alone. He reiterates that "I don't lie to myself," and that he documents the reasons for his distribution decisions.

40. Compensation

The Boston firms that serve as trustee typically charge for services based on a percentage of assets under management, with special arrangements for nontraditional assets (such as closely held business interests, for example). "Not having billable hours has a profound effect on the professional atmosphere." If asked to charge on an hourly basis, one of the panelists said he explains that the firm has a team of people working on the trust administration under a full service model. "If you want the full team of people, this is how we price it." Fees typically include custody expenses but often do not include fiduciary income tax return preparation or other personal or philanthropic advisory services (for which an additional charge would apply).

41. Insurance and Risk Management

Attorney malpractice insurance policies often do not cover fiduciary services. The attorney serving as trustee must make sure that the malpractice policy extends to the fiduciary part of the practice.

Proper risk management requires having policies and procedures manuals and actually following those procedures. The policies and procedures manual is not just a nice book on the shelf or there merely because regulators want trustees to have a manual. Having a culture of compliance within the firm is imperative. Decisions must be documented.

42. Business Continuity Planning

Terrible weather is not an excuse (this could be especially important for Boston in the winter). The trustee must still trade stocks and make distributions to beneficiaries when needed. Continuity plans require having a structure for staff to work remotely with good communication alternatives in place. One panelist's firm has a dedicated T1 line directly to the firm's custodian.

43. Structural Models—RIA or Private Trust Company

Traditional models are for the firm to have an RIA to advise attorneys serving as trustee, or to operate under a private trust company. An RIA typically does not have trust powers (so attorneys serve individually as trustees). A private trust company approach allows the entity to serve as trustee, which provides increased continuity for the trustee relationship and avoids personal individual liability. New Hampshire has a reputation as a home for private trust companies.

44. Practical Minimum Size

One panelist thinks the law firm should have at least $300-500 million of assets under management to justify the expenses and complexity of structuring a platform for serving as trustee.

Items 45-50 are observations from a session by Charles R. Rounds, Kim Kamin, and Michael D. Whitty, Multiple Models for Family Offices. (Much of this summary is excerpted and quoted directly from written materials for this session.)

45. Family Office Description

a. **General Description**. A "family office" is an organization that supports complex financial and interpersonal needs and potentially other personal needs of a specific family group. It may act as the family's chief advisor, services coordinator, or even its corporate trustee. The family office provides services defined in written agreements or unwritten understandings with individual family members. These may be advisory or agency services, but unless the family office is structured as a trust company, they generally are not fiduciary services (although individual employees or directors of the family office may serve in fiduciary roles).

   Most family offices have limited resources and functionality, but some "fully functional" family offices deliver a wide range of financial, interpersonal and personal services and coordinate the integrated planning and execution of investment, income tax, insurance, philanthropic, wealth transfer, asset protection, risk management, pre-marital, and personal services.

b. **Structure.** The family office is typically an entity (corporation, partnership, or LLC), but can be a loose association, a trust, or an informal system embedded in an operating company. If providing *trust services*, the entity generally must be a state chartered trust company. If providing *investment advisory services*, it must be registered as an RIA or the exempt as either (1) a registered trust company or (2) a family office that meets the SEC definition of serving only one "family group."

c. **Family Office Creation and Business Plan**. A family office is very much an operating business, but without external revenue to serve as a constraint and a metric. To prevent the family office from becoming excessively complex, costly, and disruptive for the family, it must have from the outset clear objectives, a written business plan, and reasonable financial projections. In the absence of these usual elements of a new

business endeavor and a clear understanding of how the office will be governed funded beyond the founding generation, the family office very likely will not survive and support healthy family governance for very long beyond the founding generation.

46. Single Family Office

The single-family office is created, managed and owned by an individual family (*i.e*,, bloodline). It may provide "investment only" or "concierge only" services, or both. It may have minimal or extensive staff. Some single-family offices are created primarily to relieve the burden from business employees of the family's operating businesses.

47. Multi-Family Office

The multi-family office serves the needs of more than one family to facilitate a common interest in asset protection, cost control, financial education, family philanthropy and a host of other needs. Client families typically are not related. The office serves the needs of individuals who may not otherwise have the economy of scale or the family member dedication to form and manage a single family office. The office combines resources for efficiency, and may provide better access to investment opportunities and technology resources. The multi-family office is typically either an RIA or trust company.

48. Virtual Family Office

a. **Typical Problematic Scenario**. Family office functions are sometimes provided by employees of the family's operating business. The services eventually get to the point that they are subject to government proceedings from the Department of Labor, IRS, and SEC, or state agencies with similar subject matter jurisdictions. The use of business employees for personal purposes is prohibited. Compensation for such services cannot be deducted for tax or financial accounting purposes. Most importantly, such poor practices can result in a business's inability to raise capital, be sold or be taken public because the executives cannot sign commonly required covenants with committing perjury or fraud. *See* Thomas Handler, *Establishing Virtual Family Offices,* TRUSTS & ESTATES 25, at 25-26 (March 2014).

b. **Description.** The virtual family office does not have a brick and mortar office, and may not even have full-time staff persons. Virtual family offices "are legally organized businesses that serve as the nerve center or quarterback for controlling a family's tax, financial, legal, investment and risk management strategies. Typically, one or more family members coordinate the functions and outsource services to independent outside providers." *Id.*

c. **Relationship With Operating Business.** The virtual family office plays dual roles of 1) securing a family's long-term wealth management and preservation goals, and (2) adding "needed discipline, integrity and compliance to the family-owned or privately held business." *Id.* The operating business submits non-business charges to the virtual family office periodically.

> This process has the impact of removing the personal, investment or unrelated business expenses from one or more operating businesses and legally transferring them to the [virtual family office], which is in the business of managing the personal finances, business and investment activities of the family. This properly organized legal entity can deduct expenses that tend to produce or protect income. *Id.*, at 27.

d. **Structure**. The virtual family office is a properly organized legal entity with limited liability—almost always an LLC, S corporation, or C corporation, depending on the family's objectives. Sometimes, it operates without established legal structures inside one or more family businesses, but that is ill-advised and susceptible to poor practices. *Id.*

49. Legal Structure

The family office is typically structured as an LLC taxed as a partnership or as a C corporation (which would be able to deduct investment management fees). The family office may serve as manager for a separate holding company entity that holds the equities, fixed income and real estate assets. It may be a Series LLC with separate series for varying classes of assets or assets of various households.

50. Ethical Considerations for Attorneys Working With Family Offices Or Families Who Have Family Offices—Who Are the Clients?

a. **Single Family Offices**. The attorney-client relationship will be complicated by the addition of family office employees who assist in coordinating issues for family members. Usually the individual client, client couple, or client family are the clients. Typical joint representation considerations exist and conflict waivers should be obtained.

   The attorney (and the family office itself) should clearly communicate with those family members who are not clients that they are not clients until a client relationship is established, and that any information regarding the client's situation shared is at the direction and with the consent of the family members who are clients.

   Sometimes the family office itself, a family holding company, and/or investment entities managed by the family office may be the client instead of or in addition to family members. Due to cross-ownership among family members, conflict waivers will be necessary between and among the family members, the family office, and its affiliated entities.

b. **Multi-Family Offices**. The attorney-client relationship will be with the particular client families served by the multi-family office, so the identity of the client is more certain than with the single-family office. The role of some multi-family offices regarding legal services may be limited to simply referring the client to an attorney. Others that provide more extensive service may serve as agent for the client and remain heavily involved in the client relationship.

   Conflict issues can arise if the attorney also represents the multi-family office or its principals on other matters.

c. **Scope of Engagement—Allocating Responsibilities**. As always, the precise scope of legal services provided should be ascertained and documented. The attorney, client, and family office should come to a clear understanding of the allocation of responsibilities.

As part of the services paid for by the client, the family office may assume some of the planning and much of the monitoring and implementation work that might otherwise have been performed by the attorney, the attorney's staff, and other outside providers. In particular, the family office manager or client relationship officer will often take the "quarterback" role for coordinating projects and tasks for all of the client's professional advisors.

d. **Impact of Family Office on Attorney Relationship**. While the family office will likely handle some work that might otherwise have been performed by others on the professional team, the family office will typically give the client the resources to properly implement and monitor *more sophisticated planning techniques*. The client's "complexity tolerance" will often increase, as the family office helps the client in handling details. The attorneys should see this as an opportunity to offer more sophisticated techniques. Conversely, the attorney who only offers the same services as before will not maintain the same level of work and revenue from that client.

The attorney may experience fewer direct interactions with clients, but having at least some direct meetings is still necessary, even if infrequent.

Considerations about how to preserve attorney-client privilege can be more complex. Employees of the family office need to realize that they will not participate in some meetings, in order to preserve the attorney-client privilege. However, agency arguments can be made for preserving the attorney-client privilege even if family office staff are privy to the attorney's advice.

Depending on the level of involvement of the family office, the attorney should receive information that is more complete, accurate and current than if receiving it directly from the client.

Significantly more legal projects may be generated as the family office takes the lead in regular estate planning reviews.

The family office may sometimes take the lead in negotiating and monitoring professional fees. This can cut both ways from the attorney's perspective. The family office can help convince the client of the necessity and value of the legal service provided. But the client may see reining in outside professional fees as part of the family office's job, thus monitoring or questioning billings to a greater degree.

Items 51-61 are observations from a session by Kathleen R. Sherby and Suzanne L. Shier, Trust Directors with Powers to Advise/Consent/Direct and with Powers of Protectors

51. Trust Directors—Overview

Delaware was the first state to have a statute dealing with investment advisors who give directions to trustees regarding investment decisions. That has expanded over time to

include directions regarding distributions and other "trust function" decisions of the fiduciary. Forty-two states and the District of Columbia now have versions of directed trust statutes. The statutes vary significantly regarding a number of issues, including the extent to which the trustee is protected from liability for acting in accordance with the directions of the person giving directions. The trust director statutes recognize the ability to bifurcate trustee responsibilities between the trustee and a trust "director" (or "advisor"), and the director/advisor generally is treated as a fiduciary as to the responsibilities allocated to that person.

52. Trust Protectors—Overview

The trust "protector" is a third party standing in the wings and not part of the ongoing operation of the trust. The trust protector can be empowered to do the types of things that settlors do (in effect, amending the trust), not subject to the general duties of loyalty, impartiality, and prudence. For example, a protector could be given the power to take steps to "turn off"" the grantor trust status of a trust. A trustee may not be able to do that without violating the duty of loyalty to trust beneficiaries. Or a protector may have the power to decant to cut off the interest of a beneficiary (for example, a beneficiary that has a drug addiction issue). Only 24 states have statutes dealing with protectors. Some are just an afterthought. The Delaware statute says (in effect) "and trust protectors are covered as well."

53. Uniform Law Commission—Uniform Directed Trust Act

A Uniform Law Commission drafting committee is working on the Uniform Directed Trust Act. (Professor Robert H. Sitkoff, Chair; Turney Berry, Vice-Chair; John Morley, Reporter) This was originally going to be called the Uniform Divided Trusteeship Act. It addresses directed trusts and having co-trustees with divided duties (by stating that the terms of a trust may provide that a co-trustee is subject only to the duty and liability of a directed trustee with respect to another trustee's power of direction, power of consent or power of protection over particular matters). This uniform act will be completed in the summer of 2017.

54. Nomenclature

States and planners have not been consistent in the names used to describe a trust "protector" or the person who gives directions to trustees regarding trust functions. The term "protector" has fallen into some disfavor, perhaps for fear that the term "protector" connotes that the person has an ongoing duty to "protect" the trust and trust beneficiaries. The Uniform Directed Trust Act, uses the term "trust directors" to refer to both. The term "*trust director with powers of direction*" refers to the person who gives directions to the trustee regarding trust functions, and the term "*trust director with powers of protection*" refers to the person who has the power to perform certain delineated non-administrative decisions but not otherwise part of a trustee's role and that are not traditional trustee powers.

The speakers suggest that planners use this nomenclature, but acknowledge that a consensus as to how to refer to "advisors" and "protectors" has not yet emerged:

> As practitioners, we need to be consistent in what we call our third-party decision maker. We need to dispense with the multiplicity of names for our third-party decision maker and utilize a single name, which is why we all need to shift our thinking to adopting the terminology of "trust director" even if your state does not adopt the Uniform Directed Trust Act.
>
> On the other hand, clients and practitioners seem to understand that a "trust protector" is a third person designated by the settlor to make certain delineated decisions about the trust administration. For that reason, while this term is far from perfect, it may unfortunately continue to be used unless or a consensus develops for the use of the name "trust director". That time when consensus is developed to use a single alternate name may be a long way off, however, since the states themselves do not use the same terminology in their various state statutes. Perhaps once the Uniform Directed Trust Act is adopted by the Uniform Laws Commission and enacted into law by a majority of the states, Trust Director will be universally adopted as the appropriate term to use."

This summary generally uses the terms "trust director with powers of direction" and "trust director with powers of protection" as suggested by the speaker, but you will quickly find just in reading this summary that these terms are awkward, and not nearly as straightforward as the terms "advisors" and "protectors."

55. Overview of Drafting Issues

Trust instruments that designate trust directors should address: what specific powers are granted; the duties and standards for liability that apply for the trust director and trustee; communication sharing procedures; appointment, acceptance and removal provisions; compensation and expense reimbursement; indemnification provisions; and amendment provisions.

56. Powers and Duties

a. **Trust Director With Powers of Direction**. Powers for the trust director with powers of direction can include powers such as those relating to investments, distributions, or other traditional trustee functions. Examples of situations in which these kinds of provisions may be used include trusts holding closely-held business interests or with concentrated investment assets, or trusts having special needs beneficiaries.

b. **Trust Director With Powers of Protection**. These powers should not routinely be used in trust documents, but only where actually needed when someone needs to have a power to authorize the trustee to do something the trustee could not otherwise do. "Trust protector" statutes sometimes list specific examples of powers that could be given (one statute lists 20 such example powers), but such lists are not exhaustive. (Interestingly, though, the current draft of the Uniform Directed Trust Act has no provision for "residual" powers that could be granted in addition to those listed in the Act.) The instrument should list the powers of protection very specifically and should address when the person should exercise those powers (*i.e.*, whether the person has a continuing responsibility of considering whether to exercise the power or only when requested to consider exercising the power). Situations in which these kinds of provisions should be used include ultra long-term trusts ("perpetual is a long time") and situations in which the settlor desires privacy and avoiding court action to authorize changes in light of unforeseen circumstances. Make sure the settlor's intent is clear so the director with powers of protection can act appropriately.

57. Standards of Care and Liability

a. **Spectrum of Standards**. The possible standards of liability of fiduciaries range from strict liability to no liability. The standard of care addresses when a fiduciary is liable if there is a breach of trust. The state direction statutes vary in the standards for liability of trustees who are directed, including—not in good faith, negligence, bad faith, reckless indifference, or willful misconduct. For example, the Delaware statute uses "willful misconduct" for the standard of liability of a trustee following directions of an advisor. The Alaska and Nevada statutes provide that the trustee has *no* liability if the trustee follows the directions from the advisor.

   Section 75 of the Restatement of (Third) of Trusts states that a trustee is required to follow directions unless "the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries."

   Section 808 of the Uniform Trust Code provides:

   > (b) If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.
   >
   > …
   >
   > (d) A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to *act in good faith* with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for *any loss that results from a breach of a fiduciary duty*. (emphasis added)

   Similarly, the standards of lability of the person giving directions must also be considered.

   The trust instrument should specifically address the standard of care (although the instrument may not be able to set a lower standard of care than prescribed by a relevant statute). Do not rely on the provisions of a statute; add the desired standard in the trust instrument.

b. **Someone Always Has Fiduciary Duties Regarding Fundamental Trust Functions**. At all times, some fiduciary must have responsibility under an appropriate standard of care for all essential trust functions.

c. **Trust Directors With Powers of Protection.** Directors with powers of protection are sometimes described as not being a fiduciary, but the person must not act in his or her own self-interest. The trust instrument should make clear that the advisor is carrying out the settlor's intent, not his or her own intent.

d. **Trust Directors With Powers of Direction.** Despite the Restatement's and UTC's use of standards referring to a breach of trust, or serious breach of trust, or absence of good faith, a more refined approach (for example, used in Delaware) is that the directed trustee is only responsible for his or her willful misconduct. The current draft of the Uniform Directed Trust Act also uses a willful misconduct standard of liability

for the directed trustee. The issue is whether some degree of dual monitoring exists and whether a directed trustee merely is required to follow the direction, or has some degree of responsibility of monitoring whether the direction is appropriate.

After the *Rollins* case, be mindful of whether the trustee has any duty to warn beneficiaries of situations in which the directed trustee would have acted differently or whether the directed trustee has any duty to give advice to the person giving directions. Following *Rollins*, trust instruments will typically provide that the directed trustee has neither of those duties.

58. Communication and Information Sharing

Trust directors with powers of protection typically have no right under state law to obtain information about the trust. Some degree of communication between trust directors and trustees is essential, however. For example, a director may have authority over investments, but the trustee having authority over distributions may need to assure that cash will be available for anticipated distributions. The trust agreement should discuss what information the trustee should share with the director, and how they should communicate (the information must be shared in a way that is secure).

59. Compensation; Indemnification; Insurance

Trust agreements should address how trust directors should be compensated (hourly rate, same as the trustee, etc.) Are trust directors with powers of direction compensated differently than trust directors with powers of protection? One New York case concluded that a protector was to be compensated on an hourly rate basis.

State law typically does not address the degree to which directors should be indemnified against losses; that issue should be covered in trust agreements.

Obtaining insurance coverage for directors may be very difficult.

60. Limitation of Actions

Section 10.05 of the Uniform Trust Code discusses the statute of limitations for actions against a trustee, but does not discuss trust advisors or protectors. None of the direction statutes address the limitation of actions for trust directors. The preferred approach will likely be to apply the same limitations period and the same triggering events to begin the limitations period as for trustees. A report to beneficiaries that triggers the beginning of a one-year limitations period for actions against the trustee under §10.05 of the UTC should also apply to directors; that should be addressed in trust agreements because the issue is not addressed in statutes. (See §12 of the Uniform Directed Trust Act current draft.)

61. What to Do Before Accepting the Role of Protector or Advisor

Issues that should be explored by a person being asked to serve as a trust director with powers of direction or powers of protection include:

- Discuss with the settlor his or her intentions

- Is the director comfortable with making those decisions?
- What time commitment will be required?
- What compensation applies and how is it determined (will the trust director need to keep time records)?
- What exit strategy and provisions for succession are provided?

Items 62-69 are observations from a session by Leiha Macauley, C. Kevin McCrindle, and J. Lee E. Osborne, Why Doesn't Everyone Do It – A Review of the Ethical and Practice Implications of Attorneys Serving As Trustee or Serving in the Dual Role of Trustee and Trust Counsel

62. ACTEC Commentary on Model Rules of Professional Conduct

The Fifth Edition of the ACTEC Commentary on Model Rules of Professional Conduct (referred to below as the "ACTEC Commentary") was approved at the 2016 ACTEC annual meeting. Various provisions in the Commentary address attorneys serving as trustee and as trust counsel. Some of these provisions are quoted in this summary.

63. Scope of Representation; Dual Role of Trustee and Trust Counsel

Engagement letters are typically used to define the scope of the engagement. The ACTEC Commentary's discussion of Model Rule 1.2, "Scope of Representation and Allocation of Authority Between Client and Lawyer" specifically addresses issues with respect to a lawyer serving the dual role as fiduciary and trust counsel.

> Some states permit a lawyer who serves as a fiduciary to serve also as lawyer for the fiduciary… Such dual service may be appropriate where the lawyer previously represented the decedent or (where permitted) is a primary beneficiary under the estate plan. See ACTEC Commentary on MRPC 1.8 (Gifts to Lawyer). It may also be appropriate where there was a long-standing relationship (personal or professional) between the lawyer in the decedent. The client may request the lawyer to serve in both capacities during the estate planning process, or the beneficiaries might request this post-mortem. Regardless of when the request is made and by whom, the lawyer should explain the costs of such dual service, the financial implications for the lawyer and the estate, and the alternatives to dual service. A lawyer undertaking to serve in both capacities should attempt to ameliorate any disadvantages that may come from dual service, including the potential loss of the benefits that are obtained by having a separate fiduciary and lawyer, such as the checks and balances that a separate fiduciary may provide upon the amount of fees sought by the lawyer and vice versa. A lawyer serving in such a dual capacity must ensure that he or she complies with the relevant conflict of interest rules.…

The ACTEC Professional Responsibility Committee is currently working on an in-depth review of model engagement letters.

64. Fees When Attorney Serves as Trustee and Trust Counsel

Model Rule 1.5 addresses attorney's fees. The basic rule is that fees must be reasonable. They should be addressed in the engagement letter. The ACTEC Commentary to Model Rule 1.5 provides that "[m]ost states allow a lawyer who serves as a fiduciary and as the lawyer for the fiduciary to be compensated for work done in both capacities. However, it is

inappropriate for the lawyer to receive double compensation for the same work." The attorney should keep contemporary time records in both capacities. Disclose the amounts to the settlor and beneficiaries on a regular basis. Consider having legal services provided by another member of the law firm. Consider adopting a practice of having fees approved by a co-trustee or the trust beneficiaries.

65. Conflict of Interest – General Considerations

Model Rules 1.7 and 1.8 address conflict of interest issues. Before an attorney agrees to serve as fiduciary for client, the attorney should make adequate disclosure of the benefits of naming others as fiduciaries and the potential risks of naming the attorney as fiduciary. Discuss whether activities as a fiduciary are covered by the attorney's malpractice insurance.

The attorney should disclose how fees for serving as fiduciary will be determined.

Consider including a removal provision to avoid the appearance of overreaching and impropriety.

ABA Formal Opinion 02-426, Lawyer Serving as Fiduciary for an Estate or Trust, dated May 31, 2002, is a 9-page excellent summary of the conflicts of interest rules that may arise when a lawyer serves as fiduciary.

The ACTEC Commentary to Model Rule 1.7 has an extended discussion of conflicts of interest issues for a lawyer serving as fiduciary or as counsel for the fiduciary.

> (a) *Selection of Fiduciaries.* The lawyer advising a client regarding the selection and appointment of a fiduciary should make full disclosure to the client of any benefits that the lawyer may receive as a result of the appointment. In particular, the lawyer should inform the client of any policies or practices known to the lawyer that the fiduciaries under consideration may follow with respect to the employment of the scrivener of an estate planning document as counsel for the fiduciary. The lawyer may also point out that a fiduciary has the right to choose any counsel it wishes. If there is a significant risk that the lawyer's independent professional judgment in the selection of a fiduciary would be materially limited by the lawyer's self interest or any other factor, the lawyer must obtain the client's informed consent, confirmed in writing. If the client is selecting a fiduciary that is affiliated with the lawyer, such as a trust company owned by the lawyer's firm, the lawyer must obtain the client's written consent, confirmed in writing.
>
> (b) *Appointment of Scrivener as Fiduciary.* An individual is generally free to select and appoint whomever he or she wishes to a fiduciary office (*e.g.*, trustee, executor, attorney-in-fact). Comment [8] to MRPC 1.8 makes clear that Rule 1.8(c) "does not prohibit a lawyer from seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position provided that doing so does not run afoul of MRPC 1.7." As a general proposition, lawyers should be permitted to assist adequately informed clients who wish to appoint their lawyers as fiduciaries. Accordingly, a lawyer should be free to prepare a document that appoints the lawyer to a fiduciary office so long as the client is properly informed, the appointment does not violate the conflict of interest rules of MRPC 1.7, and the appointment is not the product of undue influence or improper solicitation by the lawyer.
>
> The designation of the lawyer as fiduciary will implicate the conflict of interest provisions of MRPC 1.7 when there is a significant risk that the lawyer's interests in obtaining the appointment will materially

> limit the lawyer's independent professional judgment in advising the client concerning the choice of an executor or other fiduciary. See ACTEC Commentary on MRPC 1.8 (Conflict of Interest: Current Clients: Specific Rules) (addressing transactions entered into by lawyers with clients).
>
> For purposes of the of this Commentary, a client is properly informed if the client is provided with information regarding the role and duties of the fiduciary, the ability of a lay person to serve as fiduciary with legal and other professional assistance, and the comparative costs of appointing the lawyer or other personnel or institution as fiduciary. The client should also be informed of any significant lawyer-client relationship that exists between the lawyer or the lawyer's firm and a corporate fiduciary under consideration for appointment.

The written materials for the session include an excellent form letter regarding the appointment of a lawyer as fiduciary. It covers the following subjects: responsibilities as fiduciary, others who could be nominated as fiduciary, potential conflicts of interest, compensation as fiduciary and retention of the attorney's law firm as counsel, bond waiver, exculpatory language, trustee removal, and consulting independent counsel. The letter is signed by the attorney and ends with a "Confirmation of Appointment" section to be signed by the client. (As an example, Virginia requires these types of issues to be documented in writing, but does not require that it be signed by the client. The preferred practice, however, would be to have the client signed the disclosure.)

66. Concurrent Representation Conflicts Issues

The written materials for the session include a form engagement letter for an attorney representing a trustee when there is concurrent representation of the trustee individually or trust beneficiaries. Excerpts from the form letter are below.

> **Scope of Engagement**
>
> …
>
> For purposes of this engagement, the Firm will be representing only [the two/three of] you [as trustees], and not any others, including family members and others affiliated with you or any beneficiaries of the trust. [IF FIDUCIARIES ARE ALSO CLIENTS AND TRUST BENEFICIARIES: Although the Firm currently represents you and other persons affiliated with you in other matters, the Firm is undertaking in this matter to advise you only with respect to your rights and responsibilities as trustee[s] and not with regard to your personal interests relating to the trust.]
>
> In the future, should you ask the Firm to undertake an additional matter for you (for example, to advise you with respect to your personal interests relating to the trust), we will undertake that matter only after addressing any conflicts and confirming to you the arrangement in e-mail or other writing that specifies the scope of the new matter. We would bill you individually for that work.
>
> **Rates/Basis for Fees**
>
> …
>
> **[Consent to Concurrent Representation and Waiver of Conflict of Interest]**
>
> As you are aware, the Firm represents Mary, a beneficiary of the trust, in connection with [*after obtaining permission of Mary, described that matter in as much detail as possible, for example:* her estate planning]. Your interests as trustee may differ from the interests of Mary. For example, you are entitled to fees for your service as trustee and payment of those fees reduces the amounts

available for distribution to Mary [and the other beneficiaries]. Your interests and views and Mary's interests and views may also differ with respect to the payment of legal fees and other expenses of the trust, the extent of distributions of trust property to her, investment decisions, and with respect to other matters, including matters that we cannot now anticipate.

As a result of these actual and potential differing interests and our attorney-client relationship with Mary, the Firm must have your consent and the consent of Mary to represent you in connection with the administration of the trust while the Firm concurrently represents Mary [in her estate planning/and other matters]. We understand that you have considered the actual and potential conflicts created about our representations of you and Mary and that you consent with our continued representation of Mary, both during and after our representation of you, notwithstanding that actual and potential conflicts exist between your interests as trustee and the interests of Mary in the trust.

[OPTIONAL PARAGRAPH REGARDING FUTURE WITHDRAWAL: …]

[OPTION 1 REGARDING TREATMENT OF CONFIDENTIAL INFORMATION:…

OPTION 2 REGARDING TREATMENT OF CONFIDENTIAL INFORMATION:…]

[**Joint Representation**]

…

[The letter is signed by the attorney and there is a "Consented and Agreed to" signature blank for the fiduciary's signature.]

The written materials also include a sample consent to concurrent representation by trust beneficiary form letter (for a trust beneficiary to consent to the attorney's representation of the trust fiduciary when the attorney also represents the beneficiary).

67. Client Consent

A Comment in the Model Rules specifically addresses a lawyer serving as fiduciary. It addresses potential conflict issues, and requires that the client give informed consent to the conflict.

This Rule does not prohibit a lawyer from seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position. Nevertheless, such appointments will be subject to the general conflict of interest provision and Rule 1.7 when there is a significant risk that the lawyer's interest in obtaining the appointment will materially limit the lawyer's independent professional judgment in advising the client concerning the choice of an executor or other fiduciary. In obtaining the client's informed consent to the conflict, the lawyer should advise the client concerning the nature and extent of the lawyer's financial interest in the appointment, as well as the availability of alternative candidates for the position.

MRPC Comment [8] on Model Rule 1.8: Conflict of Interest: Current Clients: Specific rules, relating to rule 1.7.

68. Imputation of Conflicts of Interests to Other Lawyers in the Same Firm

The ACTEC Commentary specifically addresses when a lawyer's conflicts would be imputed to lawyers in the same firm.

MRPC 1.10 addresses when a lawyer's conflicts under MRPC 1.7 and 1.9 would be imputed to other lawyers practicing in the same firm with the conflicted lawyer or lawyers practicing in a firm where the conflicted lawyer previously practiced.

Personal Interest Exception. If a lawyer is disqualified from representing a client because of the lawyer's personal interest and that interest would not materially limit another lawyer in the firm representing the client, the disqualified lawyer's conflict is not imputed to other lawyers in the firm. Note, however, that this does not allow other lawyers in the firm to draft Wills or other donative documents favoring a lawyer who would be disqualified from drafting such documents under MRPC 1.8(c). MRPC 1.8(k) overrides in MRPC 1.10 with respect to any disqualification specified in MRPC 1.8 (except for those derived from sexual relations with a client), and would impute that conflict to all lawyers practicing with the disqualified lawyer.

There is a larger point relevant to estate planners and probate lawyers that is embedded in this interplay between MRPCs 1.8 and 1.10. MRPC 1.8(k) imputes the specific requirements for at least nine separate kinds of problematic situations to other lawyers in the firm. In addition to MRPC 1.8(c), these include MRPC 1.8(a) (business transactions with clients) and MRPC 1.8(f) (compensation for representing a client from a nonclient)…. Thus, a lawyer wishing to avoid the strictures of MRPC 1.8(a) cannot do so by sending the client down the hall to another lawyer in the firm for representation, nor may a lawyer enter into a business transaction with the client of another lawyer in the firm without complying with MRPC 1.8(a).

69. Summary of Important Considerations and Best Practices

The following excellent list of best practices for an attorney serving as fiduciary is taken largely verbatim from the written materials for the session.

a. **Written Policy**. Have a written policy regarding serving as fiduciary.

b. **Support Staff**. Ensure adequate support staff to permit the lawyer to perform fiduciary services efficiently and cost-effectively.

c. **Professional Liability Policy**. Review the professional liability policy to confirm that it includes fiduciary service.

d. **Client Consent**. If the drafting attorney or another attorney in the draftperson's firm will serve as a fiduciary, obtain the client's written, informed consent.

e. **Independent Advice**. Before accepting the fiduciary role, confirm the client's decision in writing and encourage the client to obtain independent advice from other trusted advisors or family members.

f. **Scope of Services and Fees**. Establish with certainty the services the attorney/fiduciary will provide, and the fees for those services. The clients' consent should document the disclosures and discussions mandated under Model Rule 1.4 (communication) and Model Rule 1.7.

g. **Removal and Replacement Provisions**. Consider including trustee removal and replacement provisions in each trust in which the attorney is named as the fiduciary to avoid the appearance of impropriety. If the attorney is named as trustee, but someone (the client, a beneficiary, a trust protector, etc.) is authorized to remove and replace

the attorney, concerns regarding the attorney's ability to take advantage of the fiduciary relationship may be reduced.

h. **ABA Formal Opinion 02-426 (May 31, 2002)**. This Opinion determined that a lawyer who drafts of will may act as a fiduciary thereunder and hire his own firm to represent him in connection with his fiduciary duties, so long as:

   i. The lawyer gives adequate advice to the client about choosing a fiduciary under Model Rule 1.4(b);

   ii. Confirms the client's consent in writing if there is the risk that the lawyer's judgment will be materially impaired within the meaning of Model Rule 1.7(a)(2); and

   iii. Charges reasonable fees in connection with the legal representation and the fiduciary service.

   Both may collect fees for those services, so long as the total fee for fiduciary and lawyer-for-the-fiduciary services is reasonable under Model Rule 1.5(a).

i. **Specific Circumstances**. Inquire about and carefully consider the specific circumstances. For example, the existence of a professional co-fiduciary (*e.g.*, a bank trust department), the identity and nature of the beneficiaries (is there a history of litigation?), and the nature and amount of legal work the firm would perform for the estate. Also consider the nature of the assets (are these business assets, real estate or promissory notes?).

j. **Conflicts of Interest Posed by Specific Circumstances**. Assess potential conflicts of interest issues raised by the circumstances of the specific matter.

k. **Multiple Beneficiaries, Only Some Of Whom Are Clients**. The risks of conflicts of interest allegations are multiplied when a lawyer serves as a fiduciary for the estate or trust that has multiple beneficiaries and one or more, but not all, of those beneficiaries are already clients of the firm in unrelated matters. If a non-client beneficiary perceives (justifiably or not) that the lawyer-fiduciary is favoring other beneficiaries who are clients, the allegedly disfavored beneficiary may attribute the lawyer-fiduciary's conduct to a desire to favor the client beneficiaries.

l. **Attorney-Client Privilege**. Consider the fiduciary exception to the attorney-client privilege. Will it apply to communications? Generally the attorney-client privilege protects communications between an attorney and client from being disclosed in litigation. Under the exception, however, a trustee who obtains legal advice related to trust administration is precluded from asserting the attorney-client privilege against trust beneficiaries with respect to that advice.