Report #9 (Wednesday)

A complete listing of the proceedings and speakers is available on **[the Institute's Web site]**

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Errata: Report 7, which covers the HIPAA session that was presented by Michael Graham Esq. on Tuesday afternoon, mistakenly spelled HIPAA as HIPPA. The error was occasioned in part by the humor of the title of the presentation and in part by some of the Institute's CLE materials that were available in the Registration area, where the same spelling error appears. We apologize to Michael for our not catching this before the Report went out.

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This Report contains coverage of the Wednesday Fundamentals session

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Income Taxation of Trusts, Estates, Grantors, and Beneficiaries
Presenter: Prof Jeffrey N. Pennell

Reporter: Connie T. Eyster Esq.

Professor Pennell began his presentation by stating that it is his understanding that the IRS simply is not enforcing subchapter J of Chapter 1 of the IRC and they are not training their agents to be aware of the audit issues for 1041 returns. This also means, however, that there is little authority to answer questions you might raise.

Generally, it is no longer desirable to retain income in a fiduciary vehicle. Grantor trust rules were designed to punish taxpayers by forcing them to realize income that taxpayers were trying to bury in a fiduciary vehicle. Now the rules give exactly the opposite result.
Taxpayers now are taking advantage of the grantor trust rules to achieve a lower income tax bracket or to make a tax-free gift by absorbing a trust's income tax obligation and passing greater amounts on to the beneficiary.

With regard to simple versus complex trusts, Professor Pennell says that knowing the distinction is of very little value. The simple trust rules in subpart B of subchapter J are really just the reader's digest version of the complex trust rules. You can ignore subpart B because everything that applies is the same as exists in subpart C - except in one tiny circumstance that will be discussed later in the outline.

Distributable Net Income (DNI) is taxable income that is computed very much in the same way as it is computed for individuals. The fundamental rule is (see p.6 of the materials) that fiduciary entities are NOT pass-through entities the way you think of an S-corp or partnership. They are conduit entities. Distributions carry-out to the beneficiary DNI to the extent that distributions are made. The entity gets a deduction for the amount of DNI that is carried out.
The deduction is for the taxable portion of the DNI. To the extent of the entities' deduction, the beneficiary has inclusion. To the extent DNI is not carried out, it is taxable to the entity. That is what is expensive. These rules apply to garden variety trusts and to estates, which are always taxed complex trusts.

Subchapter E of Chapter 1 of the IRC deals with the grantor trust rules. To the extent that those rules apply, they trump the subchapter J rules just described.

Note (pg. 8-9 of the materials) that not every entity that you think of as being a trust or estate is subject to subchapter J. For instance an UTMA account is not subject to these rules because the income is already taxable to the ward without the need for these special rules.

Page 10 of the materials contains the definition of a simple trust.
Although generally not useful to know, a simple trust is required to distribute all income annually and does not provide for charitable distributions or set asides, and even then it is a simple trust only for years in which the trustee also does not distribute corpus.

For the purpose of subchapter J, income means fiduciary accounting income. This will depend on state law definitions of fiduciary accounting income, which may embrace unitrust legislation and principle and income allocations.

A complex trust is not a simple trust i.e., one that can accumulate income and/or a trust from which the trustee has made a distribution of corpus. Note that some trusts may be simple in one year and complex in another.

On page 13, Pennell suggests some reasons why a fiduciary may want to accumulate rather than distribute income, even though it may be taxed at a much higher rate. These reasons generally relate to the beneficiary, who may, for instance, prefer that the trust pay the tax rather than distributing income outright, where it might be subject to estate tax treatment in the beneficiaries estate.

Beginning on page 18 there are paragraphs describing how taxable income is determined differently for taxable entities as opposed to individuals. For instance, there is no standard deduction under subchapter J, but rather there is a deduction in lieu of the personal exemption which is $600 for estates and $300 or $100 for trusts depending on whether there are mandatory or discretionary distributions of income. Note that the deduction in lieu of the personal exemption is solely for the benefit of the fiduciary if there is a tiny amount of income that doesn't get distributed in the prior year, then the fiduciary can avoid the hassle of filing a return in that second year.

Other differences are that the 3% threshold on certain itemized deductions does not apply to fiduciary entities under §68. Under §67(e), the 2% loss of miscellaneous itemized deductions does not apply to fiduciary entities to the extent that the administrative expenses are unique to the fact that the assets are held by a fiduciary entity as opposed to an individual. The materials discuss case law in which this rule has been construed in particular with regard to fees paid to investment advisors. Some courts would say that such fees are unique and are not subject to the 2% rule, (see O'Neill Irrevocable Trust v. Comm'r, 98 T.C. 227 (1992)) while others would say that they are not unique (see Mellon Bank v. United States,
2000-2 U.S. Tax Cas. (CCH) and Scott v. United States, 186 F. Supp. 2d
664 (E.D. Va. 2002)).

Note, Professor Pennell is troubled about the extent to which § 67 applies and believes this is the kind of thing the government will focus on if it decides to start getting up to speed on these returns.
As a practical matter, smartest thing to do is to adopt a position and be consistent. Don't waffle and go back and forth one year to the next.

There are elaborate rules dealing with adjustments to determine the DNI, which are found starting on page 26 of the materials. Starting with our typical notion of taxable income for an individual the first adjustment is to add back the amount of the deduction in lieu of the personal exemption to calculate DNI. Then, add back any tax exempt income, which is included in order to allow DNI to work properly with other ancillary income tax rules such at §265. Tax exempt income carries out to the beneficiary with the same character so it is never actually taxed. Also, ignore the distributions deduction which is necessary to avoid circularity. The distributions deduction is limited to the taxable portion of the DNI which would make things difficult if the DNI were equal to taxable income after allowance of the distributions deduction.

Further adjustments exist with regard to capital gains. To the extent capital gain is allocated to corpus, it gets excluded from DNI.

Here is that special rule for simple trusts that Professor Pennell thinks is the one reason you might want to know the difference between a simple and a complex trust. If there is a stock-on-stock dividend issued that is allocated to corpus under the instrument or local law and is not distributed to the beneficiary, it is excluded from DNI.

Finally, electing small business trust income is not included in DNI because it will be taxed to the trust under special rules specific for that kind of trust.

The issue of when capital gain is included in DNI is a difficult and complicated issue, which begins on page 29 of the materials. The general rule is that capital gains of a trust are NOT includible in DNI, except in the year of termination or to the extent that capital
gains is part of what is distributed in a current year. Capital
gains will be included in DNI to the extent provided by regulation, which establishes a bifurcated rule: (a) if gain is allocated to income pursuant to a mandate that is provided by both state law and the terms of the document, or (b) if gain is allocated to income pursuant to fiduciary discretion, that is permissible under either state law or the terms of the document, and the allocation is done in a reasonable and impartial manner.

Pages 32.1 and 32.2 contain added elaboration on what is a "reasonable and impartial manner." Professor Pennell again emphasized the notion that you must be consistent in how you treat capital gains. Once you've done it one way, you are cast in stone, which may not have been what Congress intended, but is the posture the IRS currently takes.

Professor Pennell did note that a special rule applies for complex trusts where there is an accumulation of income (doesn't apply to simple trust because a simple trust is not permitted to accumulate income), which allows a trustee or an executor to make income distributions in the first 65 days of the new year, which distributions will be considered as having been made in the prior tax year. (See page 41 of the materials)

Page 42 of the materials begins a discussion of the Tier rule, which governs how DNI is carried out depending on whether distributions of income or corpus are made to the beneficiaries. Note that DNI carries out regardless of the character of the property distributed, but it does so in tiers.

Take the example where there are two beneficiaries who are both required to receive equal amounts of income (each receiving $25K of income in this example) and the DNI is $40K. Beneficiary 1 also receives a discretionary distribution of corpus of $50K. Each beneficiary still receives ½ of the DNI, despite the additional distribution of corpus to beneficiary 1. Both beneficiaries are first tier beneficiaries of 50% of the DNI because that is what the trustee was mandated to distribute to them out of current income. Other amounts properly paid (i.e., amounts other than income required to be distributed) are not taxable unless there is undistributed net income subject to old throwback rules.

Professor Pennell emphasized that in this area people need to pay attention to the separate share rule, which is a rule that has been ignored for a long time. This rule is used to prevent fiduciaries from manipulating the timing of distributions to achieve favorable tax results. When the separate share rule applies, substantially independent and separately administered shares of a single trust or an estate will be treated as separate for DNI allocation. This assures that the accumulation of DNI in one share will not affect the other shares. As stated on page 47, the separate share rule applies to any trust that divides post-mortem between a marital and bypass trust. Regarded as two separate entities each dollar of income earned by the estate needs to be fractionalized so that we can calculate respective amounts of DNI to the two trusts.

"This is the devil." In normal probate administration, it may be awhile before you know the amount of the marital and the non-marital shares. You won't know the amount of the non-marital share until much later, to divide the dollar of income that comes in just after the date of death according to the fraction between the amounts.

Page 51 states that there is an exception to such rule where the value of the marital or the bypass trust is frozen in value as of the date of death and no income or interest is payable to that share. See footnote 43.14 regarding the need to substitute "interest" for "income" when freezing the marital share so that you do not run afoul of the marital deduction rules. Also, this technique may result in double taxation of the interest in order to avoid the mess of dealing with separate shares.

An important rule exists for certain specific bequests. For example, personal property specifically devised to individuals does not carry out DNI (see page 54.2 of the materials and IRC § 663(a)(1)). Many people think that a formula marital bequest should fall under this exception as well, but the government does not take that position.
The IRS says that at the moment of death, you do not know the exact amount of the marital bequest and thus is not specific enough to apply under this exception. It is, however, specific enough for allocation of gain or loss so can result in both DNI income taxation and capital gains taxation.

Page 77 discusses the selection of a tax year, which can be a fiscal year for estates but is usually a calendar year for trusts. This can enable some deferral of income for beneficiaries of estates, but can also result in bunching. Fiduciaries should think through these issues before choosing the tax year.

With regard to distributions in kind, these distributions carry-out DNI to the extent that DNI exists. § 643(e) contains a limitation on this rule. Certain in-kind distributions do not carry-out DNI to their full fair market value; rather, they carry-out DNI to the lesser of fair market value or basis. This applies in circumstances where the basis of the asset is less than the fair market value, for the reason that when the beneficiary sells the asset, the beneficiary will pay the gain of the difference between the sale price and the basis.
See pages 80-82 of the materials. Note that the trustee may elect to treat a nonrealization distribution as if it were a sale or exchange, intentionally recognizing gain on the distribution of property in kind. The beneficiary would receive a fair market value basis and the trust would pay the tax which may be beneficial if the entity is in a lower tax bracket than the beneficiary or if the entity has losses to off-set. Note that this election would apply to all in-kind distributions for that tax year. Professor Pennell says to BE VERY CAREFUL about this particular election.

On page 95 there is a description of other circumstances in which the distribution of DNI and/or type of distributions made to beneficiaries can create inequities. While this may result in income tax savings, it can run afoul of a fiduciary's obligation to treat all beneficiaries equally. Consider putting a provision in your documents that allows the fiduciary to make elections for income tax purposes without having to make a compensation adjustment to beneficiaries treated unequally.

Page 116.7 of the materials begins the discussion of IRD, which is Income in Respect of the Decedent. See IRC §691. This is income earned by the decedent, but which is collected post-mortem. There is no statutory definition for IRD. Illustrations of IRD are on page 117 of the materials: the decedent's final paycheck, installment note payments, and deferred compensation (such as in a qualified retirement plan).

One of the biggest problems with IRD is that under IRC §1014, IRD is NOT entitled to a new basis at death. Sometimes, however, the lack of receipt of a new basis is not such a bad thing because IRD is entitled to a deduction for the amount of estate tax paid on the asset. (See page 132-137 of the materials)

BUT, very important, under §691(a)(2) note that (page 139 of the
materials) certain transfers of IRD cause an acceleration of the income represented by that right, such as distributions in satisfaction of pecuniary bequests. The transferor will be taxed for built-in liability in the year of distribution. Professor Pennell says this issue is as serious as a heart attack and you do not want to accelerate the built-in-income tax liability. If you have to use IRD to fund a pecuniary bequest (think marital share) this can be a bad result and should be considered carefully.

GRANTOR TRUST RULES

Professor Pennell begins the grantor trust rules discussion by describing a very common misconception. It is street wisdom that when a grantor trust exists, we ignore the trust for income tax purposes and all of the income and deductions and losses and credits, flow through to the grantor as if the trust did not exist. That vision is okay for a rudimentary understanding or explanation to your clients, but it is almost 100% WRONG. What the code and regulations say is that the entity exists, but the items of income, deduction and loss will be taxed through to the Grantor.

This misconception is based on Rev. Rul. 85-13, which basically promulgated this misconception as fact. The sale to a defective grantor trust planning technique is primarily based on this revenue ruling and on what Professor Pennell believes was a misstatement.
Professor Pennell later states that when the IRS wises up to this misconception, and the extraordinary planning techniques it allows, we may be in trouble. Primarily, Professor Pennell thinks that allowing a transaction to be neither a gift nor a sale is fundamentally wrongheaded and bizarre and will create problems down the road.

Note that under subchapter E of Chapter 1, "income" means taxable income whereas under subchapter J, "income" means fiduciary accounting income.

The most important and difficult aspect of grantor trust rules are the "portion rules" in the regulations that provide that you can have a trust which is defective with respect to income or with respect to the corpus or with respect to the whole of the trust. Depending on the type of provision that makes the trust defective, you may or may not have a trust that is defective for the desired purposes.

Professor Pennell does not think that the definition of "adverse party" is vague and problematic and thinks a practitioner should be very careful when relying on adverse party rules to make a trust defective for income tax purposes. (See page 153 of the materials).

Professor Pennell took special note of § 672(e), the spousal unit provision, which provides a lot of drafting opportunities where it would be much more palatable if the grantor's spouse has the power that makes the trust defective. However, there is uncertainty with regard to the effect of divorce on the defective nature of the trust and it is possible that a divorce would destroy the defective character.

Under IRC § 677, generally, a grantor is treated as the owner of any portion of a trust as to which the income, without the consent of an adverse party, either must be paid or, in the discretion of the grantor, grantor's spouse, or any nonadverse party, may be paid (or accumulated for future payment) to the grantor or grantor's spouse.
An exception to the grantor's liability under this section applies if the trustee has discretion to distribute income for the support or maintenance of someone the grantor is obligated to support or maintain. (See page 169 of the materials). This provision is meant to protect grantors. Notice what this rule does not say. This rule only applies to discretionary distributions of income and does not apply to mandatory distributions of income. It applies only to legal and not contractual obligations. It can create a limit on grantor trust status when that is otherwise not desirable. An "Upjohn" provision prohibiting distributions that discharge the obligation is not effective to avoid exposure. The provision would have to say that the trustee is prohibited from making any distributions for support or maintenance to someone the grantor is legally obligated to support or maintain.

IRC § 674 contains grantor trust rules regarding a grantor's power to control someone else's beneficial enjoyment of the property. Section
674(a) is very broad, without the exceptions listed in that code section, nearly every trust would be a grantor trust.

Exceptions in § 674(c) regarding powers held by persons other than independent trustees allows a trust to toggle between grantor and nongrantor trust status by the appointment and resignation of trustees where there is more than one trustee and some of the trustees are permitted to be related or subordinate parties.

Note that in §674(b) there are a variety of powers relating to distributions of income, corpus, or both the use of which can affect what part of the trust is defective for income tax purposes.

Most people use the §675 administrative powers to create grantor trusts. Professor Pennell likes the use of 675(3) which makes the grantor the owner over any portion of the trust that the grantor or the grantor's spouse actually has borrowed and has not completely repaid before the tax year began (which necessarily includes all amounts borrowed during the current tax year). Professor Pennell thinks that you could use this rule to make a loan on 12/30 of a year and repay it on 12/31, and still achieve grantor trust status for that year, without impacting status for the next year.

Many people rely on the power, held in a nonfiduciary capacity, to substitute property of equivalent value to achieve grantor trust status. IRC § 675(4) (c). There is no estate tax inclusion caused as a result of this defect. However, it is difficult to use this defect as a means to toggle grantor trust status on an off.

Note that a trust can have multiple grantors for income tax purposes, as can happen under § 678 when there are Crummey powers granted in a trust. This result creates "pseudo grantors." The creation of pseudo grantors is not limited to circumstances in which there is a lapse of a power in excess of the

5x5 power. (See page 187 of the materials).
However, if there is a regular grantor and a pseudo grantor who could be deemed the owner of the same portion of the trust, the regular owner will trump.

Starting on page 195, there is a discussion of the portion rules and which defective grantor trust provisions affect income, corpus of both. Professor Pennell believes these are perhaps the most important parts of defective grantor trust planning.

Page 205 of the materials discusses advantages of grantor trust treatment.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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