The Good, the Bad & the Ugly of Trusts Investing in Partnerships

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Prudent Investor Rule

- For many years trusts followed the prudent man rule of investing.
- The prudent man rule favors “safe” investments such as government bonds, disfavors “speculation” in stock, and courts assess the prudence of each investment in isolation rather than in the context of the portfolio as a whole.
- Most states have abandoned the old prudent man rule in favor of the prudent investor rule.
- Drawing on the teachings of modern portfolio theory, the new prudent investor rule directs the trustee to invest based on risk and return objectives reasonably suited to the trust and instructs courts to review the prudence of individual investments in the context of the trust portfolio as a whole.

Prudent Investor Rule

- The first step of the trustee in conjunction with his professional advisors is to develop an investment policy statement based on the goals and objectives of the trust.
- The factors an advisor must consider when developing an investment plan should include the appropriate market risk to be taken, the size of the trust, and the purpose of the trust.
- If the trust is large enough, many advisors are recommending to the trust that a portion of the assets includes alternative investments.
- Examples of alternative investments include hedge funds, real estate, venture capital, and private equity.
- These investments are generally structured as limited partnerships or limited liability companies.

Prudent Investor Rule

- It would seem that there should be no reason, under a prudent man statute, why a trustee cannot invest trust funds in a limited partnership if the investment is otherwise prudent.
- Although the trustee has control over his limited partnership interest, by statute he may not participate in the management and control of the partnership business.
- However, fiduciaries invest in mutual funds or other investment trusts in which the fund or trust advisors are being paid in large part for the investment. responsibilities that the fiduciary is, in effect, delegating.
- The ownership of a partnership interest by a trust often involves unique tax considerations.

Overview of Subchapter J

- A trust can be a separate tax paying entity, a conduit that passes through its income and its deductions to the beneficiaries, or both entity and conduit.
- A trust for income tax purposes may be classified as simple or complex.
- The trust must calculate its income in two ways.
- The first computation is distributable net income (DNI) which is a tax concept of the Internal Revenue Code.
- The second computation is the fiduciary accounting income. This is not a tax concept. The income is determined by looking to local law.

Overview of Subchapter J

- In general, it is calculated by subtracting the total trust expenditures that are allocated to income from the total trust receipts that are credited to income.
- A trust that is required to distribute all of its income currently is entitled to a deduction for the income that is required to be distributed currently.
- The deduction and the amount to be included in income by the beneficiary is the lesser of the fiduciary accounting income (FAI) or the distributable net income (DNI).
- There is a general lack of clarity to the proper treatment of a partnership investment held by a fiduciary.
- There are inherent conflicts between Subchapter J and K.

Fiduciary Accounting Income and Partnerships: A State of Uncertainty

- Sometime after year-end (unfortunately often not until July or August) the trustee receives the K-1 information from the partnership.
- The items reported on the K-1 are used to compute the taxable income and DNI of the trust.
- Under the Revised Uniform Principal and Income Act of 1997 trust accounting income from partnerships is *based on distributions of cash,* not the entity's GAAP or taxable income.

Fiduciary Accounting Income and Partnerships: A State of Uncertainty

- Example. A trust invests in an investment partnership. In 2005, the partnership K-1 states that the trust is subject to tax on $30,000 of dividends and interest. The partnership makes no distributions of cash or other property. Under the revised UPIA the trust recognizes no amount as allocable to income since no distributions were received from the partnership. Therefore, if the only asset of the trust is the partnership interest it may have taxable income from the K-1 but no cash with which to pay the tax and no accounting income to distribute to the income beneficiary. In the case where the trust does have other liquid assets it may be forced to use these assets to pay the tax.

Fiduciary Accounting Income and Partnerships: A State of Uncertainty

- To continue the example, assume in 2006 the partnership K-1 states that the trust is subject to tax on $10,000 of dividends and interest. The partnership makes a distribution of $40,000 in cash in 2006. Since trust accounting income is based on distributions of cash from the partnership it would have $40,000 of accounting income. The trust document requires the distribution of accounting income. Therefore the $40,000 would be distributed to the beneficiary. However, the deduction and the amount to be included in income by the beneficiary is the lesser of the fiduciary accounting income (FAI) or the distributable net income (DNI). Thus, the beneficiary would receive cash of $40,000 but only have taxable income of $10,000. However, the trust paid tax on the $30,000 of income in 2005.

Fiduciary Accounting Income and Partnerships: A State of Uncertainty

- A trustee has a duty to exercise impartiality to the beneficiaries.
- The trustee should make an adjustment to reimburse trust principal for the tax that was paid in 2005 from principal. Assuming the tax was $9,000 in 2005 (30% x $30,000) it would be appropriate for the trustee to make an adjustment of the $9,000 between principal and income. Consequently, only $31,000 should be distributed to the income beneficiary in 2006.

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All Cash Distributions Are FAI Right—Not So Fast

- The revised UPIA provides that (1) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity and (2) money received in total or partial liquidation of the entity shall be allocated to principal.
- Money is received in partial liquidation to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation.
- Or if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's *gross* assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

All Cash Distributions Are FAI Right—Not So Fast

- Example: A trust created under the will of Francis Nave owns a 30% interest in the ABC FLP. Audited financial statements of the ABC FLP indicate $6,000,000 of gross assets at December 31, 2005. During 2005, $1,500,000 was distributed to the Nave trust. Because the distribution of $1,500,000 exceeds 20 percent of the partnership's gross assets, it would represent fiduciary accounting principal, not income.

All Cash Distributions Are FAI Right—Not So Fast

- Example: The Nave trust owns a 30 percent interest in the Trump Real Estate FLP. The Trump partnership owns multiple properties. In 2006, it sells one of these properties for $2,000,000, pays off the outstanding mortgage of $500,000, and distributes the net cash proceeds of $1,500,000 to its partners. Trump's financial statements for the year ended December 31, 2005, reflected gross assets of $10,000,000 and mortgage liabilities of $3,000,000. The $450,000 (30 percent of $1,500,000) received by Nave trust is considered to be income for fiduciary accounting purposes, because Trump's total distribution of $1,500,000 is less than 20 percent of its *gross* assets of $10,000,000.

Treatment of Distributions from Partnerships to "Cover" Income Tax Liabilities

- Frequently a partnership requires distributions of cash just sufficient in amount so that their partners will be able to pay their federal and state income tax liabilities upon income deemed taxable to them on the K-1.
- This distribution is especially important to trusts where the sole or major asset is an ownership interest in the entity.
- But, are these distributions included in FAI?

Treatment of Distributions from Partnerships to "Cover" Income Tax Liabilities

- Example. Nave Family Trust sole asset is an interest in the Nave FLP. The trust receives a K-1 from the Nave FLP reflecting reportable income of $ 200,000. The Nave FLP distributes $ 76,000 to the trust to cover its federal and state income tax liability. If the $76,000 is treated properly as FAI, a beneficiary, who is required to receive all FAI, will receive that entire amount and pay taxes of $28,880 (assuming that the same 38% rate represents the combined federal and state income taxes). The trust has taxable income of $124,000 ($ 200,000 less distribution deduction of $76,000, ignoring the exemption). It owes tax of $47,120 (38% of $124,000), but has no cash left to discharge its tax liabilities.

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Treatment of Distributions from Partnerships to "Cover" Income Tax Liabilities

- "A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ... from income to the extent that receipts from the entity are allocated to income. ..."
- Thus, the entire $76,000 represents "tax required to be paid" by the fiduciary.
- Therefore, it would appear that the FAI should be zero. That is the $76,000 receipt less the applicable taxes.

Using the Power to Adjust to Level the Playing Field

- The trustee has a duty to treat income and remainder beneficiaries fairly.
- Under certain circumstances the trustee may exercise the power to adjust to maintain impartiality concerning the investment in the pass through entity.
- Example. The real estate partnership refinances one of its properties due to large increase in value. It distributes the excess refinancing to its partners. This distribution is less than 20 percent of the gross assets so generally the distribution would be treated as income. However, it would appear under these circumstances if the trustee has the power to adjust, he should exercise this power and treat the distribution as principal.

Partnership Distribution of Capital Gains: Is It Principal or Income?

- The revised UPIA appears to give trustees the ability to treat all partnership distributions that are less than 20 percent of the partnership’s gross assets as FAI.
- The general rules under Subchapter J are that capital gains are principal.
- However, if capital gains are part of the partnership distribution that is less than 20 percent of the partnership’s gross assets, are they possibly FAI?
- Clearly, if these same gains were incurred inside the trust they would be treated as allocable to principal. It would appear that, absent a trust that has elected total return, the capital gains that pass through from the partnership should be included in principal and the tax should be paid by the trust.

Partnership Distribution of Capital Gains: Is It Principal or Income?

- However, the Revised Uniform Principal and Income Act makes no reference to receipts from capital gains other than capital gains that are distributed from RICs and REITs.
- There is a recent Tax Court case *Crisp* that may give the trustee some flexibility as to whether capital gains that pass through from a partnership are includible in DNI.
- In *Crisp* the trust instrument allowed the trustees to distribute "net earnings" and "net profits," but did not specifically authorize distributions of corpus.
- The trustee distributed $4.5 million to Caroline from gains distributed to the trust by a partnership in which the trust was a limited partner.

Partnership Distribution of Capital Gains: Is It Principal or Income?

- The court held that the partnership gains were properly allocated to FAI and includable in DNI.
- The phrase “net profits” may be properly construed as including capital gains, net of capital losses.
- There may be times that the trustee would prefer to have the capital gains from the partnership included in DNI.
- The *Crisp* case reiterates that the language of the trust document will “trump” the UPIA for tax purposes.

Separately Stated Partnership Items

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Charitable Contributions

- Contributions by the partnership are normally allocated to partners based on their interests in the partnership.
- The issue is whether these pass-through contributions are deductible by the trust.
- In *Estate of Lowenstein v. Commissioner,* 12 TC 694 (1949) the court ruled that the charitable contributions that passed through from a partnership were not made by the decedent's estate, but by the partnership as a business unit.
- Pass-through charitable contributions may cause procedural complexities for the fiduciary.

Charitable Contributions

- The trustee of a complex trust that makes a charitable contribution deductible under Section 642(c) is required to file Form 1041-A, which details that trust's income for the year, and a balance sheet of its assets, liabilities, and net worth, among other facts.
- In Revenue Ruling 2004-5, the IRS ruled that the trustee can deduct a proportionate share of the charitable gift made by the partnership.
- The IRS stated that the trust should be allowed an income tax deduction for its share of the contribution made by the partnership, even though the trust instrument did not expressly authorize the trustee to make charitable contributions.

Portfolio Expenses Incurred through a Partnership: The 2% Limitation—May Guidance Be Forthcoming

- An investment partnership will have separately stated deductions as portfolio expenses.
- Due to a split among the circuit courts, there is some uncertainty as to whether a trust may fully deduct fees paid for investment advice or whether such fees are miscellaneous itemized deductions subject to the floor of 2% of adjusted gross income.
- In *O'Neill*, the Sixth Circuit held that the investment advisory fees were deductible above the line.
- The court reasoned that a trustee—unlike an individual investor—is responsible for meeting a “prudent investor” standard in managing trust assets.
- The court decided that the costs qualify for the exception under Code Sec. 67(e).

Portfolio Expenses Incurred through a Partnership: The 2% Limitation—May Guidance Be Forthcoming

- In *Mellon Bank*, the court said that trust administration costs aren't excluded from the 2%-of-AGI floor, if an individual investor would reasonably be expected to incur the same costs, even if the trustee incurred the costs to meet its legal obligation to exercise proper skill and care.
- In *Rudkin,* the Tax Court found that because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the taxpayer could not show that they "would not have been incurred if the assets were not held in trust."
- The American Bankers Association and the New York Bankers Association have urged the court to reverse the Tax Court and allow trusts to deduct investment advisory fees in full because trustees have a duty to protect trust assets.

Portfolio Expenses Incurred through a Partnership: The 2% Limitation—May Guidance Be Forthcoming

- The UPIA "prudent investor" standards do not apply to individual investors and as recognized by the Sixth Circuit in *O'Neill,* unlike a trustee, individual investors face "no penalties or potential liability if they act negligently for themselves."
- In light of the adoption of the UPIA across most of the United States, the American Bankers Association and New York Bankers Association urge the Court to recognize that the rules governing the investment of trust assets differ from those governing an individual's investments.
- Note IRS and Treasury release 2006-2007 Priority Guidance Plan to address this issue.

Portfolio Expenses Incurred through a Partnership: The 2% Limitation—May Guidance Be Forthcoming

- It is not uncommon in the partnership agreement of both hedge funds and private equity partnerships to allocate a 'promote" or percentage of partnership income to the managing or general partner as a way to obtain the benefit of the managing or general partner's investment expertise without having a separately stated fee.
- The trustee may consider investing in partnerships with these provisions to avoid the 2% limitation described above.

Debt Financed Distributions

- A partnership that borrows money must trace the use of its debt proceeds to determine the nature of the related interest expense deduction.
- If the debt proceeds are traced to distributions to partners, the partners must then trace the use of their distribution proceeds to determine the deductibility of the interest expense passed through from the partnership.

Debt Financed Distributions

- Example : The Trump Real Estate FLP borrows money to make a distribution to its partners. A partner, the ABC Trust, receives a distribution from these debt proceeds of $100,000. Under the general rule, the proceeds distributed to any partner and the associated interest must be allocated in accordance with that owner's use of the proceeds. For example, assume the ABC Trust uses the proceeds to purchase marketable securities; the interest expense on the distribution indebtedness is allocated to investment interest expense by the trust.

Passive Foreign Investments (PFIC)

- Alternative investments will often result in PFIC's.
- There are three separate taxation regimes under the PFIC provisions.
- First excess distribution is defined by reference to prior-year distributions, and may include all or some of any actual distribution from the PFIC.
- The purpose of this regime is to approximate the tax that would have been imposed if the income had been distributed currently.
- Imposes an interest charge on "excess distributions" from PFICs.

Passive Foreign Investments (PFIC)

- Second Qualified Electing Fund which is elective.
- Need to obtain certain information from the PFIC.
- Under the QEF election, the U.S. investor is treated as receiving an annual distribution of his or her pro rata share of the PFIC's earnings and profits, classified into either ordinary income or capital gains, depending upon the underlying income of the PFIC.
- May defer taxation, but if this method is selected, the deferral tax is subject to an interest charge.

Passive Foreign Investments (PFIC)

- Third mark-to-market--This is an election by the investor to treat his stock in the PFIC as if it were sold at the end of each year.
- Required to file Form 8621, Return by Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund.
- PFIC's create much complexity and unanswered questions to the trustee.
- If the trustee is not ready to face these challenges it may be advisable to avoid investments that knowingly contain PFIC's.

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- When a trust invests in a partnership, should the material participation rules be applied based on the actions of the trustee or the beneficiary?
- Neither the Code nor the regulations provide any clear guidance.
- The Senate Finance Committee and the AICPA suggested that the trustee's participation should determine whether the passive activity rules apply to a trust.
- Rental activities are generally deemed to be passive.
- However, a real estate professional can avoid this default rule when two tests are satisfied.

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- First, more than one-half of the personal services performed in trades or businesses by the taxpayer during the taxable year must be performed in real property trades or businesses in which the taxpayer materially participates.
- Second, the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.
- If this pair of standards is met, the real estate rental activity ceases to be passive per se.

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- Assume a trust owns a 30 percent interest in a real estate LLC. Assume there are two trustees. One is a corporate trustee and other is “The Donald” Donald Trump. In year one, the trust has $300,000 of dividends and interest and a $200,000 loss from the LLC. Is the loss from the LLC active or passive? For purposes of the passive loss rules, rental real estate activities are automatically treated as passive activities, even if the owner “materially participates” in their management, operations, etc. As a result, tax losses from rental realty can’t be deducted against non-passive income. However, what about the real estate professional exception? Do one and only one of the trustees have to qualify for the real estate professional qualification to make the loss active?

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- Assume "The Donald" has made an election to treat all of his real estate activities as a single activity. This election would include the rental real estate interests held through pass through entities, as a single rental real estate activity. Therefore, "The Donald" would clearly meet the real estate professional qualification. It would appear, following the Senate Finance Committee and the suggestions of the AICPA in determining material participation, potentially the loss should be an active loss to the trust due to the activities of one of the trustees.
- As a result, the loss would enter into the DNI calculation, directly offsetting dollar-for-dollar otherwise taxable interest and dividend income from the trust's portfolio investments.

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Passive Activity Losses: Will Trusts Ever Receive Guidance?

- Consequently, the DNI should be $100,000 (portfolio income of $300,000 less the $200,000 loss).
- Change the facts above slightly. There is one corporate trustee, Trust Company X.
- The beneficiary qualifies as a real estate professional.
- The beneficiary has made an election to treat all of his real estate activities as a single activity.
- Because it appears that material participation is measured at the trustee level, the loss would be a passive loss to the trust.
- The DNI of the trust would be $300,000. But how is the $200,000 to be treated in the trust?
- It would appear the passive loss should be suspended and trapped in the trust to be used against future passive income generated by the trust.

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- Even if the trust were terminated, these suspended losses are not available to the beneficiary, but must be added to the basis of the property distributed to the beneficiary.
- Dave & his son Mike both own an LLC interest in a family business. They are both active in the business. Dave is approaching retirement. Dave transfers his LLC to an irrevocable trust as part of his estate planning. There is a single corporate trustee who is not active in the family business. Other marketable securities are also transferred to the trust.
- Mike is the income beneficiary and his children are the remainder beneficiaries.

Passive Activity Losses: Will Trusts Ever Receive Guidance?

- In year one, the trust's share of the LLC's taxable income is $200,000. Following the Senate Finance Committee and the AICPA approach, the income would appear to be classified as passive to the trust because the trustee is not a material participant.
- The DNI of the trust would include the $200,000 and taxable to Mike as passive income.
- Assume Mike also has substantial suspended losses from other activities. If Dave had made an outright gift of the LLC interest to Mike, the income would be active.
- Has the family been able to convert what otherwise would have been active income into passive income by the use of the trust? Without guidance, this could be a very risky, but sometimes beneficial, strategy where the beneficiary is active in the business.

Statute of Limitations and Audit Considerations: Trust Considerations

- Code Secs. 6221 through 6232 give to a partnership's "tax matters partner" certain duties and responsibilities in connection with the tax proceedings that may directly affect the tax liability of the trust and the period of time during which it may be exposed to liability as a result of adjustments to partnership items.

Statute of Limitations and Audit Considerations: Trust Considerations

- The tax matters partner may (1) extend the statute of limitations for the partnership, (2) determine the forum for judicial review of adjustments proposed by the IRS after a partnership audit or after denial of a refund claim by the IRS, and (3) enter into a settlement agreement that binds certain partners who have not taken specific actions to be separately notified of audit and administrative developments.
- As a result of these rules, the fiduciary of a trust should consider whether the partnership agreement contains provisions that are adequate to protect its interest.

State Income Tax Issues to the Trust

- Most states follow federal tax law and treat a partnership as a nontaxable entity.
- The trust may be required to file in multiple states.
- Some states require the partnership to collect the income tax payable by a nonresident partner by deducting the same from that partner's share of distributions and remitting it to the state.
- Some states permit the filing of composite returns.

State Income Tax Issues to the Trust

- A composite return is a single filing on behalf of the nonresident partners.
- The partnership remits tax with the composite return, usually at the top individual tax rate, for the nonresident partners' shares of partnership income.
- How does the trust treat the payment of the state tax from the partnership.
- If it is treated as a distribution does the withholding apply as a state income tax deduction to the trust.

Questions?

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