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

By David R. Nave

David Nave examines the unique tax considerations to a trust investing in alternative investments through partnerships and provides guidance to trustees and advisors.

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.[1] Needless to say, this technique results in low returns in trusts. As a result, it has been stated, "How do you make a small fortune? Give a bank a large one to manage in trust."[2]

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. Thus, the new prudent-investor law abolishes all categorical restrictions on permissible types of investments.[3]

The prudent-investor rule is designed to accommodate modern portfolio theory.[4] Prominent among the principles of modern portfolio theory is the concept that the value or price of an asset is a function of two factors: the rate of total return (ordinary income and capital appreciation) that the asset is anticipated to generate and the risk that the actual return will fall short of the anticipated return.

An analysis of the risk that returns will fall short focuses upon assets as integral parts of a whole portfolio, rather than upon each asset in isolation. This focus enhances the importance of the rate of total return and leads to the conclusion that the determination of whether a trustee has discharged its duties must focus upon the manner in which the trustee has made investment decisions.[5] The analysis leads away from labeling any asset as inherently prudent or imprudent, *per se*. The behavior of the trustee is judged in relation to the circumstances of the situation.[6] Because the prudent-investor rule is a rule of trustee conduct rather than a rule of portfolio performance, it purports to diminish the importance of hindsight.[7]

The first step of the trustee, in conjunction with his or her 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.[8]

If the trust is large enough, many advisors recommend to the trustee that a portion of the assets include alternative investments. Examples of alternative investments include hedge funds, real estate, venture

David R. Nave is SVP & Tax Director with Pitcairn Financial Group

capital and private equity.[9] These investments are generally structured as limited partnerships or limited liability companies.

It would seem that there should be no reason, under a prudent-investor rule, why a trustee cannot invest trust funds in a limited partnership if the investment is otherwise prudent. If the liability of the trustee and the trust is limited, the reasonableness of the proposed investment of trust funds in a partnership enterprise may depend upon whether the partnership business is new or untried, whether the trustee can be in a position to periodically review the soundness of the trust's investment and whether the trust's interest in the partnership can be readily marketable or convertible into cash at a price that would not be sacrificial.[10]

Although the trustee has control over his or her limited partnership interest, by statute, he or she 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 has, in effect, delegated. Fiduciaries should likewise be permitted to retain or invest in an interest as a limited partner, even though management responsibilities are the exclusive province of the general partners.[11]

The ownership of a partnership interest by a trust often involves unique tax considerations. Historically, for this reason, fiduciaries traditionally have been reluctant to make investments in partnerships. However, in today's investment environment it would be imprudent not to consider alternative investments for a larger trust.

This article will examine "The Good, The Bad & The Ugly" of the unique tax considerations to a trust investing in these alternative investments through partnerships, and will provide guidance to its trustees and advisors.

Overview of Subchapter J

In some cases, Subchapter J treats an estate or trust as a separate taxpaying entity. In other cases, it treats an estate or trust as a conduit that passes through its income and its deductions to the beneficiaries. In still other cases, Subchapter J treats an estate or trust as both entity and conduit—it will be an entity in one year and a conduit in a later year, where the previously taxed income passes through to the beneficiary.[12]

The basic tax structure follows that of an individual. There is only one level of tax. Once the trust determines its income, a tax is imposed on either the trust (entity) or the ultimate beneficiary. Subchapter J attempts to allocate the burden of tax between the entity and the beneficiary.

A trust for income tax purposes may be classified as "simple" or "complex." A trust is considered simple if (1) under the terms of the trust agreement all income is required to be distributed currently, (2) the trust makes no charitable contributions for the taxable year that are deductible under Code Sec. 642(c) and (3) no corpus is distributed in the current year.[13] The first test must be met for every year that the trust may be in existence, while the second and third tests must be met only for the current year. Any trust that is not a simple trust is considered a complex trust for that year.

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. Generally, DNI is the trust's taxable income with certain modifications. DNI is used to allocate income between a trust and its beneficiaries, and then to characterize that income. The general rule is that capital gains do not enter into the computation of DNI. The simple reason is that capital gains are usually principal, not income.

The second computation is the fiduciary accounting income (FAI). This is not a tax concept, but is determined by looking to local law. FAI is the amount that the trustee has available to distribute to the income beneficiaries, as directed by the terms of the trust agreement or other governing document. 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*.[14]

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. However, if the amount of income required to be distributed currently exceeds the DNI of the trust for the tax year, the deduction is limited to the amount of the DNI. In other words, the deduction and the amount to be included in income by the beneficiary is the lesser of FAI[15] or DNI.

There is a general lack of clarity to the proper treatment of a partnership investment held by a fiduciary. Generally, current principal and income acts are inadequate in defining what is income or principal from a partnership interest, and trust instruments frequently fail to address this matter.[16] This creates issues in determining FAI and DNI within the trust. There are inherent conflicts between Subchapters 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. Schedule K-1 is used to report a partner's distributive share of partnership items to the partner and to the IRS. The items reported on the K-1 are used to compute the taxable income and DNI of the trust. Capital gains that flow through from the partnership are generally allocated to principal.

Under the Revised Uniform Principal and Income Act of 1997, FAI from partnerships is *based on distributions of cash,* not the entity's book income (as determined under generally accepted accounting principles) or taxable income.[17]

Example 1. A trust invests in an investment partnership. In 2005, the partnership K-1 issued to the trust reflects tax on $30,000 of dividends and interest. The partnership makes no distributions of cash or other property. Under the revised UPIA, the trust has no FAI generated by its partnership interest because 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 FAI 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.

To continue the example, assume in 2006, the partnership K-1 reflects $10,000 of dividends and interest. The partnership makes a distribution of $40,000 in cash in 2006. Because FAI trust accounting income is based on distributions of cash from the partnership, it would have $40,000 of FAI. The trust document requires the distribution of FAI. 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 FAI or DNI. Thus, the beneficiary would receive cash of $40,000, but would only have taxable income of $10,000. However, the trust paid tax on the $30,000 of income in 2005.

A trustee has a duty to exercise impartiality to the beneficiaries.[18] Moreover, a trustee may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries, which arise from the ownership by the trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the trust or a beneficiary.[19] Therefore, it would appear that an adjustment should be made to reimburse trust principal for the tax that was paid in 2005 from principal.[20] Assuming the tax was $9,000 in 2005 (30% x $30,000), it would be appropriate for the trustee to make an adjustment of $9,000 between principal and income. Consequently, only $31,000 should be distributed to the income beneficiary in 2006.

All Cash Distributions are FAI, Right?–Not So Fast

Not all cash received by a trust from a partnership under the Revised Uniform Principal and Income Act of 1997 is allocated to income. The revised act 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.[21] 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 reflected on the entity's year-end financial statements immediately preceding the initial receipt.[22] A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors, or other person, or group of persons, authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.[23]

Example 2. A trust created under the will of Francis Nave owns a 30-percent interest in the ABC investment partnership. Audited financial statements of the ABC investment partnership indicate $6 million of gross assets at December 31, 2005. During 2005, $1.5 million was distributed to the Nave trust. Because the distribution of $1.5 million exceeds 20 percent of the partnership's gross assets, it would represent fiduciary accounting principal, not income.[24]

Example 3. The Nave trust owns a 30-percent interest in the Trump Real Estate partnership. The Trump partnership owns multiple properties. In 2006, it sells one of these properties for $2 million, pays off the outstanding mortgage of $500,000 and distributes the net cash proceeds of $1.5 million to its partners. Trump's financial statements for the year ended December 31, 2005, reflected gross assets of $10 million and mortgage liabilities of $3 million. The $450,000 (30 percent of $1.5 million) received by Nave trust is considered to be income for fiduciary accounting purposes because Trump's total distribution of $1.5 million is less than 20 percent of its *gross* assets of $10 million.[25]

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, or whose other assets are illiquid and provide little, if any, cash or income receipt potential. However, as previously discussed, these distributions may be included in FAI and, consequently, require distribution to the income beneficiary. Under these facts, the trust could be faced with a tax liability, without the cash to make the payment.

Example 4. The Nave Family Trust's 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.[26] 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-percent 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 percent of $124,000), but has no cash left to discharge its 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. ..."[27] Net income means[28] "... the total receipts allocated to income during the accounting period minus the disbursements made from income during the period (plus or minus transfers under the UPIA to or from income during the period) of receipt and tax payment." Thus, the entire $76,000 represents "tax required to be paid" by the fiduciary. The gross receipts should be reduced by the applicable tax at the trust level. Therefore, it would appear that the FAI should be zero. (That is, the $76,000 receipt, less the applicable taxes).

Under these facts, the trustee would be prudent not to distribute anything to the income beneficiary. The trustee should request written confirmation from the general partner that the distribution represents a tax distribution. Moreover, it would be appropriate for the trust document to state clearly that tax distributions received from the partnership are to be classified as principal, and not part of FAI.

Using the Power to Adjust to Level the Playing Field

Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them.[29] This rule applies whether the beneficiaries' interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion, except to prevent the trustee from abusing it.

The trustee has a duty to treat income and remainder beneficiaries fairly. In this regard, a trustee may adjust between principal and income to the extent the trustee considers necessary, if the trustee invests and manages trust assets as a prudent investor. The terms of the trust describe the amount that may, or must be distributed to a beneficiary, and that it is necessary to achieve impartiality.[30]

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

Refer back to the prior Example 3, where the Nave Trust received a distribution that was less than 20 percent of the gross assets of the Trump Real Estate partnership on the sale of one of its properties. Again, if the trustee has the power to adjust, he or she should exercise this power and treat the distribution as principal. If the trust had owned the property directly, the sale would have been treated as principal. The same result should apply to the passthrough entity.

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. 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.[31]

There is a recent Tax Court case that may give the trustee some flexibility as to whether capital gains that pass through from a partnership are includible in DNI. In *D.W. Crisp*,[32] the trustee of a trust was authorized to distribute income to the beneficiary, Caroline, during her lifetime and to her heirs for 21 years after her death. 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. The court held that the partnership gains were properly allocated to FAI and includable in DNI. According to the court, Reg. §1.643(a)-3(a)(1) refers to gains "[a]llocated to income under the terms of the governing instrument or local law by the fiduciary on its books…." The phrase "n[illegible] fits" may be prop[illegible] construed as inclu[illegible] pital gains, net of c[illegible] losses. While the [illegible] ship interest itself [illegible] ous, the profits distributed by it were "net profits" that the trustees could distribute and deduct. Because the trustees were authorized by the governing instrument and applicable state law to distribute capital gains, and because they did distribute those gains, the gains were included in DNI, increasing the trust's distributions deduction.[33]

There may be times that the trustee would prefer to have the capital gains from the partnership included in DNI. While the UPIA appears to make this difficult, the *Crisp* case provides guidance on how a trust document and/or state law can be used to achieve this result. This is particularly useful when the trustee has adopted a total return approach to investing. The *Crisp* case reiterates that the language of the trust document will "trump" the UPIA for tax purposes.[34]

Separately Stated Partnership Items

Charitable Contributions

Charitable contributions made by a partnership are normally allocated to partners based on their interests in the partnership. The issue is whether these passthrough contributions are deductible by the trust. Despite the fact that the governing instrument of a trust may not specifically mention the possibility of charitable contributions, it seems entirely proper to allow a deduction for a trust's share of the partnership's contributions.

In *Lowenstein Est.,*[35] 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. They were deducted on the partnership's return as an ordinary business expense and were allowed to the other two partners. It is not certain whether the deduction to the other two partners was treated as an ordinary and necessary business expense or as a charitable contribution. However, the court ruled that, in any event, the entire amount of the charitable contribution allocated to the estate from the partnership should be allowed as a deduction in computing DNI.

However, passthrough charitable contributions may cause procedural complexities for the fiduciary. The trustee of a complex trust[36] that makes a charitable contribution deductible under Code Sec. 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. Unlike the fundamental trust income tax return, however, Form 1041-A is available to the general public. A trustee who is deemed to have made a contribution actually made by a partnership in which it holds an interest should also be required to file Form 1041-A, even if the trust provisions otherwise stress the need for confidentiality. Failure to file this return could make the trustee liable for penalties under Code Sec. 6642(a).[37]

In Rev. Rul. 2004-5, a trust directed the trustee to pay all income to A, an individual, during A's life, and upon A's death, to distribute the remaining trust assets to B, another individual.[38] The trustee was not authorized to accumulate income, and no charitable contributions were authorized by the trust instrument. The trust owned an interest in a partnership. The partnership, in the tax year in question, made a cash contribution from gross income to a charitable organization. The trust had no unrelated business taxable income during that year under Code Sec. 681(a) (which reduces a trust's income tax deduction for charitable contributions, to the extent of trust unrelated business taxable income). The trust was to take into account its distributive share of the partnership's income, gain, loss, deductions and credits under the general rules of partnership income taxation.[39]

The IRS ruled that the trustee could deduct a proportionate share of the charitable contribution made by the partnership. The IRS noted that Code Sec. 642(c)(1) allows a complex trust to deduct any charitable contribution of income made pursuant to the terms of the governing instrument. The partnership income tax rules, furthermore, require each partner to take into account separately the partner's distributive share of the partnership's charitable contributions.[40] The character of each item of income, deduction, gain, loss and credit, including charitable contributions, in the hands of the partner, is determined as if the item was realized directly by the partner, in the same manner that it was realized by the partnership.[41]

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. The IRS relied on three cases that reached a similar conclusion under the predecessor of Code Sec. 642(c).[42]

Portfolio Expenses Incurred Through a Partnership— The Two-Percent Limitation

It is common in investment partnerships for the K-1 to state separately certain expenses as "portfolio expenses." For individual partners, this will result in such amounts being subject to the two-percent nondeductible base. However, does this two-percent limitation apply to trusts?

It is generally acknowledged that administrative and advisory fees are appropriate deductions for purposes of the fiduciary income tax. However, 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 two percent of adjusted gross income.[43]

Code Sec. 67(e) generally provides that "miscellaneous itemized deductions for any taxable year" are deducted only to the extent "that the aggregate of such deductions exceeds 2 percent of adjusted gross income" of the estate. However, the statutory text of Code Sec. 67(e) also creates an exception allowing for deduction of trust expenditures without regard to the two-percent floor, where two requirements are satisfied: (1) the costs are paid or incurred in connection with administration of the trust and (2) the costs would not have been incurred if the property were not held in trust.[44] Otherwise, deductibility is limited to the same extent as it would be for individual taxpayers.

In *O'Neill, Jr. Est.*,[45] the Sixth Circuit held that the investment advisory fees were deductible above-the-line (*i.e.*, not subject to the two-percent floor). The court acknowledged that the exception applies only to expenses that are unique to the administration of a trust. The court then reasoned that a trustee—unlike an individual investor—is responsible for meeting a "prudent investor" standard in managing trust assets. Although individual investors routinely pay for investment advice, they are not required to consult advisors in order to avoid potential liability for negligence. Thus, the Sixth Circuit concluded that trustees, as fiduciaries, occupy a unique position on account of which the fees are incurred. The court indicated that the trustees lacked experience in investment matters, and thus, sought the assistance of an investment advisor. Without the investment advice, the trustees would have put the assets of the trust at risk.

In *Mellon Bank,*[46] the Court of Federal Claims disagreed with the Sixth Circuit in *O'Neill*. It said that trust administration costs aren't excluded from the two-percent-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. Thus, investment advisory fees are subject to the two-percent-of-AGI floor if the fees would have been incurred in the absence of a trust. Similarly, fees for accounting, tax preparation and management services are subject to the two-percent-of-AGI floor if the services are of a type that would have been provided in a nontrust situation.[47]

In *W.L. Rudkin Trust,*[48] 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." However, in an *amicus* brief for the Second Circuit, 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.[49] The American Bankers Association and the New York Bankers Association in their brief contends that the proper standard for determining whether such fees are to be accorded an "above-the-line" deduction under the statute is not whether investment advisory fees in question are commonly incurred by individual investors, but rather whether the fees were incurred because the prudent execution of the duties imposed upon a trustee rendered it necessary to obtain investment advisory services.[50] While both trustees and individual investors often rely upon professional investment advice, a trustee has an affirmative duty to handle the investment of trust assets in a prudent fashion—a duty that is not imposed upon individual investors—and the fulfillment of that duty may require the retention of expert investment help. The brief reaches the opinion that the Court should conclude that because this duty arises out of the trust relationship, and because a prudent trustee is required to incur such expenses in fulfilling that duty, investment advisory fees are fully deductible because the cost "would not have been incurred if the property were not held in trust."[51]

The brief goes on to argue:

> The fact that individual investors may also incur costs associated with seeking investment advice is irrelevant to the analysis, and it should not guide the Court's decision. Unlike a trustee, individuals investing on their own behalf are not subject to any of the duties to which trustees are subjected. While an individual may engage an investment advisor or manager, he or she will be doing so to enhance their personal net worth, not to avoid a surcharge for mishandling fiduciary assets. Moreover, such an individual can choose to establish the parameters she wishes to guide the investment advisor and measure its performance. Simply put, an individual investor's investment or asset management choices are not subject to any standards but his or her own.[52]

The UPIA "prudent investor" standards do not apply to individual investors and, as recognized by the Sixth Circuit in *O'Neill,*[53] 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.[54]

Therefore, it is quite possible to argue, consistent with the *O'Neil*[55] decision and the arguments set forth by the American Bankers Association and the New York Bankers Association, discussed above, that a trust appropriately should treat these amounts as "above-the-line" deductions on Form 1041, not subject to the two-percent limitation. It would appear that this argument has even greater validity when passed through from a partnership.

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.[56] The trustee may consider investing in partnerships with these provisions to avoid the two-percent limitation described above.

Debt-Financed Distributions and the Issues Relative to Interest Deductions

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. If, for example, a partner uses money received in a debt-financed distribution for personal expenditures, that partner's share of the partnership's interest expense on the debt is nondeductible personal interest under Code Sec. 163(h)(l). Thus, partnerships must separately report the amount of debt-financed distributions to each partner, and must also report the partner's share of interest expense related to the distributions.[57]

A special rule allows partnerships to avoid the special reporting of debt-financed distributions by treating the debt proceeds traced to distributions as being used to make other expenditures of the partnership during the same tax year, to the extent that the other expenditures do not already have debt allocated to them.[58] Note that the term "expenditures" includes not only deductible expenses, but also capital expenditures and all other cash outflows of the partnership during the tax year of the distribution. The effect of this special rule is to treat debt-financed distributions as being financed instead by partnership working capital, and to treat other expenditures as being financed by the debt. There is no formal election statement required of partnerships using the special rule. Presumably, the special rule is elected when the partnership fails to separately report interest expense traced to debt-financed distributions (if there are enough other expenditures of the partnership).

If the partnership does not use the special rule, all interest expense relating to debt-financed distributions should be separately reported to partners on line 13 of Schedule K-l (other deductions), and an explanatory statement should accompany Schedule K-1.

Example 5. The Trump Real Estate partnership 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.

Query: Assume the trustees of the ABC Trust have discretion to make distributions to the beneficiary, and they exercise this discretion and distribute the distribution from the Trump Real Estate Partnership to its income beneficiary. Because the trust is not a pure conduit, should the interest be a nondeductible personal expense by the trust? Or, because the trust is a hybrid entity/conduit does the interest expense associated with this distribution also pass through, and is it necessary to examine the use of the distribution by the beneficiary for deductibility purposes?

Passive Activity Losses–Will Trusts Ever Receive Guidance?

Code Sec. 469 contains a complex set of rules designed to limit the use of losses and credits from passive investments to offset compensation, active business income and portfolio investment income. Congress may have been concerned that individuals would evade these rules by having trusts hold their interests in a passive activity, but the extension of these rules to trusts and estates creates several important problems through the interaction of Code Sec. 469 and the ordinary rules of Subchapter J.

The term "passive activity" means any activity that involves the conduct of any trade or business, and in which, the taxpayer does not materially participate.[59] In addition, any rental activity is deemed to be passive, unless the taxpayer qualifies as a real estate professional.[60]

A taxpayer materially participates in an activity if the taxpayer is involved in its operations on a regular, continuous and substantial basis.[61] There are seven tests for determining "material participation" in connection with nonrental activities.[62] Most of these tests examine the amount of time a taxpayer devotes to the activity.

Rental activities are generally deemed to be passive. However, a real estate professional can avoid this default rule when two tests are satisfied. First, more than one-half of the personal services performed in trades or businesses by the taxpayer during the tax 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 tax 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*.[63]

Who Materially Participates in a Trust

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 suggested that the trustee's participation should determine whether the passive activity rules apply to a trust.[64] However, a footnote in the 1986 TRA Blue Book[65] casts doubt on the Senate Finance Committee statement by declaring that it is unlikely that a trust treated as such for federal income tax purposes will be materially participating in a trade or business activity. The Joint Committee's rationale for this position is that, if a trust materially participates in a trade or business, it may be treated as an association taxable as a corporation. The AICPA has suggested that material participation should be measured by the activities of the trustee (viewed as though the trustee were an individual), not the beneficiary.[66] Moreover, they recommend that when there are multiple trustees, material participation by one should be sufficient to establish an "active" activity; it should not be necessary for all, or a majority of the trustees to be material participants. It would appear that if we ever get guidance, it will most likely follow the Senate Finance Committee statement and the AICPA recommendation.

Example 6. 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 nonpassive income. However, what about the real estate professional exception described above? Do one, and only one, of the trustees have to qualify for the real estate professional qualification to make the loss active?

Assume "The Donald" has made an election to treat all of his real estate activities as a single activity.[67] This election would include the rental real estate interests held through passthrough 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. Consequently, the DNI should be $100,000 (portfolio income of $300,000, less the $200,000 loss).

Example 7. Change the facts of Example 6, above, slightly. There is one corporate trustee, Trust Company X. However, the beneficiary qualifies as a real estate professional. Moreover, 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. Moreover, even if the trust were terminated, these suspended losses are not available to the beneficiary,[68] but must be added to the basis of the property distributed to the beneficiary.[69]

Example 8. Dave and 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. 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?[70] Without guidance, this could be a very risky, but sometimes beneficial, strategy where the beneficiary is active in the business.[71]

Although an extensive discussion of the passive loss rules is beyond the scope of this article, the trustee must be very alert to the potential consequences of Code Sec. 469 and the related sections thereof.[72] The uncertainty due to the lack of regulations and case law provides a real challenge to the trustee.

Statute of Limitations and Audit Considerations–Trust Considerations

Under the provisions of Code Secs. 6221 through 6232, all partnerships,[73] except certain partnerships with 10 or fewer partners, are subject to audit, administrative and judicial handling of partnership items at the partnership level that could result in all partners being bound.[74] Unless a partner treats a partnership item inconsistently with its treatment on the partnership return, there can be no adjustment of the partnership item on the partner's return, except in conformity with these provisions.

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 [illegible] trust and the peri[illegible] time during which [illegible] be exposed to li[illegible] as a result of adju[illegible] s to partnership i[illegible] Specifically, 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. These provisions should include special notice, consultation and consent provisions with respect to the actions of the tax matters partner and his communication with the IRS, and with respect to the various acts noted above, authorized to be taken by the tax matters partner. The partnership agreement should also include provisions concerning the appointment of counsel to be employed by the tax matters partner and the remedies available to the partnership and other partners if the tax matters partner breaches any of these special provisions.[75]

State Income Tax Issues to the Trust

The fiduciary should also take into account the implications under state tax laws of retaining or purchasing a partnership interest. Most states follow federal tax law, and treat a partnership as a nontaxable entity.[76] Nevertheless, to ensure the collection of taxes from nonresident partners for partnership activities having a taxable situs in the state, 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. Under such a statute, the failure of the partnership to collect the tax may subject the partnership to liability for the tax and may cause the partnership to become involved in garnishment proceedings.[77]

In order to lessen the filing burden that could otherwise be imposed upon nonresident individual partners, some states permit the filing of composite returns. 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. In addition to reducing the filing burden, the composite return has the potential advantage of creating a partnership-level tax that may be deductible (as a business expense) in other states. The same tax paid by individual partners may be nondeductible in other states, or even nondeductible for federal purposes (if the partner does not itemize deductions). In order to deduct the tax at the partnership level, the payment must be treated as an expense, instead of as a distribution to the partners on whose behalf the tax was paid. If, instead, a partnership pays tax on a partner's behalf with a composite return and treats the payment as a distribution, the partners should be able to claim any credit allowed in their state of residence for taxes paid to another state.

For these reasons, the fiduciary should seek assurances from the general partners that proper procedures are being followed to preclude liability of the partnership for the payment of tax on income distributed to nonresident partners.[78]

Conclusion

As trusts trend mo[illegible]folio theory of investin[illegible]ule, the trustee will b[illegible]tive investments. The s[illegible]generally partnership[illegible]sues under Subchapter [illegible] the trustee understand the good, the bad and [illegible]y of investing in partnerships.

Endnotes

1 For an excellent discussion of the Prudent Investor Rule *see*, Max M. Schanzenbach and Robert H. Sitkoff,, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?* NYU, Law and Economics Research Paper No. 05-30 at pages 1-2 (December 5, 2005).

2 Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. Rev. 1303, 1335 (2003).

3 *See supra* note 1 at page 2.

4 *See generally* Restatement (Third) of Trusts §227 cmts. e-h (1992) (introducing modern portfolio theory and other investment concepts); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule 7 (1986) (providing an overview of modern portfolio theory for a fiduciary subject to the prudent man rule); Jonathan R. Macey, An Introduction to Modern Financial Theory (2d ed. 1998) (studying the elements of modern finance theory); Burton Gordon Malkiel, A Random Walk Down Wall Street (6th ed. 1996) (defining modern portfolio theory and the related risks).

5 *See* Restatement (Third) of Trusts §227 cmt. b (1992).

6 *See id.*

7 *See id.*

8 For an excellent discussion of trust investing *see* Joel C. Dobris, *Speculations on the Idea of "Speculation" in Trust Investing: An Essay*, 39 Real Property, Probate and Trust J., pages 440-508.

9 It would not be uncommon for a larger trust to allocate 10-20 percent of its assets to alternative investments.

10 *See* G Bogert, Trusts and Estates, §679 (discussing fiduciary's right to invest in limited partnership).

11 *See* A. Scott, The Law of Trusts, §227.9A (majority of states by statute permit fiduciaries to invest in stocks of management-type investment companies).

12 *See* Acker, 852-2nd T.M., Income Taxation of Trusts and Estates, at A-5.

13 Code Sec. 651(a); Reg. §1.651(a)-4.

14 *See* Byrle M. Abbin, Income Taxation of Fiduciaries and Beneficiaries, §203.1 at 2-5, Aspen Publishers.

15 Note that because FAI is not a tax concept, restrictions such as passive activity losses, at risk limitations and the 2 percent miscellaneous deduction floor do not apply in the computation of FAI.

16 *See supra* note 14, §203.1 at 2-8.

17 Revised UPIA §401(b).

18 Revised UPIA § 103(b).

19 Revised UPIA § 506(a)(3).

20 *See generally Warms Est.*, 140 NYS2d 169 (Surr. Ct. N.Y. Co. 1955).

21 Revised UPIA § 401(c)(2) and (c)(3).

22 Revised UPIA § 401(d)(2).

23 Revised UPIA § 401(f).

24 Revised UPIA § 401(d)(2).

25 *Id.* Note that UPIA §401(d)(2) is based on gross assets, not net assets.

26 Assumes a federal rate of 35 percent and state rate of three percent.

27 UPIA §505(c)(1).

28 UPIA §102(8).

29 Restatement (Third) of Trusts: Prudent Investor Rule §183 (1992).

30 *Id.* at §104(a).

31 *Id.* at §401(b)(4).

32 *D.W. Crisp*, 95-2 ustc ¶50,493, 34 FedCl 112..

33 For a more detailed discussion *see* Zaritsky

& LANE, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS, ¶3.03.

34 *See* ABBIN, *supra* note 14, §206.2.6 at 2-59 & 60.

35 *Lowenstein Est.,* 12 TC 694, Dec. 16,946 (1949).

36 Under the Code, a trust does not qualify as "simple," if it provides that any amounts are to be paid, set aside or used for charitable or similar purposes. Under the regulations, the mere provision for charity in the trust instrument has no such disqualifying effect. Disqualification results only from the allowance of the charitable deduction. For any tax year for which no such deduction is allowed—for instance, because in that year there was no addition to the corpus ultimately designated for charity—the trust, which is required to distribute all its income currently and makes no corpus distribution still is a simple trust, despite the trust terms providing for a gift to charity.

37 *See* discussion in Banoff and Eisenberg, *Charitable Gifts Cause Problems for Trust-Partners*, 79 J. TAX'N 127 (Aug. 1993).

38 Rev. Rul. 2004-5, 2004-3 IRB 295 (Jan. 20, 2004).

39 For a discussion of the ruling see Lawrence I Richman, *Two Recent Rulings Highlight the Different Treatment of Charitable Contributions under Subchapters J and K*, J. PASSTHROUGH ENTITIES, July-Aug. 2004, at 5.

40 Code Sec. 704(a); Reg. §1.702-1(a)(4).

41 Reg. §1.702-1(b).

42 *See Bluestein Est.*, 15 TC 770, Dec. 17,969 (1950),; *Lowenstein Est.*, 12 TC 694, Dec. 16,946 (1949), *aff'd sub nom, First Nat'l Bank of Mobile,* 50-2 USTC ¶9372, 183 F2d 172.

43 *See* Carol A. Kelley, *Trust Investment Fees and Application of the 2% Floor*, TAX MANAGEMENT MEMORANDUM, December 29, 2003, Volume 44, No. 26.

44 Code Sec. 67(e)(1).

45 *O'Neill, Jr. Est., CA-6,* 93-1 USTC ¶50,332, 994 F2d 302.

46 *Mellon Bank, N.A.*, 2000-2 USTC ¶50,642, 47 FedCl 86.

47 Courts reached similar conclusions in *J.H. Scott,* CA-4, 2003-1 USTC ¶50,428, 328 F3d 132 and *W. L. Rudkin Trust,* 124 TC 304, Dec. 56,073 (2005).

48 *Rudkin, id.*.

49 *See Bankers Urge Second Circuit to Allow Investment Advisory Fee Deduction*, 2006 TNT 5-14, Jan. 6, 2006.

50 *See* Brief of the American Bankers Association and New York Bankers Association, 05-5151-AG. at p.3.

51 *Id.* at p. 4.

52 *Id.,* at 11.

53 *O'Neill*, 994 F.2d at 304.

54 The *Rudkin* decision is currently under appeal to the Second Circuit Court of Appeals, *W.L. Rudkin Trust*; No. 05-5151-ag.

55 O'Neill, 98 T.C. 226 (1992).

56 *See* Lawrence I Richman, "*Investment Advisory Fees Paid by Trusts*," J. PASSTHROUGH ENTITIES, Nov.–Dec. 2005, at 66.

57 *See* JENNINGS AND BOLAR, PARTNERSHIP FEDERAL AND STATE INCOME TAX REPORTING, pages 15-24 & 15-25, JB Publications, 1997.

58 IRS Notice 89-35, 1989-1 CB 675, §V.

59 Code Sec. 469(c)(1).

60 Code Sec. 469(c)(2).

61 Code Sec. 469(h)(1).

62 Temp. Reg. §1.469-5T.

63 Code Sec. 469(c)(7)(B).

64 S. REP. NO. 99-313, 99TH CONG., 2ND SESS. 735 (1986) ("An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.").

65 [illegible] ommittee on Taxation, 99TH [illegible], GENERAL EXPLANATION OF THE [illegible] OF 1986, p. 242.

66 The AICPA approach is to make all relevant determinations for *Code Sec. 469* purposes at the fiduciary level. For a complete discussion of the AICPA recommendations *see* ABBIN, *supra* note 14, §708-4 at 7-31 to 7-32.

67 Absent this election, he must satisfy the more-than-50-percent test and the 750-hours test for each property separately in order to qualify as a real estate professional—and qualifying for one property wouldn't mean he would qualify for any other property. Thus, if he doesn't make the election, qualifying as a real estate professional becomes more difficult and most likely impossible in his case. But by making the election, he only has to establish material participation, and satisfy the more-than-50-percent test and the 750-hours test, for the combined properties as a whole, which would not be a problem for him.

68 Code Sec. 642(h).

69 Code Sec. 469(j)(12).

70 This analysis ignores any potential gift tax considerations on the transfer to the trust.

71 See *M.K. Carter Trust,* DC Tex., 2003-1 USTC ¶50,418, 256 FSupp2d 536., where, in a case of first impression, a district court has held that in determining whether a trust materially participated in a business for passive activity loss purposes, the participation of those who ran the business on its behalf should be considered, rather than just the participation of its trustee.

72 For in depth and excellent discussion of the passive loss rules as they relate to trust *see* ABBIN, *supra note* 14, §§701-719, at 7-1 to 7-64, Aspen Publishers, *see also* Leo L. Schmolka, *Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)*, TAX LAW REVIEW, Volume 58, Pages 191-274, 2005.

73 Code Sec. 6231(a)(1)(A) provides generally that a "partnership" for purposes of the audit, administrative, and judicial rules and procedures set forth in Code Secs. 6221 through 6232 is any partnership required to file a return under Code Sec. 6031(a).

74 Code Sec. 6231(a)(1)(B). Under this exception, all partners must be United States citizens, United States residents or estates. In addition, the partnership agreement cannot provide for special allocations.

75 *See* Baumann and McBryde, *Ownership of a Partnership Interest by an Estate or Trust: Tax and Other Considerations*, TAX LAWYER Vol. 38, No. 1 at pages 48, 49.

76 *See, e.g.,* Cal. Rev. & Tax Code . §17851 (partnership is nontaxable entity).

77 *See* Baumann and McBryde, *supra* note 73, at page 50.

78 *See* Bruce, Grissom, & Houser *State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, TAX NOTES, March 28, 2005.