Fiduciary Income Tax Refresher and Update
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Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications)

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Fiduciary Income Tax Refresher and Update

by Steven B. Gorin[*]

These materials are excerpted from, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," approximately 1,200 pages available in a fully searchable PDF.

The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete http://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must have a physical mailing address, even though delivery is electronic. You may also email for the PDF, which you can get with or without subscribing to the newsletter. Please also add ThompsonCoburnNews@tcinstitute.com to your "trusted" list so that your spam blocker will not block it. Send any inquiries to the author at sgorin@thompsoncoburn.com and not to ThompsonCoburnNews@tcinstitute.com, which is not the author's email address but rather is an address used to transmit newsletters.

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

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

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II.I.1. Taxpayers and Years Affected

For taxable years beginning after December 31, 2012,[1016] net investment income in excess of certain thresholds is subject to a 3.8% tax.[1017] The preamble to the final regulations explains:[1018]

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

II.I.2. Regulatory Framework

The preamble to the final regulations described the regulatory framework:[1019]

> On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the Federal Register (REG-130507-11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the Federal Register (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at www.regulations.gov[1020] or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.
>
> In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the Federal Register (REG-130843-13) relating to the Net Investment Income Tax.

The preamble to the final regulations explained taxpayer reliance on proposed and final regulations:[1021]

> These regulations are effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.
>
> Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for

[1016] P.L. 111-152, section 1402(b)(3).
[1017] Code § 1411(a).
[1018] T.D. 9644.
[1019] T.D. 9644.
[1020] A more direct link is http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;dct=PS;D=IRS-2012-0049.
[1021] T.D. 9644.

the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.

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

Effective/Applicability Date

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

The final regulations were issued with additional proposed regulations, the preamble to which explained the regulatory background:[1022]

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

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

[1022] REG-130843-13.

PFICs in § 1.1411-10 with the section 664 category and class system adopted in § 1.1411-3(d)(2) of the 2013 Final Regulations.

> Furthermore, these proposed regulations allow CRTs to elect to apply the section 664 system adopted in the 2013 Final Regulations or the simplified method set forth in the 2012 Proposed Regulations. Some comments responding to the 2012 Proposed Regulations requested that we provide an election. The Treasury Department and the IRS request comments with regard to whether or not taxpayers believe this election is preferable to the section 664 system adopted in the 2013 Final Regulations. If it appears that there is no significant interest in having the election, the Treasury Department and the IRS may omit it from the regulations when finalized, and the simplified method contained in the 2012 Proposed Regulations would no longer be an option.

> These proposed regulations also address the net investment income tax characterization of income and deductions attributable to common trust funds (CTFs), residual interests in real estate mortgage investment conduits (REMICs), and certain notional principal contracts.

> The Treasury Department and the IRS also received comments on the 2012 Proposed Regulations questioning the proposed regulation's methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. In view of these comments, the 2013 Final Regulations removed § 1.1411-7 of the 2012 Proposed Regulations and reserved § 1.1411-7 in the 2013 Final Regulations.

> This notice of proposed rulemaking proposes revised rules regarding the calculation of net gain from the disposition of a partnership interest or S corporation stock (each a "Passthrough Entity") to which section 1411(c)(4) may apply.

The preamble to the 2013 proposed regulations explained effective dates:[1023]

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

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

The preamble describes how to calculate the tax:[1024]

> In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under

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[1023] REG-130843-13.
[1024] T.D. 9644.

section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411-2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.

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

Thus, the threshold amount is not indexed for inflation for individuals but is for trusts.[1025]

Short taxable years use the full threshold,[1026] without proration,[1027] unless the short year results from a change in the annual accounting period.[1028]

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

The preamble describes how to calculate net investment income:[1029]

> Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411-4 and 1.1411-10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).

> Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is: (A) a passive activity

[1025] Compare Code §§ 1411(a)(1)(B)(ii) and 1411(b) (fixed dollar amounts for individuals) with Code § 1411(a)(2)(B)(ii) (referring to the annually indexed top bracket for trusts and estates).
[1026] Reg. § 1.1411-1(d)(1) sets forth the thresholds.
[1027] Reg. § 1.1411-1(d)(2).
[1028] Reg. § 1.1411-1(d)(3).
[1029] T.D. 9644.

(within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

Section 1.1411-5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).

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

In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

Section 1411(c)(5) provides that net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1.1411-8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).

Section 1411(c)(6) provides that net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1.1411-9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Regarding properly allocable deductions in excess of investment income, the preamble to the final regulations provides:[1030]

Proposed § 1.1411-4(f)(1)(ii) provided that any deductions described in § 1.1411-4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.

The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by

[1030] T.D. 9644.

subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

Regarding net operating losses (NOLs), the preamble to the final regulations provides:[1031]

> Proposed § 1.1411-4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a "net investment loss" for a loss year (for example, using a ratio of the portion of the loss attributable to "net investment loss" to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.
>
> The final regulations adopt a modified version of the commentator's approach in § 1.1411-4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the section 1411 NOL amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount

[1031] T.D. 9644.

of the NOL deduction for the taxable year that is properly allocable to net investment income.

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

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

Except as otherwise provided, all provisions that apply for Chapter 1 of the Code purposes in determining taxable income[1032] also apply in determining net investment income ("NII").[1033]

NII[1034] is the excess (if any) of:[1035]

1. The sum of:

    a. Gross income from interest,[1036] dividends,[1037] annuities,[1038] royalties,[1039] and rents,[1040] except to the extent excluded by the ordinary course of a trade or business exception;[1041]

[1032] As defined in Code § 63(a)

[1033] Reg. § 1.1411-1(a). However, Code § 1411 treatment does not affect treatment under any provision of the Code other than Code § 1411. Reg. § 1.1411-1(c). Also, credits generally allowable against income tax or other taxes are not creditable against the tax on NII. Reg. § 1.1411-1(e).
To add some levity to your day, note that approximately 30 years ago NII was suggested to be a very bad word. If you don't believe me, see https://www.youtube.com/watch?v=zIV4poUZAQo (short version) or https://www.youtube.com/watch?v=QTQfGd3G6dg (long version) from *Monty Python and the Holy Grail*.

[1034] Reg. § 1.1411-1(d)(8) provides:

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

[1035] Reg. § 1.1411-4(a).

[1036] Reg. § 1.1411-1(d)(6) provides:

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

[1037] Reg. § 1.1411-1(d)(3) provides:

> The term <u>gross income from dividends</u> includes any item treated as a dividend for purposes of chapter 1. See also § 1.1411-10 for additional amounts that constitute gross income from dividends. The term <u>gross income from dividends</u> includes, but is not limited to, amounts treated as dividends--
> (i) Pursuant to subchapter C that are included in gross income (including constructive dividends);
> (ii) Pursuant to section 1248(a), other than as provided in § 1.1411-10;
> (iii) Pursuant to § 1.367(b)-2(e)(2);
> (iv) Pursuant to section 1368(c)(2); and
> (v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

b. Other gross income derived from a passive trade or business;[1042] and

c. Net gain from the disposition of property,[1043] except to the extent attributable to property held in an active trade or business[1044] or otherwise provided,[1045]

[1038] Reg. § 1.1411-1(d)(1) provides:

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

[1039] Reg. § 1.1411-1(d)(11) provides:

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

[1040] Reg. § 1.1411-1(d)(10) provides:

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

[1041] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[1042] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[1043] Reg. § 1.1411-4(d)(1) provides:

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

Reg. § 1.1411-4(d)(2) provides:

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

Reg. § 1.1411-4(d)(3)(i) provides:

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

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2. Deductions allowable for income tax purposes that are properly allocable to such gross income or net gain.[1046]

The corollary to self-employment income being excluded from NII is that items excluded from SE income might constitute NII.[1047] Note also that wages are not among the type of income constituting NII.

II.I.6. Deductions Against NII

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

- Deductions allocable to gross income from rents and royalties included in NII.[1048]

- Deductions allocable to gross income from trades or businesses included in NII, to the extent the deductions have not been taken into account in determining self-employment income.[1049]

- Penalty on early withdrawal of savings.[1050]

[1044] See generally part II.I.8.b 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets and also part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[1045] Reg. § 1.1411-4(d)(4)(ii) provides:

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

[1046] Reg. § 1.1411-4(f). See part II.I.6 Deductions Against NII.

[1047] Reg. § 1.1411-9(a) provides:

> General rule. Except as provided in paragraph (b) of this section [income derived from a trade or business of trading in financial instruments or commodities], net investment income does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, taken into account means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)-(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus
>
> may be included in net investment income if such amounts are described in § 1.1411-4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see § 1.1402(a)-2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

[1048] Reg. § 1.1411-4(f)(2)(i).

[1049] Reg. § 1.1411-4(f)(2)(ii).

- Net operating loss arising from NII items.[1051]

The following itemized deductions also apply to NII:

- Investment interest expense.[1052]

- Investment expenses.[1053]

- State, local, and foreign income, war profits, and excess profit taxes that are allocable to net investment income.[1054]

- Deduction for unrecovered investment in an annuity in the decedent's final income tax return if the annuity was NII.[1055]

- Deductions for estate GST tax allocable to income in respect of a decedent that is NII.[1056]

- Deductions in connection with the determination, collection, or refund of any tax arising from NII.[1057]

[1050] Reg. § 1.1411-4(f)(2)(iii).
[1051] Reg. § 1.1411-4(f)(2)(iv), cross-referencing Reg. § 1.1411-4(h).
[1052] Reg. § 1.1411-4(f)(3)(i) , cross-referencing Code § 163(d)(3), which provides:

> *Investment interest*. For purposes of this subsection—
>
> (A) *In general*. The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.
>
> (B) *Exceptions*. The term "investment interest" shall not include—
>
> (i) any qualified residence interest (as defined in subsection (h)(3)), or
>
> (ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.
>
> (C) *Personal property used in short sale*. For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

Reg. § 1.163-8T provides interest tracing rules, which provide taxpayer with significant latitude to trace loan proceeds as they wish. Notice 88-74 provides guidance on various issues relating to the home mortgage interest deduction under Code § 163(h)(3).
[1053] Reg. § 1.1411-4(f)(3)(ii), cross-referencing Code § 163(d)(4)(C).
[1054] Reg. § 1.1411-4(f)(3)(iii), cross-referencing Code § 164(a)(3). For the effect of refunds of those taxes, see Reg. § 1.1411-4(g)(2).
[1055] Reg. § 1.1411-4(f)(3)(iv).
[1056] Reg. § 1.1411-4(f)(3)(v).
[1057] Reg. § 1.1411-4(f)(3)(vi) provides:

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

Reg. § 1.212-1(*l*) provides:

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

- Amortizable bond premium on a taxable bond.[1058]

- Fiduciary expenses.[1059]

Other deductions include:

- Loss deductions.[1060]

- Ordinary loss deductions for certain debt instruments.[1061]

- Other deductions not yet announced.[1062]

Generally, deductions limited for regular income tax purposes are also limited for NII purposes.[1063]

> any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

[1058] Reg. § 1.1411-4(f)(3)(vii).

[1059] Reg. § 1.1411-4(f)(3)(viii) provides:

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

Reg. § 1.212-1(i) provides:

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

Such fees include the trust's reimbursement of legal fees paid by the beneficiaries to change the trustee and improve the investment of the trust's assets. Letter Rulings 201642027, 201642028.

[1060] Reg. § 1.1411-4(f)(4)(i) provides:

> *General rule*. Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

[1061] Reg. § 1.1411-4(f)(5) provides:

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

[1062] Reg. § 1.1411-4(f)(6) provides:

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

[1063] Reg. § 1.1411-4(f)(7) provides:

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

If a properly allocable deduction is allocable to both NII and taxable items of income that are not NII, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method.[1064] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. When using expenses to offset taxable items of income, consider which items of income constitute NII,[1065] as well as the overall federal and state income tax rates that apply to those items.

If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a deduction against NII in a prior year, and such amount is not otherwise included in NII in the year of recovery, the amount of the recovery will reduce the taxpayer's total deductions against NII in the year of recovery (but not below zero).[1066]

Deductions in respect of a decedent also count against NII if they are described in any of the preceding paragraphs.[1067]

Deductions on termination of a trust or estate generally receive NII treatment consistent with their character.[1068]

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section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

[1064] Reg. § 1.1411-4(g)(1) provides:

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

[1065] See part II.I.5 What is Net Investment Income Generally.

[1066] Reg. § 1.1411-4(g)(2) provides additional details how this works.

[1067] Reg. § 1.1411-4(g)(3) provides:

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

[1068] Reg. § 1.1411-4(g)(4), referring to Code § 642(h) items. See part II.J.3.i Planning for Excess Losses.

Special rules apply to losses allowed in computing taxable income by reason of the rules governing former passive activities[1069] or losses allowed when a passive activity is disposed of.[1070]

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

Generally,[1071] a trust or estate is taxed on the lesser of its undistributed net investment income (UNII) or the excess (if any) of its adjusted gross income[1072] over the taxable income threshold[1073] for its highest marginal income tax bracket.[1074]

Regarding grantor trusts, the tax is imposed on the deemed owner rather than the trust:[1075]

- Thus, the beneficiary of a qualified subchapter S trust (QSST)[1076] would include the S corporation's income in the beneficiary's income and determine the applicability of the tax based on the beneficiary's tax attributes and participation in the S corporation's activity. Consider switching from an ESBT to one or more QSSTs in

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[1069] Reg. § 1.1411-4(g)(8), referring to losses under Code § 469(f)(1).
[1070] Reg. § 1.1411-4(g)(9), referring to losses under Code § 469(g)(1).
[1071] Reg. § 1.1411-3(a)(1)(i). Reg. § 1.1411-3(b)(1) exempts the following trusts from the tax:

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

A charitable remainder trust's beneficiaries are taxed when the CRT distributes to them NII the CRT received for all taxable years that begin after December 31, 2012. Reg. § 1.1411-3(d)(iii). Although in the past a CRT that had a huge capital gain tier would have been neutral to whether to harvest losses (because accumulated capital gain would exceed distributions whether or not the losses were taken), now one should consider the 3.8% tier as well. Thus, consider recognizing losses to offset post-12/31/2012 gains.
[1072] As defined in Code § 67(e) and as adjusted under Reg. § 1.1411-10(e)(2), if applicable.
[1073] Code § 1(e).
[1074] Reg. § 1.1411-3(a)(1)(ii).
[1075] Reg. § 1.1411-3(b)(1)(v).
[1076] See part III.A.3.e.i QSSTs.

light of not only issues relating to the 3.8% tax but also increases in the top income tax bracket (to which all ESBT S corporation income is subject) relative to the beneficiaries' income tax rates.[1077] For more about ESBTs and QSSTs, see parts II.J.14 Application of 3.8% Tax to ESBTs and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

- See generally part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts regarding other trusts that are deemed owned by beneficiaries rather than grantors, including part III.B.2.h.vi Portion Owned When a Gift (discussing how to compute the portion deemed owned by the beneficiary during and after the lapse of a withdrawal right). A minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in the minor, notwithstanding that no guardian has been appointed for the minor.[1078]

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

UNII[1079] is the estate's or trust's NII reduced by distributions of net investment income to beneficiaries[1080] and by charitable deductions.[1081]

[1077] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[1078] Rev. Rul. 81-6.

[1079] Reg. § 1.1411-3(e)(2). Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual. Reg. § 1.1411-3(e)(1). Reg. § 1.1411-3(e)(5) provides examples.

[1080] Reg. § 1.1411-3(e)(3) provides:

> (i) In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in § 1.1411-1(d)(4)), the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. See § 1.661(c)-1 and Example 1 in paragraph (e)(5) of this section.
>
> (ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411. The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662, as applicable, from foreign estates and foreign nongrantor trusts.

[1081] Reg. § 1.1411-3(e)(4) provides:

> <u>Deduction for amounts paid or permanently set aside for a charitable purpose</u>. In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income, the allowable

To the extent that the rules governing the allocation of deductions for regular income tax purposes conflict with their NII counterparts, the regular income tax rules control.[1082] See parts II.I.6 Deductions Against NII (especially the text accompanying fns. 1064-1065) and II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

The beneficiary's NII includes the beneficiary's share of distributable net income (DNI) distributed to the beneficiary, as described in the rules governing inclusion in the beneficiary's income under the regular income tax rules, to the extent that the character of such income constitutes NII.[1083] Distributions include amounts required to be distributed[1084] and any other amounts properly paid, credited, or required to be distributed to such beneficiary.[1085] Generally, an amount is considered credited if the trustee must pay it on the beneficiary's demand (without the trustee exercising any

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> deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and Example 2 in paragraph (e)(5) of this section.

If the trust does not sufficiently authorize distributions to charity, consider forming a partnership (which also might have benefits under part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries) that makes gifts deductible to the charity under Rev. Rul. 2004-5, which is discussed in fn. 2726, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Query whether the trustee would be violating fiduciary duties in allowing the partnership to make donations to charity and whether a beneficiary who fails to object is deemed to be the donor for income tax purposes. A safer approach in planning mode would be granting the noncharitable beneficiaries an inter vivos power to appoint gross income to charity; if the trust is already in place, consider decanting to grant the beneficiary such an inter vivos power. Letter Ruling 200906008. If the trust is an ESBT, see fn. 3601 regarding limitations on charitable deductions.

[1082] Reg. §§ 1.1411-1(c) (NII rules do not affect regular income rules), 1.1411-3(e)(3) (if any NII comprises all or part of a distribution for which an NII distribution deduction is allowed, such items retain their character as NII for purposes of computing the recipient's NII). Reg. § 1.652(b)-3(b), reproduced in fn. 1408, controls the allocation of deductions to items comprising DNI for regular income tax purposes.

[1083] Reg. § 1.1411-4(e)(1)(i) provides:

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

For how the rules of Code §§ 652 and 662 work, see fn. 1418 and the discussion in part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries).

[1084] Code §§ 652(a), 662(a)(1).

[1085] Code § 662(a)(2). Reg. § 1.662(a)-3(a) provides:

> There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

discretion when the beneficiary makes the demand) and there is no practical or legal impediment to making the payment.[1086] Query whether, instead of or in addition to exercising discretion by making payments to or for a beneficiary, a trustee can inform a beneficiary that the trustee is crediting $____ (but no more than 5% of the trust's assets at any time from the time of grant until the end of the year), that the beneficiary may withdraw that at any time during the year, and that this withdrawal right will lapse at the end of the year, perhaps with the effect that the beneficiary is taxed on the amount credited (even without receiving it)[1087] and that the lapse would make the trust a partial grantor trust taxable to the beneficiary.[1088] This might be more appropriate for converting a trust to a partial grantor trust than as the preferred method for deeming income to be distributed, in case the IRS argues that one is making a gift by allowing the lapse of a payment made from income instead of made from any part of the trust.[1089] Because the lapse does not constitute a gift for gift tax purposes, the lapse does not cause a portion of the trust to be included in the beneficiary's estate for estate tax purposes. The latter might be important even for QTIP marital deduction trusts that are included in the beneficiary's estate anyway, because the inclusion of such a trust's assets might be valued at a lower rate as a QTIP asset than as an incomplete gift or Code § 2036 asset.[1090]

[1086] See *Cecelia K. Frank Trust of 1931 v. Commissioner*, 8 T.C. 368 (1947), *aff'd* 165 F.2d 992 (3d Cir. 1948); *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir.), *cert. den.* 290 U.S. 670 (1933); *Weed's Estate v. United States*, 110 F.Supp. 149 (E.D. Tex. 1952); *Igoe v. Commissioner*, 19 T.C. 913 (1953); *Estate of Cohen v. Commissioner*, 8 T.C. 784 (1947); *Estate of Bruner v. Commissioner*, 3 T.C. 1051 (1944); *Estate of Johnson v. Commissioner*, 88 T.C. 225, *aff'd* 838 F.2d 1202 (2d Cir. 1987); *Estate of Hubbard v. Commissioner*, 41 B.T.A. 628 (1941); *cf. Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied* 414 U.S. 820 (1973); *Warburton v. Commissioner*, 193 F.2d 1008 (3d Cir. 1952). The author thanks Lad Boyle for providing the above citations from his and Jonathan Blattmachr's treatise. Additional authority includes *Bohan v. U.S.*, 326 F.Supp. 1356 (W.D. Mo. 1971), *aff'd* 456 F.2d 851 (8th Cir. 1972), *nonacq.* Rev. Rul. 82-396; see also Reg. § 1.451-2, "Constructive receipt of income." Note also that Code § 643(g) provides circumstances under which a trustee may credit a beneficiary with the trust's estimated tax payments.

[1087] If the withdrawal right were included in the agreement instead of the crediting taking place, the beneficiary would be taxed on a portion of the trust instead of being treated as having been credited with a distribution. Rev. Rul. 67-241; see parts III.B.2.h.i Trusts Intended to Be Beneficiary Grantor Trusts from Inception, especially fn. 4018, and III.B.2.h.ii Can a Trust without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 4026.

[1088] See parts II.J.3.h Drafting for Flexibility and III.B.2.h.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[1089] Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."

[1090] For the potentially lower valuation of QTIP assets, see fn. 2079.

Trustee fees are not NII to the recipient and do not constitute self-employment income unless the trustee is engaging in a trade or business.[1091] Paying reasonable trustee fees[1092] to a trustee who is a beneficiary would reduce NII while maintaining the same

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[1091] Rev. Rul. 58-5 held:

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

After citing some examples, including imposing self-employment tax on a trustee who manages a trade or business (see fn. 1761, found in part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues), the ruling concluded with a caveat:

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

[1092] For authority on constructive receipt of trustee fees, see Rev. Ruls. 56-472 (waiver by executor did not constitute gift or assignment of income), 64-225 (waiver after serving for many years not respected when, under the circumstances, the services performed by the trustees were not intended to be rendered gratuitously), and 66-167 (waiver made six months after beginning to serve given retroactive effect); see *Breidert v. Commissioner*, 50 T.C. 844 (1968), which held:

> Not only did petitioner waive his right to executor's fees, he did not even have sufficient cash on hand in the estate after paying the claims of creditors and the expenses of administration to pay himself such fees had he desired them. In fact, the cash on hand was insufficient to cover the fees of the attorney and the accountants who rendered substantial services to the estate. There was never any point at which executor's fees in the amount of $9,100.20, or any other sum, were credited to petitioner's account, set apart for him, or otherwise made available to him either by the estate or by the legatees and devisees of the estate. See sec. 1.451-2, Income Tax Regs. Thus, there is no factual basis here for application of the doctrine of constructive receipt. See *Mott v. Commissioner*, 85 F.2d 315, 317-318 (C.A. 6), *affirming on this issue* 30 B.T.A. 1040, 1044-1045; *Estate of W. H. Kiser*, 12 T.C. 178, 180; *S.A. Wood*, 22 B.T.A. 535, 537, *Cf. Weil v. Commissioner*, 173 F.2d 805 (C.A. 2).
>
> Although the Government's principal contention is based upon "constructive receipt," a doctrine that we have found inapplicable on the facts of this case, it also suggests that petitioner must be charged with the executor's fees because he "earned" them. It does not go so far as to argue that an executor may never waive his fees so as to prevent them from being included in his gross income, but it relies upon certain revenue rulings (Rev. Rul. 66-167, 1966-1 C.B. 20; *cf.* Rev. Rul. 64-225, 1964-2 C.B. 15; Rev. Rul. 56-472, 1956-2 C.B. 21) to support its position that petitioner must in any event be

aggregate taxable income between the trust and beneficiary, subject to the following caveats:

- If the trust has tax-exempt income, some of the trustee fees will be disallowed as a deduction.[1093]

- If and to the extent that trustee fees reduce qualified dividend income or other income taxed at lower rates, the tax rate on the trustee might exceed the tax benefit of the deduction.

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

For a description of special NII rules governing charitable remainder trusts, see the text accompanying fn. 1022 in part II.I.2 Regulatory Framework.

The AICPA has resources on the Estate and Trust Impact of 3.8% Net Investment Income Tax.[1094]

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accountable for the executor's fees. The precise theory of these rulings is not clear. Rev. Rul. 66-167, *supra*, appears to indicate that an executor may waive his right to compensation without incurring income tax liability, and the test is whether the waiver "will at least primarily constitute evidence of an intent to render a gratuitous service" (p. 21). Accordingly, if a waiver is made "within a reasonable time" after commencing to serve, it is regarded as "consistent with an intention to render gratuitous service" (headnote), but "if the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof" (p. 21). We need not consider whether this represents sound theory, because from our appraisal of the evidence we think petitioner never had any intention to receive compensation for his services, and that the factual foundation for applying the ruling against him is absent.

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

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

[1093] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1407.

[1094] See http://www.aicpa.org/InterestAreas/Tax/Resources/TrustEstateandGift/ToolsandAids/Pages/EstateandTrustImpactof38MedicareSurtax.aspx.

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

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

Gross income from interest,[1095] dividends, annuities, royalties,[1096] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[1097] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1098] Gain from the

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[1095] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

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

As described in fn. 1098, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[1096] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[1097] Reg. § 1.1411-4(b), which provides:

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

[1098] Reg. § 1.1411-6(a), which also provides:

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

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

> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
>
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
>
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
>
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

sale of an asset is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[1099] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1100] Other gross income from a trade or business is NII if it a passive activity.[1101]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[1102]

Income from a trade or business of trading in financial instruments[1103] or commodities[1104] is also subject to NII tax.[1105] This rule applies to traders – not to dealers or investors.[1106]

> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
>
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
>
> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

[1099] Reg. § 1.1411-4(a)(1)(iii).

[1100] Reg. § 1.1411-6(a), which also provides:

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

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

[1101] Reg. § 1.1411-4(c).

[1102] Reg. § 1.1411-5(b)(1)(ii).

[1103] Reg. § 1.1411-5(c)(1) provides:

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

[1104] Reg. § 1.1411-5(c)(2) provides:

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

[1105] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[1106] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[1107] Although a partnership's income from a trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[1108] one should consider that exit strategies[1109] and basis step-up issues[1110] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[1111]

Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous." *Boatner v. Comm'r*, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).

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

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

[1107] See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 1112.

[1108] See part II.L.4 FICA: Corporation.

[1109] See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.13 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.

[1110] See part II.H.2 Basis Step-Up Issues.

[1111] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

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

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

- Significant participation activities (more than 100 hours of participation).[1112]

- Certain rental activities.[1113]

- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity[1114] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[1115] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[1116]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or business constitutes a passive activity solely with respect to such recharacterized income or gain.[1117] The relevant portfolio income provision is either:

    - the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[1118] or

    - the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[1119]

[1112] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 1689 of part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[1113] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 1675 and 1651, respectively, within part II.K.1.e Rental Activities.

[1114] Reg. § 1.469-2(c)(2)(iii), which provides, generally:

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

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

[1115] Reg. § 1.469-2(c)(2)(iii)(F).

[1116] Reg. § 1.1411-5(b)(2)(i).

[1117] Reg. § 1.1411-5(b)(2)(iii).

[1118] Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).

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

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[1120]

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

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[1121]

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

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

Certain self-charged interest[1122] or rent[1123] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive

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[1119] Reg. § 1.469-2(c)(2)(iii)(F).

[1120] Part 6.B.1.(b)(4) of the preamble.

[1121] Reg. § 1.1411-5(b)(3), Example (2).

[1122] Reg. § 1.1411-4(g)(5) provides:

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

[1123] Reg. § 1.1411-4(f)(6)(i) provides:

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

trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[1124]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[1125] to satisfy the self-rental exception of footnote 1123:

- Although significant participation (more than 100 hours) suffices for other business income,[1126] it does not for the self-rental exception. If this contrast in treatment (between material participation and significant participation) is significant (particularly if the property is about be sold)[1127] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.4 Recommended Long-Term Structure - Flowchart,[1128] perhaps migrating as depicted in part II.E.7 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[1129]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[1130]

See fn. 1160 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).
See fn. 1651 for the text of Reg. § 1.469-2(f)(6).

[1124] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[1125] See part II.K.1.a.ii Material Participation.

[1126] See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[1127] See fn. 1130

[1128] This structure often is ideal; see part II.E.3 Recommended Long-Term Structure – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.

[1129] See fn. 1650 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1130] Reg. § 1.1411-4(f)(6)(ii) provides:

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

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

If an individual, estate, or trust owns or engages in a trade or business,[1131] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[1132]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[1133]

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

- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[1134] is determined at the entity level.

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

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[1135] The preamble to the proposed regulations explains:[1136]

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

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See fns. 1160 and 1652 regarding Reg. § 1.469-2(f)(6).

[1131] Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.

[1132] Reg. § 1.1411-4(b)(1).

[1133] Reg. § 1.1411-4(b)(2).

[1134] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[1135] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.

[1136] Part 7 of the preamble.

section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.

A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[1137]

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

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception is somewhat moot.[1138]

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

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[1139]

Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.

As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.

In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final

[1137] T.D. 9644.
[1138] Reg. § 1.1411-5(b)(3), Example (5).
[1139] T.D. 9644.

regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.

One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.

The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

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

The preamble to the final regulations addressed former passive activities:[1140]

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

[1140] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.i Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

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

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

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

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

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[1141] trade or business.[1142]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[1143]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[1144] the portion of the sale proceeds attributable to business assets does qualify.[1145]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[1146] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[1147]

[1141] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 1102.
[1142] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[1143] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital.
[1144] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[1145] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[1146] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[1147] Reg. § 1.1411-4(d)(4)(i)(B)(3).

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

As mentioned above, rental income is NII unless it is self-rental[1148] or not only is from a trade or business but also nonpassive.[1149]

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

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

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[1150] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[1151] if the taxpayer materially participates.[1152]

[1148] See fn. 1123.

[1149] See fn. 1097. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d*.

[1150] See part II.K.1.e Rental Activities.

[1151] Reg. § 1.1411-5(b)(3), Example (3) provides:

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

[1152] Reg. § 1.1411-5(b)(3), Example (4) provides:

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

The general rule that rental is per se passive does not apply to certain real estate professionals.[1153] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[1154]

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

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[1155]

> Application of section 469 and other gross income under §1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

[1153] See fns. 1643-1656.

[1154] T.D. 9655.

[1155] Reg. § 1.1411-4(g)(7) provides:

> (7) *Treatment of certain real estate professionals*
>
> > (i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than

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

See also part II.G.23 Real Estate Dealer vs. Investor.

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

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

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business.[1156]

> 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—
> (A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and
> (B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.
>
> (ii) *Definitions*—
> (A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.
> (B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.
>
> (iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

[1156] Part 6.B.1.(b)(4) of the preamble explains:

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

The preamble to the final regulations explains how the IRS views rental as a trade or business (emphasis added):[1157]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as Fackler v. Commissioner, 45 BTA 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.
>
> The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[1158]
>
> Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

[1157] T.D. 9655.

[1158] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

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

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

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

The example cited above is as follows (emphasis added):[1159]

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

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[1160]

With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.

[1159] Reg. § 1.1411-5(b)(3), Example 1.

[1160] T.D. 9655. Reg. §1.1411-4(g)(6)(i):

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

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.

However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[1161] It has been further suggested that the Board of Tax Appeals and Tax Court have found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[1162] The article that made these comments offers

[1161] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

[1162] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes excellent planning tips.[1163] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[1164] Equipment rental appears to have much easier standards in qualifying as a trade or business.[1165]

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constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq*., 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
>
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issu*e, 776 F.2d 1428, 1433 (9th Cir. 1985).

[1163] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

[1164] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[1165] Part II.L.1 Income Subject to Self-Employment Tax discusses cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

Combining all of the ideas above:

- The IRS considers:
  - The type of property (commercial real property versus a residential condominium versus personal property),
  - The number of properties rented, the day-to-day involvement of the owner or its agent, and
  - The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).
- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person.

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from triple-net leases and moving towards leases in which the landlord provides significant services, such as insider and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply. Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[1166]

[1166] See part II.E.7 Real Estate Drop Down into Preferred Limited Partnership.

See also part II.G.23 Real Estate Dealer vs. Investor.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[1167]

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[1168]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

[1167] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.1.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 2369, the latter for rates.

[1168] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).

II.I.8.d.iii. Treatment of Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[1169]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[1170]

[1169] REG-130843-13.

[1170] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 1175

For the self-employment consequences of guaranteed payments for services, see parts II.L.2 Self-Employment Tax: General Partner or Sole Proprietor and II.L.3 Self-Employment Tax: Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[1171] the preamble to the 2013 proposed regulations explains certain general ideas:[1172]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").
>
> Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.
>
> Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469-2(e)(2)(iii) contains rules on the extent to

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clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 1124.

[1171] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1172] REG-130843-13.

> which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[1173]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[1174]

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[1175] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411

[1173] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

> In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[1174] REG-130843-13.

[1175] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

> purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

Thus, Code § 736(b) payments are treated as sales of partnership interests,[1176] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[1177] even though for income tax purposes each year's payment stands alone.[1178]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[1179]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.
>
> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[1180]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of

[1176] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[1177] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[1178] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 3148 and 3174 and the accompanying text.

[1179] REG-130843-13.

[1180] REG-130843-13.

> section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.
>
> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[1181] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive share is not NII.[1182] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[1183] note that a retired partner generally would not be materially participating, although it is possible that the retired partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[1184] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[1185]

[1181] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 1175 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

[1182] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.

[1183] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).

[1184] See part II.K.1.a.ii Material Participation.

[1185] See part II.K.1.a.ii Material Participation, including fn. 1533, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[1186]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[1187]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.
>
> The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).
>
> If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an

[1186] REG-130843-13.
[1187] REG-130843-13.

installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[1188] and goodwill,[1189] for NII purposes it is treated as gain from the disposition of a partnership interest.[1190] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and goodwill, for NII purposes it is treated as payment for services[1191] or the payment of interest consistent with its characterization under the passive loss rules.[1192]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[1193]

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

> In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as

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[1188] Within the meaning of Code § 751(c).

[1189] As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 1642.

[1190] Prop. Reg. § 1.1411-4(g)(11)(iii)(A).

[1191] Because this characterization is only for NII purposes (see fn. 1033), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 FICA: Retiring or Deceased Partner.

[1192] Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 1124.

[1193] For the favorable rules regarding prior participation, see text accompanying fns. 1184-1185.

gain from the sale or exchange of such partnership interest or S corporation stock).

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.

For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest. See Example 7 of proposed § 1.1411-7(e) for a situation involving the transferor of an interest in an S corporation with two trades or businesses, only one of which is described in proposed § 1.1411-5.

The preamble to the final regulations explains:[1194]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

The preamble to the 2013 proposed regulations summarized these rules:[1195]

> 9. <u>Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S Corporations</u>
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.
>
> The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock <u>only to the extent of</u> the transferor's share of gain/loss from the Passthrough Entity's passive assets.
>
> The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of

[1194] T.D. 9655

[1195] REG-130843-13.

section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[1196] held in a nonpassive trade or business.[1197]

To determine whether net gain is from property held in a trade or business:[1198]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[1199] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.

[1196] As described in Reg. § 1.1411-6.
[1197] Reg. § 1.1411-4(d)(4)(i)(A).
[1198] Reg. § 1.1411-4(d)(4)(i)(B).
[1199] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:

    - from a passive trade or business activity is determined at the owner level; and

    - derived in trade or business of a trader trading in financial instruments or commodities[1200] is determined at the entity level.

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

The preamble to the final regulations explains how rules governing the disposition of a passive activity interact with the 3.8% tax:[1201]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.
>
> Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).

[1200] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[1201] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:

> *Treatment of section 469(g)(1) losses*. Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

For more about Code § 469(g), see part II.K.1 Passive Loss Rules Generally, especially the text accompanying fns. 1510-1511.

> The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.
>
> Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[1202]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

[1202] Reg. § 1.1411-4(f)(9).

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[1203]

- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[1204] or

- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[1205]

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[1206]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[1207]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[1208]

- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 1206

[1203] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.
[1204] See part II.K.1.a.ii Material Participation, including fn. 1533, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[1205] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.
[1206] See fns. 1530-1531 and accompanying text, found in part II.K.1.a.ii Material Participation.
[1207] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1208] See part II.K.1.a Counting Work as Participation.

above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).

- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[1209]

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[1210]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[1211]

See also part II.G.23 Real Estate Dealer vs. Investor.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker and II.L.6 FICA: Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[1212] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see

[1209] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.
[1210] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.
[1211] For details and nuances, see fn. 1675 in part II.K.1.e Rental Activities.
[1212] Code § 164(f)(1).

part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 1238-1242.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S Corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the landlord to materially participate in the tenant's business.[1213] Material participation in the tenant's business includes owning an interest in the tenant's business.[1214] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary, not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[1215] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last), perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[1216]

- Regrouping passive activities.[1217]

[1213] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 1129, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 1650-1651.

[1214] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1215] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1216] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.

- Pre-2013 installment sales that might generate net investment income in 2013 and later years.

- Controlled foreign corporation and qualified electing fund stock.

- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[1218]

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring minimum distributions to be taken.[1219] Even though retirement plan distributions are not NII, income from distributions increases MAGI.

- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[1220]

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[1221]

[1217] See parts II.K.1.b.i Grouping Activities – General Rules and II.K.1.b.iii Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.

[1218] Code § 1411(e)(1).

[1219] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).

[1220] Code § 453, which is subject to Code §§ 453A and 453B.

[1221] Reg. § 301.7701-4(a), which further provides:

> Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

That a beneficiary provided consideration for the trust's establishment does not prevent the trust from being classified as such. *Hanover Bank v. Commissioner*, 40 T.C. 532(1963), *acq.* 1964-2 C.B. 5, which further held:

> There does not appear to be any ambiguity in the agreement concerning the creation of the trust and, in fact, all the parties to that agreement, including Frances, have long treated the agreement as creating a valid trust. Petitioners Strong reported as trust income in 1953 and 1954 most of the amounts paid to them by the trustee. Long-standing interpretations should be given consideration and will not lightly be set aside even when there is ambiguity in the instrument, *Babette B. Israel*, 11 T.C. 1064 (1948).

> an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

A life estate might create a relationship that rises to the level of a trust.[1222]

However, a mere agency agreement does not constitute a trust.[1223]

See also part II.D Special Purpose Trusts.

This part II.J tends to focus on estates and nongrantor trusts and often refers to such entities when referring to trust. In many ways, estates are taxed as nongrantor trusts that are not required to distributed all of their income, so a reference to such a trust tends to apply to an estate as well; however, as with anything in these materials, a tax professional should apply independent judgment to any such inference.

For a focus on grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and III.B.2.g How to Make a Trust a Grantor Trust.

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

Our fiduciary income tax system, generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[1224]

> Furthermore, the Supreme Court of New York previously construed the agreement as creating a valid trust and the material parts of that judgment are set forth in our Findings of Fact. Judicial constructions by State courts are conclusive as to the legal extent and character of the interests created under such an agreement, *Louise Savage Knapp Trust A*, 46 B.T.A. 846 (1942).
>
> The situation here is distinguishable from cases such as *Lyeth v. Hoey*, 305 U.S. 188, and *Chase National Bank et al., Executors*, 40 B.T.A. 44 (1939). In each of those cases the taxpayer threatened to take contrary to a will and in each case compromised his claims. The Courts determined that the property received in compromise was the substitute for an inheritance. In the instant case, Frances did not contest the disposition and the amounts she received were not in compromise of any claim she may have had.

[1222] Taxpayers sought that conclusion in fn. 3555 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

[1223] Rev. Rul. 76-265 held:

> In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.
>
> Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

Letter Ruling 200227012 followed Rev. Rul. 76-265.

[1224] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[1225] It also deducts any other amounts of DNI that are "properly paid or credited or required to be distributed" for the taxable year.[1226] Thus, a mandatory income feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[1227] The beneficiary includes in income the amount of the trust's deduction for DNI.[1228]

The above is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[1229] and charitable deductions.[1230]

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended

Code § 663(b) allows distributions in the first 65 days of the taxable year to count as distributions in the current or prior year's tax return.

Thus, the trustee can count distributions from January 1, 2016 through and including March 5, 2016 as 2015 or 2016 distributions or a combination thereof.

When in doubt, distribute more rather than less (if distributions are appropriate).[1231] The tax return, including extensions, will determine how much of the distribution counts as a distribution for the year just ended or for the year in which the distribution is made, but the distribution needs to be made within the 65-day period.

[1225] Code § 651 and Code § 661(a)(1), (c). Code § 643(a) defines DNI, and Code § 643(b) defines accounting income. For more on accounting income, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which generally covers the area of accounting income, with extra attention paid to capital gains.

[1226] Code § 661(a)(2), (c). A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a US person. For the latter rule, see Code § 643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); TAM 8341005 (following Plant - real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3rd Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust.

[1227] Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

[1228] Code §§ 651, 652.

[1229] See part II.J.9.a Separate Share Rule.

[1230] Code § 642(c) generally governs charitable deductions. Among other issues, see part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity, which also covers how a trust's income from business or certain other activities affects the charitable deduction..

[1231] See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[1232]

II.J.3. Strategic Fiduciary Income Tax Planning

Planning for fiduciary income tax is a matter of comparing taxation at the trust level, beneficiary level, or deemed owner level, including the following issues:

- Who is best taxed on gross income?[1233]
- Who benefits most from deductions?[1234]
- Consider not only the effect of federal tax but also state and local income tax.[1235]
- Does the method of shifting the incidence of taxation undermine any material purpose of the trust?
- Do decisions made for the current taxable year affect taxation in future years?
- How much flexibility does a trustee have for currently irrevocable trusts, and can this flexibility be enhanced?
- How should one draft to provide more flexibility?

For distributing capital gain, see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

Also note that beneficiaries who are trustees can reduce income subject to the net investment income tax by taking reasonable trustee fees; however, this strategy is not a good idea if the trust has any significant tax-exempt income (because the deduction would be disallowed to the extent allocable to tax-exempt income,[1236] but the entire fee income would still be recognized) or if and to the extent the deduction would offset income (such as qualified dividends or long-term capital gain) taxable at a lower rate. For other aspects of the NII tax, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and II.I.9 Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII.

II.J.3.a. Who Is Best Taxed on Gross Income

Increased adjusted gross income (AGI) might cause a beneficiary to lose tax benefits, effectively increasing the beneficiary's marginal income tax rate. Therefore, even if the trust and beneficiary have the same nominal rate, the beneficiary might have a higher effective tax rate. Increased beneficiary AGI can cause the following tax detriments:

[1232] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[1233] See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
[1234] See part II.J.3.d Who Benefits Most from Deductions.
[1235] See part II.J.3.e State and Local Income Tax.
[1236] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1407.

- Reduction of Overall Itemized Deductions. Generally, itemized deductions are reduced by 3% of the extent to which AGI exceeds certain thresholds. If the itemized deductions offset ordinary income, this effectively imposes an additional tax of approximately 1.2% on AGI.

- Reduction in Particular Itemized Deductions. Itemized deductions such as medical expenses, miscellaneous itemized deductions, and casualty losses are reduced as AGI increases.

- Phase Out of AMT Exemption. The alternative minimum tax exemption is phased out and eventually eliminated once income exceeds certain limits.

- Phase Out of Personal Exemption. The regular tax personal exemption is phased out and eventually eliminated once income exceeds certain limits.

- Net Investment Income (NII) Tax.

  - Once an individual's income exceeds certain thresholds, NII tax applies.[1237] Although a trust's income quickly becomes subject to the NII tax, the threshold for an individual is much higher.

  - NII tax applies to passive income.[1238] The trustee of a nongrantor trust might not be a suitable person to participate sufficiently to avoid the income being characterized as passive, and the rules governing whether a trustee's work constitutes participation are challenging to apply.[1239] If the trust is a grantor trust, the deemed owner's work is what counts while that person is the deemed owner,[1240] although the trustee's work might be important to set the stage for future nonpassive treatment.[1241] For a nongrantor trust, beneficiary's participation should count for depreciation but does not count for other items of business income.[1242]

[1237] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[1238] See part II.I.8 Application of 3.8% Tax to Business Income.
[1239] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[1240] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1075.
[1241] The trust will cease to be a grantor trust when the deemed owner dies, if the grantor trust powers are not turned off before then. If a QSST sells its S corporation stock, the sale is taxed to the trust rather than to the beneficiary. Consider having the trustee work in the business to try to establish participation, looking toward those events. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax), II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[1242] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.

- If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[1243]

Also, consider whether the trust or the beneficiary has capital loss (or, less likely but still possible, net operating loss) carryovers against which to offset trust income.

II.J.3.b. Effect of Kiddie Tax on Rates

Code § 1(g) requires the tax of certain children, including certain students who have not attained age 24 as of the close of such calendar year, to compute their income tax based on their parents' rates.

However, no comparable rule applies to computing children's 3.8% net investment income tax.[1244]

Thus, shifting income to children subject to the kiddie tax can still result in tax savings.

II.J.3.c. Who Is Benefits the Most from Losses

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

II.J.3.d. Who Benefits Most from Deductions

Consider that generally[1245] the fiduciary income tax system allows nongrantor trusts[1246] to net deductions against income before allocating income to beneficiaries. Thus, incurring expenses at the trust level provides benefits similar to trapping income inside trusts described in part II.J.3.a Who Is Best Taxed on Gross Income. Furthermore, favorable treatment is provided deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.[1247]

Charitable deductions often produce more benefit to a trust than to an individual.[1248]

Certain losses from the sale of small business stock[1249] are not available to nongrantor trusts,[1250] so grantor trust planning might be considered for that asset. Similarly,

[1243] Individuals cannot deduct charitable contributions against NII (the charitable deduction is not listed in part II.I.6 Deductions Against NII), but trusts can. See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1081.
[1244] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.
[1245] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.
[1246] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.
[1247] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought.
[1248] See part II.J.4.c Charitable Distributions.
[1249] See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

depreciation deductions allocated to the remaindermen of a nongrantor trust that is included in the grantor's or beneficiary's estate reduce the basis step-up; presumably this rule would not apply to a grantor trust.[1251]

II.J.3.e. State and Local Income Tax

II.J.3.e.i. Residence Generally

Consider whether income trapped inside a trust might be taxed at a lower state and local income tax rate (or entirely exempt from such tax) than income reported on a beneficiary's income tax return.

Generally, states do not tax nonbusiness income earned by a nonresident trust. Some high income-tax states fail to tax income earned by trusts set up by their residents that are administered in other jurisdictions, which has led to the creation of incomplete gift nongrantor trusts to cause capital gain from investments to avoid state income tax.[1252]

II.J.3.e.ii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence

A state might ignore a trust's existence while the trust is a grantor trust.[1253] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[1254]

[1250] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[1251] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[1252] "Incomplete nongrantor" is abbreviated ING, so one often hears of DING (Delaware ING) or NING (Nevada ING) trusts, even though the strategy is available for trusts established in other states (including Missouri). Private letter rulings approving such trusts treat certain trustees as adverse for income tax but not gift tax purposes without explaining how those conditions can coexist.

Now I have some silly comments to add spice to your day:

- Suppose your DING also has some asset protection features. It might be a bankruptcy avoidance trust (BAT). Being a DING-BAT, it was referred to frequently on the TV series, "All in the Family."
- Suppose you have a Missouri ING, and to the extent the grantor allocates GST exemption at death it terminates in favor of a perpetual trust. This MING Dynasty Trust might be appropriate to hold 13th century Chinese artifacts.

[1253] For example, in defining what is a trust, Illinois disregards the existence of a grantor trust. 35 ILCS 5/1501(a)(20)(D) and 86 Ill. Admin. Code § 100.3020(a)(4) refer to grantor trusts under Code §§ 671-678.

[1254] Nenno, 869 T.M. II.A. states:

> As noted above, if a trust is treated as a grantor trust for federal and for state income-tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the trustor, making planning difficult if not impossible while that status continues. Nevertheless, where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. For instance, Pennsylvania and Tennessee don't have grantor-trust rules for irrevocable trusts; Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in limited circumstances;[21] and Massachusetts classifies a trust as a grantor trust based on §§ 671–678 only, so that a trust that falls under § 679 will be a

Given that clients often retire to jurisdictions that are not subject to income tax, keeping the trusts as grantor trusts until the clients move to those jurisdiction might mean that the state in which the trust was created will not treat the trust as a resident trust, because for income tax purposes the trust was deemed not to exist until the grantor was not a resident.

See also part II.J.15.b QSSTs and State Income Tax Issues.

II.J.3.f. Consider Trust Purposes

If shifting the incidence of taxation requires making distributions, consider whether distributions are appropriate. Consider whether distributions undermine the following nonexclusive list of concerns:

- Supplemental needs trusts designed to protect the flow of governmental benefits
- Protection from tort creditors
- Protection from business creditors
- Protection from spouses or ex-spouses
- Otherwise keeping funds inside the family
- Poor spending habits
- Inability to handle money
- Discouraging undue influence
- Funding addictive behavior
- Protecting from estate tax
- Other spendthrift concerns

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grantor trust for federal but not for state purposes. Unfortunately, a number of those states tax individuals based on federal taxable income,[22] which captures all federal grantor-trust income,[23] making the foregoing planning option unavailable.

[21] Ark. Inc. Tax Reg. § 4.26-51-102; D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187; Mont. Code Ann. § 15-30-2151(5).

[22] § 63.

[23] § 671.

Instructions to Pennsylvania's fiduciary income tax returns explain that they respect the grantor trust rules only for revocable trusts.

II.J.3.g. Effect on Future Years

The first time a distribution of principal is made from principal without referring to or actually distributing capital gain proceeds, the trustee is essentially electing for that year and all future years whether such distributions will carry out capital gains.[1255]

Causing a trust to be taxed to the grantor can be turned on or off by the presence or absence of a swap power or other powers.[1256]

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[1257] If one wants flexibility in turning on or off beneficiary grantor trust treatment, consider using QSST strategies (which can cause difficulty splitting up trust assets if more than one person is a remainderman).[1258]

II.J.3.h. Drafting for Flexibility in Trust Income Taxation

When drafting using an ascertainable standard for distributions ("support" in my documents),[1259] one can give the trustee the flexibility to consider or ignore the beneficiary's other resources. If the trustee has a legal duty to support one or more beneficiaries, consider using "reasonable support and comfort"[1260] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[1261]

[1255] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[1256] See part III.B.2.g How to Make a Trust a Grantor Trust.

[1257] See generally part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

[1258] See parts III.A.3.e.vi QSST (including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts) and III.A.3.e.iv Flexible Trust Design.

[1259] See Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules), 20.2041-1(c)(2) (exception to estate tax general power of appointment) and 25.2511-1(g)(2) (gift tax ascertainable standard – reproduced in fn. 1376).

Some documents include a statement that the trustee's determination is conclusive and binding on all parties. Reg. § 25.2511-1(g)(2) takes the position that such language undermines the ascertainable standard exception, but the other two regulations are silent on the issue. Those regulations were promulgated before the Uniform Trust Code ("UTC"), section 814(s) of which provides:

> Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

UTC §§ 1002(b), 1008(a)(1) (see also the sections to which the Comments to Section 103(8) refer) provide similar references to good faith and the beneficiaries' interests in determining whether a trustee is liable. Thus, the assumption that "conclusive and binding" language makes the trustee's discretion unreviewable might be incorrect. I would not use such language in connection with trying to establish an ascertainable standard, but generally I would not urge reformation of an irrevocable trust merely for using that language. *Jennings v. Smith*, 161 F2d 74 (2nd Cir. 1947), upheld as not causing estate inclusion an ascertainable standard that included some language about the trustee's "absolution discretion."

[1260] As defined in Reg. §§ 25.2511-1(g)(2) and 1.674(b)-1(b)(5)(i).

[1261] Generally, a legal support obligation encompasses a much more narrow view of support than does what is permitted for an ascertainable standard, but one would want to check state law to

I also like to include standards that are not ascertainable ("welfare" in my documents). To avoid the IRS alleging adverse estate/gift tax consequences, the trustee either cannot have been appointed by the beneficiary or was appointed by the beneficiary but is not a related or subordinate party (as defined in Code § 672(c))[1262] with respect to the beneficiary.[1263]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[1264] one twist on the power would be giving the trustee or a trust protector the power to turn off the power for a year (or range of years) before the year starts, allowing the power to be turned off if creditors are hovering. Absent such a provision, one might convert a trust to a partial beneficiary grantor trust by exercising one of the standards described above with respect to the lesser of $5,000 or 5% of the trust's assets and giving the beneficiary the power to withdraw the declared amount or portion.[1265] In either case, such treatment generally has a permanent effect.[1266]

If locking in the beneficiary as the deemed owner is unattractive, the trust can dump its assets in an S corporation, make a QSST election when taxing the beneficiary is attractive,[1267] and convert to an ESBT when trapping income in the trust (primarily when the trust is not subject to state income tax but the beneficiary is) is more attractive.[1268] However, planning using S corporations involves additional long-term planning.[1269]

Also, to promote flexibility in including capital gains in distributable net income that the trustee can elect to carry out to the beneficiaries, consider using flexible language regarding allocating receipts between income and principal.[1270]

II.J.3.i. Planning for Excess Losses

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[1271] to beneficiaries except in the year of termination. Also consider the points made in

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verify. Also, if a trust makes distributions for items encompassed by a support obligation, query whether the trust has a claim against the person who has the support obligation. Finally, state laws prohibiting trustees from discharging their legal obligations, as well as any such prohibitions in the trust instrument itself, should reinforce the idea of the trust having a claim against the beneficiary. Nevertheless, many estate planners prefer to have other mechanisms for getting distributions to dependent children.

[1262] See Rev. Rul. 66-160 (director of a corporation is not an "employee" under Code § 672(c)); Letter Rulings 9842007 and 9841014.

[1263] For the latter, see fn. 4006.

[1264] See part III.B.2.h.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[1265] See text accompanying fns. 1086-1088.

[1266] For flexibility regarding beneficiary grantor trust status, see fn. 1258.

[1267] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, which is part of the larger part III.A.3.e QSSTs and ESBTs.

[1268] See parts III.A.3.e.ii.(c) When ESBT Income Taxation Might Help and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

[1269] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

[1270] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1374.

part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good in light of planning a trust's and its beneficiaries' income and losses.

If the trust is not terminating by the end of the calendar year, consider accelerating income (perhaps selling appreciated assets, among other items) or deferring deductions if and to the extent that the trust's deductions otherwise would exceed its income.

On the final termination of an estate or a nongrantor trust, it can pass to its beneficiaries a net operating loss carryover under Code § 172, a capital loss carryover under Code § 1212, or for the last taxable year of the estate or trust deductions (other than the exemption and charitable deduction) in excess of gross income for such year, all to the extent provided in regulations.[1272]

A trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[1273]

II.J.4. Tips for Fiduciary Income Tax Preparers

The IRS' web page for fiduciary income tax returns is https://www.irs.gov/uac/about-form-1041.

Income tax preparers might consider the following:

II.J.4.a. Distributions after Yearend to Carry Out Income to Beneficiaries

Prepare a rough draft of the income tax return in February and compare it to the beneficiaries' income tax rates.

If distributions are appropriate, make them by March 5 or 6.

For details, see part II.J.2 Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended.

II.J.4.b. Capital Gain Elections

Tax return preparation software automatically treats capital gains as trapped in the trust.

Consider whether current or future capital gains should be shifted to the beneficiaries.[1274]

Although a prior year return might have constituted an election not to distribute capital gains under one particular option, the tax laws are much more flexible than might appear at first. See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[1271] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.
[1272] Code § 642(h).
[1273] Reg. § 1.641(b)-3(b), incorporated by reference by Reg. § 1.642(h)-1(a).
[1274] See part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.4.c. Charitable Distributions

Even more generous than the 65-day rule mentioned in part II.J.4.a, a charitable contribution made any time in the current year can count for the current or immediately preceding year.[1275] For example, a contribution made December 31, 2017 can count as a 2016 contribution for a calendar year fiduciary taxpayer.

A nongrantor trust or estate's charitable deduction reduces adjusted gross income distributed to the beneficiaries and is the only way a charitable deduction can reduce net investment income subject to the 3.8% tax.[1276]

For the requirement that the contribution be paid from gross income and complexity that applies when the trust has S corporation, business, or debt-financed income, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Special rules apply to electing small business trusts owning S corporations that make charitable contributions.[1277]

But for these limitations, generally a nongrantor trust's charitable deduction is not subject to the limitations that would apply to a beneficiary. Nongrantor trusts and estates may deduct charitable contributions made during the taxable year or in the next taxable year,[1278] whereas generally individuals may deduct contributions made during the taxable year. Furthermore, charitable gifts from nongrantor trusts and estates do not appear to be subject to the strict substantiation rules that apply to individuals[1279] and

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[1275] Code § 642(c)(1); Reg. § 1.642(c)-1(b)(1). Although an estate can deduct any amounts set aside and paid any time before termination, that election can be fraught with danger. See part II.J.7 Election to Treat a Revocable Trust as an Estate, with the caution described in fn. 1331.

[1276] See fn. 1081.

[1277] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3601.

[1278] See fn. 1275.

[1279] Code § 170(f)(8) disallows contributions under Code § 170(a) if certain substantiation requirements are not met but does so without referring to Code § 642(c). Also, Code § 642(c) says that the deduction is "in lieu of the deduction allowed by section 170(a)," further disconnecting Code § 642(c) for Code § 170(f)(8). Note also that Reg. § 1.170A-13(f)(13) provides:

> Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or § 1.664-3(a)(1)(i)(b)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

In a reviewed decision, *15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (2016), disallowed a $64 million charitable deduction. The charity's acknowledgement of the gift failed to recite, as required by Code § 170(f)(8)(B)(ii), whether the charity provided any goods or services to the donor. The taxpayer lost even though the charity later filed an amended Form 990 stating the gift's value. Because no regulations implement Code § 170(f)(8)(D), taxpayers cannot rely on a charity's filing with the IRS as an exception to Code § 170(f)(8)(B)(ii).

appear to be more liberal as to who the donee is.[1280] However, rules requiring nongrantor trusts and estates to use gross income to make contributions can be tricky,[1281] especially when a nongrantor trust has unrelated business income.[1282]

A trust claiming a charitable deduction must identify the "governing instrument," show that the charitable contributions were paid "pursuant to" the terms of that instrument as required by Code § 642(c)(1), and demonstrate that each contribution was paid for a charitable purpose under Code § 170(c).[1283] Trustee discretion to distribute to charity satisfies the "pursuant to" standard.[1284] Payments an estate made to charity out of estate income attributable to that part of the estate transferred to charity, under the terms of a settlement agreement resulting from a will contest, qualify for a Code § 642(c) deduction.[1285] When a charitable lead annuity trust distributed more to charity than its annuity amount and that distribution was not clearly authorized, the trust received neither a charitable nor an income distribution deduction for those excess distributions.[1286] When a surviving spouse who had a general power of appointment over the marital trust created for her, exercised that power in favor of her estate, and left her estate to charity, the marital trust was not entitled to a charitable income tax deduction.[1287] When a trust

[1280] Code § 170(c) provides that "the term 'charitable contribution' means a contribution or gift to or for the purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A))."

[1281] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2725-2726.

[1282] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2732-2738, which impose individual percentage limitations in lieu of Code § 642(c) and seem to undo the benefits described above in the text accompanying fns. 1279-1280. This rule does not apply to estates. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2743-2744.

[1283] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67, citing *Brownstone v. United States*, 465 F.3d 525, 529 (2nd Cir. 2006).

[1284] *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), construing the predecessor to Code § 642(c), rejecting the IRS' narrow construction and adopting a broad definition of "pursuant to":

> We are asked to hold that the words "pursuant to" mean directed or definitely enjoined. And this notwithstanding the admission that Congress intended to encourage charitable contributions by relieving them from taxation. *Lederer, Collector, v. Stockton*, 260 U.S. 3, 43 S.Ct. 5, 67 L.Ed. 99; *United States v. Provident Trust Co., Administrator*, 291 U.S. 272, 285, 54 S.Ct. 389, 392, 78 L.Ed. 793.
>
> "Pursuant to" is defined as "acting or done in consequence or in prosecution (of anything); hence, agreeable, conformable; following; according."[3]
>
> [3] *Webster's New International Dictionary, Unabridged* (2d Ed.) 1935.

[1285] Rev. Rul. 59-15.

[1286] *Crown Income Charitable Fund v. Commissioner*, 98 T.C. 327 (1992), *aff'd* 8 F.3d 571, 573 (7th Cir. 1993). In denying the income distribution deduction as an alternative when the charitable deduction was disallowed, the Tax Court referred to Reg. § 1.663(a)-2, which provides:

> Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c).

[1287] *Brownstone v. U.S.*, 465 F.3d 525 (2nd Cir. 2006). Instead of claiming the charitable deduction, the trust should have taken an income distribution deduction and the estate then taken the charitable deduction. Thus, the court was correct to deny the charitable deduction. However, rather than saying the above, the court used the following reasoning:

> Appellant's arguments are equally unavailing. Appellant asks us to consider Ethel's power of appointment and Lucien's will together as the governing instrument, but as the district court noted on the record, the statute refers to "governing instrument" in the

gave a beneficiary an inter vivos power of appointment in favor of charity that the

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singular. To combine Ethel's power of appointment with Lucien's will and deem the resultant agglomeration the "governing instrument" strains the statute's text. We agree with appellant that ordinarily "governing" can imply a broader subject-object relationship than does "creating." Nevertheless, we find that the implication is neutralized by the statute's legislative history, which deems the current statute and its predecessor "comparable." We also agree with the district court that "the legislative history doesn't suggest that there is any attempt to broaden the prior law...."

In construing the statute, however, we do not go so far as to equate "governing instrument" with "will or deed creating the trust." Instead, we note "[i]t is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'" *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Here, Congress has not made clear provision that an instrument subsequent to the creating instrument, such as Ethel's exercise of the power of appointment, in Article Third of her will, when combined with the "creating" deed or will, such as Lucien's will, could qualify as a "governing instrument." Under this rule of construction, because there is no such clear provision, Ethel's appointment, combined with Lucien's will, cannot qualify as a governing instrument under § 642(c)(1). Indeed, were the Tax Code to permit a trustee to agglomerate the separately manifested intents of diverse testamentary instruments so as to create a single, chimerical "governing instrument," it would greatly enhance the ability of trusts to obtain income tax deductions. For this, Congress has not made clear provision. We hold, therefore, that the governing instrument in this case is not a combination of two separate instruments. It is Lucien's will alone.

The second step in our inquiry leads us to determine whether Ethel's distribution was made "pursuant to" the governing instrument, Lucien's will. In *Old Colony*, the U.S. Supreme Court held: "'Pursuant to' is defined as 'acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according.'" 301 U.S. at 383-84. This standard is permissive, but it "still conveys more than 'not in violation of'." *Weir Foundation*, 362 F.Supp. at 939. Therefore, "the instrument must be shown to possess some positive charitable intent or purpose of the settlor–not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty." *Id.* Ethel's will, in exercising the power of appointment, did not make the charitable distribution "pursuant to" the terms of Lucien's will because Lucien's will does not express sufficient charitable intent with respect to the Trust principal. In Article Seventh of his will, Lucien established the Trust for the support and maintenance of his wife. Article Seventh also gave Ethel a power of appointment that allowed her to distribute the Trust principal in any manner she saw fit. Only if she did not validly exercise that power would the Trust principal pass to a charitable organization. By the terms of Lucien's will, Ethel could have distributed the Trust principal entirely to private individuals. Just as easily, she could have distributed the Trust principal entirely to charity. But the choice was Ethel's alone, and Lucien's will expressed no preference. Indeed, Lucien's will necessarily abandoned all charitable intent with respect to the Trust principal in creating the power of appointment; if it had not, the Trust could not have taken advantage of the marital deduction. See 26 U.S.C. § 2056(b)(5). Once Ethel received the power of appointment, Lucien's will could not bind her to any course of action, charitable or otherwise. We agree with the district court: "She was not compelled to give one penny to charity. The governing instrument did not govern her free exercise of her discretion in any way, shape or form." Thus, Ethel did not make her distribution "pursuant to" the terms of the governing instrument.

The above analysis went way beyond what was necessary to resolve the case.

beneficiary exercised to direct charitable distributions, Letter Ruling 201225004 allowed the charitable deduction. However, CCA 201651013 asserted no charitable deduction and no income distribution deduction when a court order gave a beneficiary an inter vivos power to appoint to charity and the beneficiary exercised it.[1288] Furthermore, the "pursuant to" requirement was not met when a court modified a trust to add charities as income beneficiaries when only individuals were beneficiaries and the charities did not become beneficiaries until a later taxable year, even though the court action purported to be a construction and not a modification.[1289] To avoid controversy, consider expressly authorizing the trustee to make charitable distributions or a beneficiary to exercise an inter vivos power of appointment in favor of charity. Also, consider having the trust participate in a partnership that makes the donation, which may avoid needing to satisfy the "pursuant to" requirement.[1290]

A trust claiming Code § 642(c) charitable deduction may have additional filing requirements. Split-interest trusts described in Code § 4947(a)(2) have their own filing requirements.[1291] Other trusts claiming Code § 642(c) deductions have certain filing

[1288] The CCA, which was issued in the name of Brad Poston, a well-respected senior IRS official, reasoned:

> In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to *Old Colony*. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both *Crown* and *Brownstone* have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

In denying the income distribution deduction, the CCA looked at Reg. § 1.663(a)-2, reproduced in fn. 1286, but took a much closer look at the issues that it said that the regulation definitively resolved. However, the CCA failed to consider Rev. Rul. 73-142, which would seem to resolve the issue in favor of the taxpayer; see fn. 3826, in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers, giving <u>prospective</u> effect to a court modification.

[1289] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67. The probate court order stated:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.

The Tax Court rejected the purposed construction, holding that the will did not provide for charitable contributions during that time period and that there was no ambiguity about that. Note that Rev. Rul. 73-142, referred to in fn. 1288, provides relief prospectively only.

[1290] See fn. 2726, in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[1291] Code § 6034(a). Code § 4947(a)(2) describes:

> … a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in

requirements (Form 1041-A)[1292] unless "all the net income for the year, determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries,"[1293] or the trust is described in Code § 4947(a)(1).[1294]

Charitable contributions are merely deductions and do not trigger issuing a K-1 to the charity.[1295]

II.J.4.d. Possible Change in Beneficiary's Residence

A beneficiary changing residence might change the beneficiary's income tax posture and possibly the trust's residence. See part II.J.3.e State and Local Income Tax.

II.J.4.e. Material Participation for Business or Rental Activities

The 3.8% tax on net investment income[1296] applies to passive activities a trust holds.[1297] However, if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income.

Special rules apply to trusts when determining whether an activity is passive.[1298]

Consider how to document[1299] the trustee's participation as trustee in business activities,[1300] whether the trust should be converted to a beneficiary grantor trust to use

> section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 ….

[1292] Code § 6034(b)(1).

[1293] Code § 6034(b)(2)(A). Form 1041-A instructions refer to Code § 643(b) income. For more on Code § 643(b) income, see parts II.J.8.c.i.(a) Power to Adjust, II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[1294] Code § 6034(b)(2)(B). Code § 4947(a)(1) describes:

> … a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law)….

[1295] See fn. 2747, found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[1296] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1297] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.g Structuring Businesses in Response to 3.8% Tax.

[1298] See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

[1299] See part II.K.1.a.vi Proving Participation.

[1300] The IRS argues that the trust does not get credit for work a trustee does as an individual. See part II.K.2.b.i Participation by a Nongrantor Trust: Authority. Although the IRS has lost in court, one might consider avoiding being a test case. Accordingly, for steps one might consider to comply with the IRS' position, see part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

the beneficiary's work rather than the trustee's work,[1301] and the effect of the beneficiary's participation on any depreciation deductions.[1302]

II.J.4.f. Making Trust a Partial Grantor Trust as to a Beneficiary

If the trustee believes that a permanent change to the trust's income tax posture shifting income to the beneficiary would be helpful,[1303] the trustee might try to convert a trust to a partial beneficiary grantor trust[1304] by exercising discretion to declare a distribution. However, rather than make an actual distribution, with respect to the lesser of $5,000 or 5% of the trust's assets the trustee grants the beneficiary the power to withdraw the declared amount or portion.[1305] When the withdrawal right lapses, presumably Code § 678(a)(2) would make the beneficiary a deemed owner as to that portion.

Over time, the portion deemed owned by the beneficiary increases.

II.J.4.g. Making the Trust a Complete Grantor Trust as to the Beneficiary

If the beneficiary being taxed on the trust's income is desirable, whether because of rates or a desire to accumulate funds in the trust, then consider converting the trust to a qualified subchapter S trust (QSST).[1306]

The trust forms an S corporation, the trust is modified as needed to be eligible for a QSST election, and the beneficiary makes a QSST election.

The beneficiary is taxed on the trust's distributive share of the S corporation's income.

Although the trust must distribute all of its income, income generally means distributions from the S corporation, and the trustee as the sole shareholder can control how much the S corporation distributes.[1307] Note that the trust can continue to be a discretionary trust as to income if all of the income is actually distributed.[1308] Mandatory income is safer in that it prevents a misstep in not distributing enough income, but in some cases the flexibility is more important (in a mandatory income trust, the beneficiary might pressure the trustee to distribute more from the S corporation).

[1301] See parts II.K.2.c Participation When Grantor Trusts Are Involved; Effect of Toggling and III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

[1302] As described in part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses), depreciation deductions often pass through to the income beneficiaries, bypassing the usual fiduciary income tax filter. Therefore, the beneficiary's work is the only counted as participation in deciding whether the deductions are allowable.

[1303] See part II.J.3 Strategic Fiduciary Income Tax Planning.

[1304] See part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.h.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[1305] See text accompanying fns. 1086-1088.

[1306] See parts III.A.3.e.i.(a) QSSTs Generally and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

[1307] See part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries and III.A.4 Trust Accounting Income Regarding Business Interests.

[1308] See parts III.A.3.e.i.(a) QSSTs Generally (especially fn. 3557) and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

Unlike the partial grantor trust strategy mentioned above, this trust's beneficiary grantor status can be toggled off, with income being accumulated in the trust.[1309]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1310]

II.J.4.h. Trapping Income in Trust Notwithstanding Distributions – ESBT

Just as in the above strategy, the trust forms an S corporation, only this time makes an electing small business trust (ESBT) election[1311] or creates another trust.

The trust's distributive share of S corporation income is taxed to the trust, even if distributed to the beneficiary.

To better control the effect of distributions, if the trust reinvests its distributions in taxable investments then it should divide and put those assets in a separate trust.[1312]

If circumstances change, the trust could toggle to being taxed to the beneficiaries.[1313]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1314]

II.J.4.i. Modifying Trust to Make More Income Tax Efficient

In some states, the settlor and all beneficiaries may amend a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust.[1315]

Also, depending on the distribution standard and state law, the trustee might be able to amend a trust using decanting.[1316]

[1309] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

[1310] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

[1311] See part III.A.3.e.ii ESBTs.

[1312] See part III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.

[1313] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

[1314] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

[1315] Uniform Trust Code § 401, found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.4A-411, found at http://www.moga.mo.gov/mostatutes/stathtml/45604A04111.html.

[1316] Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S. Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. Before considering decanting a QSST, see fn. 3552, found in part III.A.3.e.i.(a) QSSTs Generally.

II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure

II.J.4.j.i. Need to Provide Notices

In Missouri and many other states, a beneficiary can sue a trustee any time before five years after the first to occur of the trustee's removal, resignation, or death of the trustee, the termination of the beneficiary's interest in the trust, or the trust's termination.[1317]

However, a beneficiary may not sue a trustee more than one year after the last to occur of the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and the date the trustee informed the beneficiary of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.[1318]

A report adequately discloses the existence of a potential claim if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.[1319] The trustee may choose to disclose less than complete information; in that case, the trustee is protected only with respect to the information that is disclosed.

The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it. Given that a beneficiary's failure to bring a claim might

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[1317] Section 1005(c) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provides:

> (c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:
> (1) the removal, resignation, or death of the trustee;
> (2) the termination of the beneficiary's interest in the trust; or
> (3) the termination of the trust.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[1318] Section 1005(a) and (b) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provide:

> (a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than one year after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.
> (b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[1319] Uniform Trust Code § 1005(b), found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.10-1005.2, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

constitute a gift,[1320] allowing any disputes to settle annually might minimize gift tax issues.

Each year, after a tax return preparer's peak period ends, the preparer might consider suggesting that the trustee contact counsel and obtain help in putting together an annual notice. The tax return preparer can compile the information, especially given that many preparers keep records in PDFs and can easily burn them to a CD. Part II.J.4.j.ii provides an example of what that might look like.

Every trustee should consider following this procedure:

- Litigious Beneficiaries. Having as few years as possible open will help reduce the stakes and make it less worthwhile for them to spend money to take legal action. Annual notices require them to state their concerns now, rather the criticizing many years in the future – put up or shut up. And, if the trustee has made a mistake (nobody's perfect), the trustee is in a better position to rectify it now than after the mistake's effects have been compounded for many years.

- One Big Happy Family. Sure, everyone's happy now. But relationships can change overnight – a beneficiary gets divorced, has a business failure, becomes addicted to drugs, is struck by physical or mental illness that changes his or her outlook on life, undergoes other financial or emotional stress, or simply starts disliking the trustee. Provide notices now, while everyone is happy and unlikely to complain. Besides, the trustee generally should be keeping beneficiaries informed anyway. Notices now can prevent a big claim later if a blow-up occurs.

Generally, a trustee may use the trust's resources to provide notices, respond to questions, provide distributions to some beneficiaries to adjust for perceived unfairness in distributions to other beneficiaries, and defend lawsuits (so long as the trustee did not engage in bad faith or reckless indifference to the beneficiaries' interests).

Countervailing this recommendation are concerns about the effect of notices on the beneficiaries themselves. The trustee might be concerned that knowing that a pool of funds is available for a beneficiary might change the beneficiary's behavior – make the beneficiary more interested in draining the trust than earning a living, generate a sense of entitlement, or encourage the beneficiary to ask the grantor or the grantor's surviving

[1320] The failure to assert a claim is a gift when the right to assert the claim becomes foreclosed, Rev. Rul. 84-105, which is described in fn. 3827, which is found in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers. Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> … the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

If somehow the consent does somehow consist of any power or right to enlarge or shift a beneficial interest, note that a principal/income allocation generally is only a few percent, and a beneficiary's failure to object to an accounting – if somehow characterized as a lapse of a general power of appointment - might very well be less than the 5% lapse of a general power of appointment that, under Code § 2514(e), does not constitute a gift. Having an annual report keeps the grievances within the 5% range.

spouse for money. The trustee will need to weigh those concerns against the trustee's legal exposure and general duties to provide information and might even decide that serving as trustee is too thankless a task. Better to think about these issues now and with eyes opened than to encounter a surprise.

II.J.4.j.ii. Sample Notice

After this paragraph, the rest of this part II.J.4.j.ii is a shell of a notice I have used. The trustee should consult with the trustee's own legal counsel to determine the advisability and sufficiency of such a notice under the circumstances.

Re: Trustee's Notice re: [trust's name]

As you know, the [trust's name] (the "Trust") was created by the [name of trust agreement].

As a beneficiary of the Trust, and on behalf of any other current or future beneficiaries of the Trust, you have the right to request a copy of the [name of trust agreement] and to receive information about the Trust's investments and other activity.

[Disclose any related party transactions.]

The enclosed CD-ROM contains the following information for the Trust for the period of January 1, 20xx, through December 31, 20xx:

1. [any trust accounting regularly prepared]

2. [brokerage statements]: January 1, 20xx, through December 31, 20xx

3. 20xx Fiduciary Income Tax Return for the Trust

4. Investment policy for [brokerage account or for trust as a whole]

If you have any questions with respect to this letter and the information contained on the enclosed CD-ROM, or if you have any difficulty accessing the information, please contact me. If you want to make a claim that I, as trustee, have breached any duty with respect to the Trust, you have one (1) year from the last to occur of (i) the date on which you (or your representative) were sent a report that adequately disclosed the existence of potential claim for breach of trust, and (ii) the date you were informed of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.

Attached you will find an Acknowledgement confirming receipt of this information. Please sign and date the acknowledgement and return it via fax or email to my attention.

Thank you.

[closing]

[page break]

ACKNOWLEDGEMENT

On my behalf and on the behalf of any other current or future beneficiaries, I hereby acknowledge receipt of the Trustee's Notice to the beneficiaries of the [trust's name], which includes reports relating to the trust's activities for the period January 1, 20xx, through December 31, 20xx.

[signature line and date blank]

II.J.5. Issues Arising with Mandatory Income Trusts

Some of the interplay between entities and trusts is described in parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

Also consider what happens when a trust holds only illiquid business assets and the trust needs to pay the trustee fee. Generally, one-half of trustee fees and certain other administrative expenses is allocated to income and one-half to principal.[1321] Using the trust's income to pay trustee fees, etc. attributable to would be problematic. Consider:

- Draft into the trust agreement language flexible enough to opt out of this general rule.[1322]

- Consider exercising a power to adjust, reclassifying some of the entity's distributions from income to principal, if the income that the business generates after the adjustment fairly balances the interests of the income beneficiary and remaindermen.[1323]

- Consider that the trustee might not have any significant activities directly on behalf of the trust and might instead spend most of his or her time running the business entity. This would especially be true if the entity was formed to hold investment assets. Perhaps the business entity should pick up a large majority of the burden of compensating the trustee, so that the above two recommendations are more palatable?

- Have the entity make noncash distributions, which generally are treated as principal.[1324] The trust can then sell those assets and use the proceeds to pay trustee fees. Note that a distribution of property is a recognition event for corporations[1325] and might be a recognition event for partnerships,[1326] so consider distributing high basis assets (which the entity might need to purchase).

[1321] Section 501 of the Uniform Principal & Income Act.
[1322] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1374.
[1323] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1359.
[1324] Section 401(c)(1) of the Uniform Principal & Income Act.
[1325] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[1326] See part II.Q.8.b.i Distribution of Property by a Partnership.

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[1327]

II.J.6. Income Allocation on Death of a Beneficiary

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for the beneficiary's last taxable year or in the gross income of the beneficiary's estate is determined by the computations under Code § 652 for the taxable year of the trust in which his last taxable year ends.[1328] Consider whether income should be expressly payable or not payable to the beneficiary's estate.

If an amount is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under Code § 662 for the taxable year of the estate or trust in which his last taxable year ends.[1329]

Both of these rules are subject to part II.J.9.a Separate Share Rule.

[1327] See parts III.A.4.c.iii.(b) What The Trustee Must Do To Alter The Trust's Investments If The Trust Agreement Does Not Address The Issue and III.A.4.c.iii.(c) How To Minimize Disputes About What The Trustee Should Do.

[1328] Reg. § 1.652(c)-2, which further provides:

> Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

[1329] Reg. § 1.662(c)-2, which further provides:

> Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

II.J.7. Election to Treat a Revocable Trust as an Estate

An election under Code § 645, filing IRS Form 8855, causes a qualified revocable trust[1330] to be taxed as part of an estate. The form is due by the time of the first income tax return filed for the grantor's estate (or grantor's revocable trust, if no probate estate exists). Although the form allows the trust to simply use the estate's EIN, consider whether the trust might not be distributed past the "applicable date" described below and therefore should obtain its own EIN so that accounts do not need to be changed after the "applicable date."

Among benefits are an unlimited charitable set-aside (which is not always beneficial)[1331] and UBTI not reducing the charitable deduction,[1332] deducting losses on funding pecuniary bequests, more favorable time deadlines for holding or making elections with respect to stock in an S corporation, and being able to deduct losses from certain active real estate rental.[1333] However, beware state income results – it might be easier for a state to claim jurisdiction over an estate than a trust, so making the Code § 645 election might convert a nonresident trust to a resident estate;[1334] note that this result might be better if the trust would be taxed in a high-tax state and the estate taxed in a low-or-no-tax state.

This treatment expires on the "applicable date." If no estate tax return is required to be filed, the "applicable date" is two years after the date of the decedent's death;[1335]

[1330] "Qualified revocable trust" means any trust treated under Code § 676 as owned by the decedent by reason of a power in the grantor, determined without regard to Code § 672(e). Code § 645(b)(1).

[1331] Code § 642(c)(1) and the regulations thereunder allow trusts to deduct gross income paid to charity during the taxable year and the following taxable year. Code § 642(c)(2) and the regulations thereunder (as well as Reg. § 1.645-1(e)(2)(i) and(e)(3)(i)) authorize estates to deduct gross income permanently set aside; however, contingent claims, regardless of size, might disallow the entire set-aside deduction. *Belmont v. Commissioner*, 144 T.C. No. 6 (2015). Reg. § 1.642(c)-2(d) provides, "No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." *Estate of John D. DiMarco v. Commissioner*, T.C. Memo. 2015-184, citing *Belmont*, concerned with the uncertainty of administrative expenses in light of litigation, disallowed the charitable set-aside, holding, "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

[1332] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 2743.

[1333] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 1674.

[1334] For example, RSMo § 143.331 (http://www.moga.mo.gov/mostatutes/stathtml/14300003311.html) treats an estate as a resident merely if the decedent was domiciled in Missouri, whereas a trust is not a resident unless not only was the settlor a resident but also the trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

[1335] Code § 645(b)(2)(A).

otherwise, it is six months after the date of the final determination of estate tax liability.[1336] Final determination of estate tax liability is the earliest of the following:[1337]

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

The IRS might not issue a closing letter until the estate requests one, thereby extending the time that a Code § 645 might continue to apply under (A) above.[1338]

After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the Code § 6166 election.[1339]

[1336] Code § 645(b)(2)(B).
[1337] Reg. § 1.645-1(f)(2)(ii).
[1338] See fn. 4351, found in part III.B.3.d.iv.(g).
[1339] Reg. § 1.645-1(f)(2)(ii). Jonathan Blattmachr suggested this idea. Note that Rev. Rul. 76-23 held that, "where the sole purpose for retaining stock of a small business corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under section 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged for purposes of section 641(a)(3), and thus the estate will continue to be an eligible shareholder within the meaning of section 1371(a) for the period during which the estate complies with the provisions of section 6166." Contrast this to an estate, for which Reg. § 1.641(b)-3(a) discusses whether administration is unduly prolonged:

> The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[1340]

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[1341]

Code § 643(a)(3) provides:[1342]

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

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reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

[1340] Reg. § 1.643(a)-3(e), Example (14).

[1341] Code § 643(a) provides:

For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[1342] Code § 643(a)(3) further provides:

Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[1343]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset.[1344] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[1345] Whether other real estate is a capital asset depends on various facts.[1346]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[1347] to the extent it does not constitute certain depreciation recapture.[1348] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[1349] Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

1343 Code § 643(a)(3); Reg. § 1.643(a)-3(a).
1344 Code § 1221(2).
1345 Section 401(c)(1) of the Uniform Principal & Income Act.
1346 See part II.G.11 Future Development of Real Estate, especially fn.688.
1347 Code § 1231(a)(3)(A)(i). See part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.
1348 Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 664. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 665. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015).
1349 Letter Ruling 200243002. For more discussion of goodwill, see fns. 859, 2296, and 2328 (especially the latter).

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal.[1350] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[1351]

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

[1350] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.
[1351] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading would be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[1352] are excluded from distributable net income (DNI).[1353]

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the

[1352] Reg. § 1.643(a)-3(d) provides:

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[1353] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note that (b)(1) relates to determining whether capital gain has been allocated to income for state law purposes, and (b)(2) and (b)(3) relate to distributing capital gains that have been allocated to corpus.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[1354]

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act.[1355]

[1354] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:
>
> (1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,
>
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
>
> (3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.
>
> However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[1355] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.c.i Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[1356]

Generally, the Act allocates capital gains to principal.[1357] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[1358] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

A trustee may adjust between principal and income to the extent the trustee considers necessary if:[1359]

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustments is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

The impartiality component recognizes that an income beneficiary would want the trustee to invest for income and the remaindermen want the trustee to invest for growth. A prudent investor would tend to invest for both income and growth and make fair distributions of total return to the income beneficiary. The power to adjust authorizes the trustee to invest for total return and allocate part of the growth component to the income beneficiary. If the trustee is actually distributing the capital gain to the income beneficiary as part of a fair sharing of the trust's total return, then it would seem fair to tax the income beneficiary on the capital gain that the income beneficiary receives. Depending on the overall situation, it might also be fair to include in that adjustment compensation for the taxes the income beneficiary pays on those capital gains.[1360] Often, the trustee couches the power to adjust in terms of a target percentage of the trust's value; however, the trustee might vary the target percentage as the trustee deems appropriate.

The Act prescribes a number of the factors the trustee should consider[1361] and circumstances that limit or prevent the exercise of this power.[1362] Illinois has a more

[1356] See part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.
[1357] Act § 401.
[1358] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).
[1359] Act § 104(a).
[1360] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[1361] Act § 104(b).
[1362] Act § 104(c).

concise power to adjust that is in some ways more flexible and in some ways less flexible than the Act.[1363]

This power to adjust would not apply when the same standards apply to the distribution of income and principal.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[1364] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.[1365]

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

[1363] 760 ILCS 15/3(b)(2) authorizes the trustee to use discretion in allocating receipts to income or principal:

> if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.

[1364] See part III.A.4 Trust Accounting Income Regarding Business Interests.

[1365] See part II.J.8.c.i.(a) Power to Adjust.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets for important tactical issues in implementing these ideas.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[1366] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[1367] The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.c.iii Advising Clients about the UPAIA Section 505 Changes (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. Computing this average adds to the trustee's recordkeeping burden, although the calculation itself might or might not be simple. For a trust holding marketable securities, the calculation might not take very long. On the other hand, for a trust with closely-held business interests or real estate, the calculation might impose

[1366] Part II.J.8.c.i.(a) Power to Adjust.

[1367] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

additional costs on the trust; in such a case, one might draft a trust applying the unitrust only to easy-to-value assets and using either more traditional principal and income concepts or the power to adjust for difficult-to-value assets.

Beyond practical valuation issues, the main conceptual difference between a unitrust and a power to adjust is that the trustee might vary the percentage applied to the value, whereas a unitrust uses a percentage that never changes.

Providing a fixed unitrust percentage allows the trustee to avoid fights with the income beneficiary and remaindermen over what percentage to use. However, it also can cause the trust to sell assets in a down year. For example, if the trust provides a 3% unitrust and interest and dividends are 2%, the trustee needs to raise the 1% difference by selling assets. That's fine when asset values increase, but it can cause the trust to be depleted if trust values have not increased, especially if the trust has several down years. Using a power to adjust, the trustee might distribute only interest and dividends in down years and distribute capital gains in up years, perhaps making extra distributions in up years to make up for decreased distributions in down years. The problem is that the income beneficiary might rely on a particular level of distributions, and distributing less in a down year might not be acceptable. Using a unitrust based on an average of the past few years' value would help smooth fluctuations, giving the beneficiary time to adjust spending habits when notified that values are down but that the decrease will be spread over time. When assets appreciate, the trustee might consider taking some of those gains and reserving them for down years, so that a unitrust will not have to sell assets in a down market.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to

Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[1368]

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[1369]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];

[1368] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

> State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

[1369] Act § 103(a).

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[1370] The Uniform Principal and Income Act authorizes the trust agreement to override the Act.[1371]

However, Reg. § 1.643(b)-1[1372] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

[1370] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[1371] Section 103(a) of the act provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

[1372] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

The regulation respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[1373]

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

Section 103(b) of the Uniform Principal and Income Act addresses the "reasonable and impartial exercise" requirement:

> In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a

[1373] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

> trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[1374] That language comes from the marital deduction regulations.[1375] Generally, the trustee's

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[1374] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 1496.

[1375] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income*. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

authority to allocate between income and principal does not constitute a power of appointment,[1376] nor does it have generation-skipping transfer tax implications.[1377] The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[1378]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should

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[1376] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

See fn. 1259 for additional authority on ascertainable standards.

[1377] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

> … administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

[1378] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[1379]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

II.J.8.c.ii. Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to

[1379] See fn. 1398.

the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example (3). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. <u>The beneficiary's need for distributions in excess of income is sporadic</u>. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[1380] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[1381] For example, any distribution made on or before March 5, 2016 can be treated as a 2015 or 2016 distribution.[1382] This election applies to the greater of accounting income under

[1380] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

[1381] Code § 663(b).

[1382] In a leap year, the deadline is March 5; in other years, the deadline in March 6.

Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7.[1383] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[1384]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only of the trustee has discretion to distribute corpus.[1385] The income tax return preparer determines that the trust's effective capital gain tax rate is too high relative to the beneficiary's rate, so the trust distributes part or all of the capital gain to the beneficiary. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[1386]

II.J.8.c.iv. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

[1383] Reg. § 1.663(b)-1(a)(2)(i).

[1384] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).

[1385] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 4006. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

[1386] Code § 643(e)(2).

- Electing not to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) unless it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.v. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.v. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind

Except as provided below and except to the extent that it carries out DNI[1387] or constitutes a bequest of income,[1388] a distribution is a nontaxable gift[1389] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[1390]

When a trust distributes property to satisfy a pecuniary obligation, the trust recognizes gain on the deemed sale.[1391] Otherwise, the trust does not recognize any gain or loss unless the trust elects[1392] to treat the distribution as a sale.

The amount deemed distributed is the lesser of the property's basis or fair market value,[1393] unless gain was recognized, in which case it is the property's value.[1394]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.e. Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time.[1395] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[1396]

[1387] Reg. § 1.102-1(d).
[1388] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).
[1389] Reg. § 1.102-1(a), (d).
[1390] See part III.B.1.c Gifts With Consideration – Bargain Sales.
[1391] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

[1392] Code § 643(e)(3).
[1393] Code § 643(e)(2).
[1394] Code § 643(e)(3).
[1395] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.
[1396] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act,[1397] consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[1398]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[1399] Only the following distributions from an entity are not considered trust accounting income:[1400]

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

> related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

[1397] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[1398] In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.

[1399] Act § 401(b).

[1400] Act § 401(c).

- money received in total or partial liquidation of the entity; and

- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[1401] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division.[1402] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[1403]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[1404] Furthermore, interrelated calculations might be required for a mandatory income trust.[1405] Generally, we should look to see whether planning under part II.J.8.c.i Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[1401] See part II.M.3.b Exception: Diversification of Investment Risk.
[1402] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[1403] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 3057.
[1404] See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.
[1405] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.D.2 Trust Accounting and Taxation.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[1406] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[1407]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[1408] Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[1409] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income.[1410] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S.

[1406] Reg. § 1.652(b)-3(a).
[1407] Reg. § 1.652(b)-3(d).
[1408] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

[1409] Reg. § 1.652(b)-3(c).
[1410] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 1064-1065).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[1411]

- Special rules apply to depreciation deductions.[1412]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[1413]

[1411] Reg. § 1.642(c)-3(b)(2) provides:

Determination of the character of an amount deductible under section 642(c). In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:

Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.

Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

[1412] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[1414] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[1415]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[1416] it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[1417]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands[1418] (which, among other things, is important for net investment income tax purposes).[1419]

[1413] Code § 661(b).

[1414] Reg. § 1.661(b)-1.

[1415] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[1416] See fn. 1411.

[1417] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 1411, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

[1418] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust,

> unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[1419] See fn. 1083, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[1420]

When allocating among beneficiaries:[1421]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared

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[1420] Reg. § 1.662(b)-1, which is quoted in fully in fn. 1418. Furthermore, Reg. § 1.652(b)-2(a) provides:

> The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

[1421] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

> (1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.
>
> (2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.
>
> (3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

II.J.9. Separate Share Rule; Trust Divisions

II.J.9.a. Separate Share Rule

In addition to its significance for fiduciary income tax purposes, the separate share rule can be critically important for determining a trust's eligibility for QSST treatment[1422] and for certain nonqualified deferred compensation plans.[1423]

"A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists,"[1424] which really means that "distributions of the trust are to be made in

[1422] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 3563-3565.
[1423] Reg. § 1.404(a)-12(b)(3).
[1424] Reg. § 1.663(c)-2(a), which applies to trusts other than qualified revocable trusts within the meaning of Code § 645(b)(1). For estates and such qualified trusts:

> The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate

substantially the same manner as if separate trusts had been created."[1425] If a trust (or estate) has separate and independent shares, such treatment "must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the

> economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.

Reg. §§ 1.663(c)-3(c) and 1.663(c)-4(c) discuss this economic interest:

> A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Reg. § 1.663(c)-3(b) explains how rights to distributions need to be separated:

> Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:
>
> (1) Distribute, apportion, or accumulate income, or
>
> (2) Distribute corpus
>
> to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

Reg. § 1.663(c)-3(d) explains that remote possibilities of distributions outside the separate share's targeted beneficiaries will not ruin separate share treatment:

> Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

However, such remoteness is not permitted for a QSST. See part III.A.3.e.i.(a) QSSTs Generally, fn. 3563.

[1425] Reg. § 1.663(c)-3(a), which explains:

> Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

trust instrument and the requirements of proper administration require different treatment."[1426] This rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[1427] Special rules apply to specific bequests, trusts with Code § 645 elections, and elective shares;[1428] also see part III.A.3.d Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

If different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income (DNI) allocable to the respective beneficiaries under Code §§ 661 and 662.[1429] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[1430]

- Gross income includible in DNI that is fiduciary accounting income "is allocated among the separate shares in accordance with the amount of income that each

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[1426] Reg. § 1.663(c)-1(d).

[1427] Reg. § 1.663(c)-1(c).

[1428] Reg. § 1.663(c)-4(a) provides:

> Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

Reg. § 1.663(c)-4(b) provides:

> Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

[1429] Reg. § 1.663(c)-1(a). Reg. § 1.663(c)-1(b) elaborates:

> The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:
>
> (1) The filing of returns and payment of tax,
>
> (2) The deduction of personal exemption under section 642(b), and
>
> (3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

[1430] Reg. § 1.663(c)-2(b)(1), which further provides:

> Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

share is entitled to under the terms of the governing instrument or applicable local law."[1431]

- Gross income includible in DNI that is income in respect of a decedent under Code § 691(a) and is not fiduciary accounting income "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."[1432]

- Gross income includible in DNI "that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items) … is allocated among the separate shares in the same proportion as [fiduciary accounting] income from the same source would be allocated under the terms of the governing instrument or applicable local law."[1433]

- "Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."[1434] It is unclear whether (a) this merely keeps the deduction within its share to offset its share's income but allows a net loss from a separate share might lower the trust's and therefore the other shares' tax liability, or (b) it completely prevents the loss generated by one share from reducing the amount included in the income of the other shares' beneficiaries.[1435] I believe that the former is the better view,[1436]

1431 Reg. § 1.663(c)-2(b)(2).
1432 Reg. § 1.663(c)-2(b)(3).
1433 Reg. § 1.663(c)-2(b)(4).
1434 Reg. § 1.663(c)-2(b)(5).
1435 Although the above allocations govern the allocation of DNI, Code §§ 661 and 662 govern how much income the trust can deduct and consequently include in a beneficiary's income. That amount is the lesser of DNI or the sum of income required to be distributed for a taxable year and any other amounts properly paid or credited or required to be distributed for such taxable year. Code § 661(a). These amounts are allocated to the beneficiaries and included in their income. Code § 662(a).
However, because the only mechanism for a beneficiary to deduct a loss is either depreciation deductions (see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss) or loss on termination (Code § 642(h)), a beneficiary cannot deduct a loss and the trust cannot carry over a loss other than one generated by a business (Code § 642(d)) or a capital loss (Code § 1212). Thus, if a separate share has a net loss, the beneficiary(ies) will not deduct that loss. See part II.J.3.i Planning for Excess Losses.
Consider the following scenario: Trust has $10,000 of taxable interest income, allocated to share A, and $10,000 of state income tax liability, attributable to taxes on the prior year's municipal bond interest earned by share B earned before the bonds were sold at no gain or loss. The trust distributes $10,000 to A and $10,000 to B, each out of her own share. The trust's taxable income, ignoring exemptions, is zero. Applying Reg. § 1.663(c)-2(b)(5) to disallow the state income tax deduction would result in A including $10,000 in income and the trust having a $10,000 loss ($10,000 interest income minus the $20,000 sum of the $10,000 income distribution deduction and the $10,000 state income tax liability). Which is correct: zero taxable income for everyone, or $10,000 taxable income to A and the trust has a $10,000 loss that benefits nobody?

although when taking that position one might attach IRS Form 8275-R because on its face that position appears to contradict Reg. § 1.663(c)-2(b)(5).[1437] If one or more separate shares benefit from the overall ceiling of tax liability, then the trustee should consider making an equitable adjustment to compensate the share that generated the loss for the benefit that the other share(s) received – especially because that loss is probably reflected in lower tax basis of assets held by the share that generated the loss. If one is doing an interim division of a trust, holding some back in the general residue but opening up a separate account within a trust to represent a separate share for each beneficiary or group of beneficiaries, one might consider raising this issue and clarifying the approach to be taken if one share generates a loss.

In making the above allocations to separate shares, "the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations…."[1438] For

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In other words, does the trust's overall DNI of zero control, or do A's DNI of $10,000 and B's DNI of negative $10,000 control?

Consider another scenario: share A has $10,000 of dividends and $10,000 of capital gain through a partnership that distributes $20,000 as a distribution of operating income (and not a distribution in partial liquidation), and share B has no dividends and $10,000 of capital loss through a partnership that distributes $20,000 of cash as a distribution of the prior year's operating income. On Form 1041, Schedule D, the capital gain and loss offset. We know that the separate share rule prevents B from reporting any of A's income. However, does the separate share rule tax $20,000 ($10,000 of dividends and $10,000 of capital gain) or $10,000 (dividends only, because capital gains were offset by capital loss) to A? If the former, what mechanism is there for preserving the $10,000 capital loss allocated to B? Nowhere do the Instructions for Schedule D (Form 1041) address this issue; even if one allocated share B's capital loss to the trust instead of to the beneficiaries, neither the tax return nor the Capital Loss Carryover Worksheet in the Instructions provides a mechanism that prevents netting the beneficiaries' capital gain against the trust's capital loss in a manner that would generate a capital loss carryover for share B.

[1436] Yu, "Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate," 5 Pitt. Tax Rev. 123 (2008) (saved as my document no. 6167169), reviews the two approaches to resolve the issue raised in fn. 1435 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's article cited F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008), as saying on pages 3-104 to 3-105 the following about Reg. § 1.663(c)-2(b)(5):

> Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

Informal email conversations with Lad and Jonathan in April 2015 confirmed that they had not changed their view on this issue.

Reg. § 1.663(c)-1(a) explains the philosophy of the separate share rules, applying them to an example, and concludes, "In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B." Yu's preferred approach that I adopted does not cause any income to be shifted from one beneficiary to another; it merely limits the estate's deduction consistent with the overall DNI limitation of Code § 661(a).

[1437] Such an explanation is saved as my document no. 6149985.

[1438] Reg. § 1.663(c)-2(c).

example, a principal distribution from one share that is disproportionately larger than a principal distribution from another share should affect the relative allocation of income between those shares.[1439]

However, the amount the trust deducts[1440] and the amount each separate share includes in income[1441] is the lesser of the DNI allocated to[1442] or the amount actually distributed to that separate share.

If a beneficiary dies, to the extent that this part II.J.9.a does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

II.J.9.b. Trust Divisions

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[1443] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI. [1444]

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter

If an estate tax audit results in higher values and therefore higher basis, the related fiduciary income tax return might need to be amended to take advantage of higher basis to reduce gain on sale of assets or increase depreciation deduction.

[1439] Reg. § 1.663(c)-5, Example (3) provides:

> The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

T.D. 8849 added this example December 27, 1999, presumably superseding the approach taken in Letter Ruling 9644057, which ruling approved disproportionate distributions of principal without changing the distribution of income.

[1440] Code § 661(a).

[1441] Code § 662(a).

[1442] Code § 663(c) allocates DNI and therefore is a factor the determining, rather than the sole determinant of, the amount deducted by the trust or estate and included in the beneficiary's income.

[1443] Letter Ruling 201642028.

[1444] Letter Ruling 201642028.

II.J.11. Trust Business Income Tax Nuances

II.J.11.a. Depreciation Advantages and Disadvantages

II.J.11.a.i. Code § 179 Disallowance for Nongrantor Trust

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[1445] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[1446] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed.[1447] Presumably, this complexity would be avoided by using a grantor trust.[1448]

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses)

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary

When a depreciation deduction of a trust is allocable to its beneficiaries, and where such deductions if separately taken into account by the trust would result in an income tax liability for the trust different from that which would result if the trust did not take such deductions into account separately, then the partnership's depreciation must be separately reported on the K-1 that the trust receives; a similar rule applies to depreciation allocated between a life tenant and the remaindermen or between an estate and its beneficiaries.[1449]

[1445] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).

[1446] Code § 179(d)(4).

[1447] Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense (including bonus depreciation – see part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation) to the trust or estate. Presumably, an S corporation or partnership would allocate the asset's inside basis, depreciation expense, and other tax attributes to the trust, including not reducing the basis of the trust's interest in the business until depreciation expense is incurred.

[1448] See fn 2417, citing Rev. Rul. 2007–13 as further authority (beyond Rev. Rul. 85–13) that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

[1449] Rev. Rul. 74-71. See 2013 Form 1041, Schedule K-1, line 9. Code § 167(d) provides:

> *Life tenants and beneficiaries of trusts and estates*. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

The allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;[1450] however, if the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve is apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each,[1451] and the trust agreement may not override this rule.[1452] No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument.[1453] I am unaware of any guidance how to allocate in a sprinkle trust; presumably, those beneficiaries who tend to receive distributions would be the ones entitled to the depreciation deductions.

If a trust holds mortgaged property and the trustee charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, depreciation must be allocated to the trust, by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated and the denominator of which is the total trust income computed under Code § 643(b).[1454]

For an in-depth discussion of allocating depreciation, see Lawson, "Tax Planning for Rental Real Estate Owned by a Trust," *Estate Planning Journal* (Vol. 40, No. 9, Sept. 2013).

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss

Although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.[1455]

See Ransome, "Allocating Partnership Depreciation Between Trusts and Beneficiaries,"
For an elaboration on rules governing estates, see *Estate of Nissen v. Commissioner*, 345 F2d 230 (4th Cir. 1965), *rev'g* 41 T.C. 522 (1964); *Lamkin v. U.S.*, 533 F2d 303 (5th Cir. 1976).

[1450] Code § 642(e) provides:

> An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(d) and 611(b) .

[1451] Reg. § 1.167(h)-1(b), incorporated by reference by Reg. § 1.642(e)-1, the latter of which (not yet amended to reflect changes made by P.L. 101-508, P.L. 97-34, P.L. 94-455) provides:

> An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

[1452] *Dusek v. Commissioner*, 376 F.2d 410 (10th Cir. 1967).

[1453] Reg. § 1.167(h)-1(b).

[1454] Rev. Rul. 90-82.

[1455] Rev. Rul. 74-530.

Therefore, a fiduciary might be able to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust.[1456]

See also part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property

If the trust holds depreciable property through a partnership, the trustee might not be making any decision regarding depreciation reserve, if the trustee is counting on the partnership to make any appropriate reserve.[1457] In that case, presumably the depreciation deduction would be allocated solely to the beneficiaries who do or may receive current distributions. Furthermore, passing the deductions through to any beneficiaries who participate in the business would simplify any passive loss issues (if and to the extent that the passive loss rules do not supersede this part II.J.11.a.ii),[1458] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[1459]

If a trust holds depreciable property through an S corporation, consider the following:

- If a nongrantor trust is permitted to hold the stock without making an ESBT or a QSST election,[1460] then see the discussion above regarding partnerships.

- If and to the extent an ESBT is a nongrantor trust, the depreciation deductions are trapped inside the trust.[1461] (This is a bad result if the trust is included in a person's estate.)[1462]

[1456] Rev. Rul. 74-530.

[1457] Query whether the aggregate theory of partnership taxation affects this analysis any.

[1458] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

[1459] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

[1460] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation and III.A.3.e QSSTs and ESBTs.

[1461] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, which generally traps in a trust all items on an S corporation's K-1. Reg. § 1.641(c)-1 does not expressly discuss the depreciation issue, the only authority being Reg. § 1.641(c)-1(d)(2)(i):

> (i) *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. [then discusses ESBT elections for a partial year]

The second sentence tends to suggest applying this part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) would apply to S corporation K-1 items. However, in requiring breaking out separately stated items, Code § 1366(a)(1)(A) cross-references Code § 702(a)(4), (6), but depreciation deductions under this this part II.J.11.a.ii would fall under Code § 702(a)(7) by reason of Reg. § 1.702-1(a)(8)(ii). On the other hand, fiduciary

- If and to the extent the trust is grantor trust deemed owned by the grantor or the beneficiary (the latter including QSSTs), the deemed owner (including the deemed owner of an ESBT)[1463] would be allocated the depreciation deductions, because the grantor trust rules supersede everything.

II.J.11.b. Code § 1244 Treatment Not Available for Trusts

Individuals may deduct as an ordinary a loss incurred on the first $50,000 or $100,000 on the sale of small business corporation stock under Code § 1244.[1464]

Trusts and estates are not entitled to this treatment.[1465]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[1466] so that the S corporation's ordinary losses will provide current annual benefit to the trust, and the trust's basis in the stock would be correspondingly reduced, which reduces the chance of the trust having a capital loss on disposition of the S corporation stock. Therefore, this issue is much more of concern for trusts owning C corporation stock than for trusts owning S corporation stock.

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act

Articles by Dobris (1979)[1467] and Blattmachr (1984)[1468] seem to be the leading authority in this area.

Harris Trust & Sav. Bank v. MacLean, 542 N.E.2d 943 (1st Dist. Ill. 1989), involved a common situation: Trust recognizes big capital gain and pays federal and state capital gain tax. Both taxes are charged to principal. However, the income beneficiaries benefitted the following year by deducting the state capital gain tax. The court held that the trustee could not reduce the beneficiaries' income account by the tax benefit they received, because a trustee should be able to make an equitable adjustment only for inequities resulting from a trustee's discretionary decisions.[1469] The court viewed the tax

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income tax return form instructions refer to items under this part II.J.11.a.ii from a pass-through; by not specifying the type of pass-through, do these instructions suggest that S corporation items would fall under this part II.J.11.a.ii? Ultimately, the issue appears decided in favor of trapping these deductions in the trust by the language at the end of Code § 641(c)(2)(C), "…no item described in this paragraph shall be apportioned to any beneficiary," which per Code § 641(c)(2)(C)(i) includes any item described in Code § 1366.

[1462] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[1463] Reg. § 1.641(c)-1(c).

[1464] Part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation.

[1465] Code § 1244(d)(4).

[1466] See part II.G.3.c.i Basis Limitations for S Corporation Owners.

[1467] "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms," 65 *Iowa L. Rev.* 103 (1979), saved as Thompson Coburn doc. no. 6174776.

[1468] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).

[1469] The court reasoned and held:

benefit from the deduction of state income taxes to be very small compared to the sales proceeds that benefitted the principal beneficiaries, even though the benefit was probably hundreds of thousands of dollars. Blattmachr had indicated mixed results on this issue before this case was decided.[1470]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[1471] takes the following approach:[1472]

> The question of whether a trustee is required to make an equitable adjustment between the trust's income and principal accounts where inequitable consequences result from the mandatory application of tax laws is one of first impression in Illinois. Several courts in other jurisdictions have addressed this issue. Some courts have suggested that an equitable adjustment should only be applied in response to a trustee's election or discretionary decision (*In re Dick's Estate* (1961), 29 Misc.2d 648, 218 N.Y.S.2d 182; *In re Kent's Estate* (1964), 23 Fla. Supp. 133), while one court has approved an adjustment to correct inequities not caused by any discretionary decision of the trustees (*Rice Estate* (1956), 8 Pa. D & C 2d 379) and another has rejected a distinction between discretionary decisions and mandatory applications (*In re Holloway's Estate* (1972), 68 Misc.2d 361, 327 N.Y.S.2d 865).
>
> We believe the better view is that equitable adjustments should be applied only in response to inequities resulting from a trustee's discretionary decisions which favor one beneficiary or class of beneficiaries over another. We agree with the trustees' position that the common law doctrine of equitable adjustments should only be employed in such circumstances because this concept is grounded in the fiduciary duty of a trustee not to be partial in making decisions or elections impacting on successive beneficiaries. (See *In re Warms' Estate* (Surr. Ct. 1955), 140 N.Y.S.2d 169; *In re Bixby's Estate* (1956), 140 Cal.App.2d 326, 295 P.2d 68.) The fiduciary should not be required to cure the inequities resulting from the application of mandatory tax laws; rather, any corrective action is more properly left for the legislature. *In re Dick's Estate*, 29 Misc.2d 648, 218 N.Y.S.2d 182; accord *In re Kent's Estate*, 23 Fla. Supp. 133.

I have been told that a Massachusetts court reached the same result.

[1470] See fn. 1468, ¶ 1403.3 Corpus Expenses Benefit Income and Not Corpus but Not as a Result of Fiduciary Election, fns. 30-33. A leading case he cited, *In re Holloway's Estate*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held:

> It is this court's considered opinion, however, that the *Dick* case rationale lacks the requisite equitable approach. As one writer observed: "Sections of the 1954 Code dealing with estate and trusts yield other examples directly contrary to both estate and trust law and common sense. For example, subchapter J, part I, was apparently drawn by tax lawyers not entirely familiar with trust concepts or fiduciary accounting principles. *The fiduciary and the court must be free in such cases to repair the damage by equitable adjustment*" (Browning, Problems of Fiduciary Accounting, 36 N.Y.U.L.Rev. 931, p. 953 [1961]). (Italics supplied.)

[1471] However, 760 ILCS 15/3(b)(2) allows a trustee to reallocate receipts "if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal." The statute enacting the quoted provision was included in 1991 Ill. Legis. Serv. P.A. 87-714 (S.B. 717) (WEST).

[1472] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

Section 506. Adjustments Between Principal And Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

The official Comments include:

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

> Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

See also part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation.

Settlement of an ambiguous provision allocating capital gain tax between income and principal should not carry with it any gift, GST, or income tax consequences (except, of course, to the extent that they modify cash distributions that carry out DNI).[1473]

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not

A nongrantor trust's NII passes through to beneficiaries as NII.

For a nongrantor trust, the determination of whether business income is passive and therefore constitutes NII is made at the trust level.

If the beneficiary is active but the trustee is not, considering doing the following:

1. The trust contributes its interest in the partnership or sole proprietorship into one or more S corporations.

2. The trust converts into a trust eligible to be subjected to a QSST election.

3. The beneficiary makes a QSST election.

For cautions in applying this strategy, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

[1473] Letter Ruling 201528024, addressing construction of a provision directing the trustee to collect all the income and out of such income pay or provide for "all proper taxes."

II.J.14. Application of 3.8% Tax to ESBTs

Electing small business trusts (ESBTs)[1474] are separated into S and non-S portions[1475] and subjected to the NII tax as follows:[1476]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[1477] and then combine these amounts to calculate the ESBT's undistributed net investment income.

2. The ESBT calculates the non-S portion's-adjusted gross income,[1478] increased or decreased by the S portion's net income or net loss, after taking into account all the S portion's deductions, carryovers, and loss limitations, as a single item of ordinary income (or ordinary loss).

3. The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income, or (b) the excess of the ESBT's adjusted gross income[1479] over the dollar amount at which the highest fiduciary income tax bracket begins.

Beyond the 3.8% tax on NII, consider parts II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, particularly noting the IRS' position on NOLs incurred by an ESBT when the S corporation stock it owns generates losses.[1480]

1474 See part III.A.3.e.ii ESBTs.

1475 Reg. § 1.1411-3(c)(1) provides:

> The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

1476 Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

1477 In the manner described in Reg. § 1.1361-3(e).

1478 As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

1479 As calculated under Reg. § 1.1361-3(c)(2)(ii).

1480 See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3597.

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax)

The preamble to the 2013 proposed regulations for net investment income tax generally explains the regular income tax treatment of sales involving QSSTs when discussing how the proposed regulations would treat the sales for net investment income tax purposes:[1481]

> H. <u>Qualified subchapter S trusts (QSSTs)</u>
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).
>
> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.
>
> For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.
>
> One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that

[1481] REG-130843-13.

the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.

This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.

First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.

Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs [1482] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

[1482] Particularly the text accompanying fns. 3568-3570, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional

For planning issues relating to the dispositions described in this part II.J.15.a, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

II.J.15.b. QSSTs and State Income Tax Issues

As a grantor trust with respect to S corporation items, the trust is not subjected to state income tax on those items; instead, the beneficiary is.

A state might even treat the trust as not existing while it is a grantor trust, providing the opportunity to treat the trust as a nonresident trust if the grantor moves to another state (for example, a state with no income tax).[1483] Thus, if a QSST holds only S corporation stock, then the QSST election might allow the trust's residency to be determined at a later, perhaps more favorable date.[1484]

Some trust agreements provide that any S corporation will be held in a separate QSST, leaving the original trust undisturbed as to any provisions that might be consistent with QSST status. This approach would appear to maximize the possibility of the delayed residence determination described above.

Of course, one would also want to consider the other factors mentioned in part II.J.3 Strategic Fiduciary Income Tax Planning rather than focusing exclusively on this issue.

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets

Consider the following:

- The sale of ownership of a business entity is allocated to principal. Assuming the business interest is a capital asset, any capital gain is included in DNI only if certain exceptions are satisfied[1485] and any ordinary income[1486] is automatically included in DNI.[1487]

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planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). See also part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs, especially part III.A.3.e.v.(b) Implementation and, within that, the paragraph that includes a reference to fn. 3640.

[1483] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

[1484] Illinois Schedule K-1-P, which partnerships and S corporations use to report K-1 income includible in their owners' income, has a separate line, line 9b, which was "expanded to allow grantor trusts and other federally disregarded entities to identify the taxpayer that will report the income or loss shown on the Schedule K-1-P…." See Illinois Dept. of Rev. Info. Bulletin, No. FY 2013-09, 01/01/2013. That line was also on 2014 returns.

[1485] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[1486] For example, the sale of a partnership interest might generate ordinary income from the sale of "hot assets" – see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.

[1487] Code § 643(a).

- A flow-through entity might sell its assets, or a sale of S corporation stock might be taxed to the shareholders as a sale of the entity's assets followed by the corporation liquidating.[1488] Generally, assets used in business activities do not constitute capital assets, so capital gain from their sale is included in DNI without needing to apply the special rules for gain from the sale of a capital asset,[1489] and of course any ordinary income generated by depreciation recapture is included in DNI as well. Goodwill is a capital asset unless it has been subject to any amortization.[1490] Because this gain/income is included in DNI, the allocation of such gains to principal does not cause any particular limits to be placed on shifting them to beneficiaries if they are properly paid, credited, or required to be distributed.[1491] However, if and to the extent that they are not paid or credited during the year or within 65 days thereafter[1492] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[1493]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[1494] Often the best way to prevent these items from triggering AMT is to pay them in the year in which the income that generated them is recognized. Given that a state might allow one to use the prior year's income tax as a safe harbor or might not require estimated tax payments at all, one might easily overlook the need to pay state income tax in the year of the sale (or other major income recognition event).

Although items on a K-1 from an S corporation generally are taxed the beneficiary as if the QSST were a grantor trust, gain from sale of the stock and gain from the sale or deemed sale of the corporation's assets (even if reported on a K-1) are taxed to the trust, not as part of the grantor trust portion.[1495] However, if the beneficiary's federal and state/local income taxation (including the 3.8% tax net investment income) are more favorable than the trust's and a distribution form the trust would not frustrate the trust's objectives, consider using the ideas in the bullet points above to shift taxation on any items otherwise taxable to the trust. It is not unusual for an income tax preparer to be unfamiliar with the QSST rules regarding taxation of the sale or deemed sale of the corporation's assets and not to plan for the correct taxation, so be sensitive to this issue up front and also consider reallocating principal to income if the trust is a mandatory

[1488] See parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[1489] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[1490] See fns. 2324-2328.
[1491] Code § 661(a)(1), (c).
[1492] See part II.J.2 Tactical Planning Shortly After Yearend.
[1493] See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[1494] Code § 56(b)(1)(A)(ii).
[1495] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs (particularly the text accompanying fns. 3568-3570, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale) and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result.

income trust.[1496] Although one might initially view the election to tax a stock sale as a sale of the business' assets (followed by liquidation) as merely substituting gain on the sale of assets for gain on the sale of stock, note that state income taxation might also generate surprising results; see part II.H.8.a.ii State Income Tax Disconnect.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[1497] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[1498] making an allocation to the S portion even more desirable. In addition to that concern, allocating state income tax to the non-S portion might generate a large alternative minimum tax bill,[1499] which would not be owed if allocated to the S portion and paid in the year of sale.

If the trust is a QSST or if the trust is a grantor trust that would be converted to an ESBT shortly before the sale, consider making the trustee active in the business to maximize opportunities to avoid the 3.8% tax on net investment income and, in the case of a grantor trust, converting it to an ESBT far enough in advance of the sale for the trustee to accumulate sufficient hours of participation. See generally part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax

This part II.J.17 assumes that avoiding NII characterization is the most important objective. Before making that assumption, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.[1500]

Making income from operations and gain on sale be nonpassive income is the key to avoiding NII characterization:

- Generally, income from a trade or business is exempt from the 3.8% tax if it is nonpassive income.[1501]

[1496] See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation. In a QSST, one might be able to allocate principal to income to make up for expenses ordinarily allocated to principal that were allocated to income as an adjustment needed due to cash flow issues; see text accompanying fns. 3559-3562 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 1374, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[1497] For ESBT tax issues, see parts II.J.14 Application of 3.8% Tax to ESBTs and III.A.3.e.ii.(b) ESBT Income Taxation - Overview, the latter especially including fns. 3599-3600.

[1498] Code § 642(h). See part II.J.3.i Planning for Excess Losses.

[1499] Code § 56(b)(1)(A)(ii).

[1500] Particularly note the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3597.

[1501] See part II.I.8 Application of 3.8% Tax to Business Income.

- Gain on the sale of assets used in a nonpassive trade or business (or from the part of the sale of a partnership interest or S corporation stock allocable to such assets) is exempt from the 3.8% tax.[1502]

- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[1503]

Consider the following:

- In an ESBT, the trust is the taxpayer.

- In a QSST, for normal operations, the beneficiary, as deemed owner under the grantor trust rules, is the taxpayer.

- In a QSST, when the business is sold, generally the trust will be the taxpayer.[1504]

- In a grantor trust, the deemed owner is the taxpayer, but the deemed owner might turn off the grantor trust powers before selling the business, generally making the trust the taxpayer, whether the trust is an ESBT or a QSST (or the business is taxed as partnership).

Thus, even when a trust is taxable to the grantor or beneficiary under the grantor trust rules, one might consider establishing the trustee's material participation at least a year before the business might be sold;[1505] whether this would count given the trust's being disregarded for income tax purposes has never been addressed, but, with rules regarding trust material participation so uncertain, these extra precautions might be worthwhile if the tax at risk is significant enough. This might require jumping through extra hoops if the entity was formed as a state law corporation, because a traditional corporate structure does not lend itself to the type of participation the IRS seeks.[1506]

For more discussion of QSSTs and ESBTs, see generally part III.A.3.e QSSTs and ESBTs, which compares and contrasts those types of trusts and discusses strategies for switching back and forth.

II.J.18. Other Special Purpose Trusts

See part II.D Special Purpose Trusts.

[1502] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[1503] See part II.K.1.a Counting Work as Participation.
[1504] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[1505] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[1506] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

II.K. Passive Loss Rules

II.K.1. Passive Loss Rules Generally

Although owners of partnerships and S corporations[1507] generally can deduct losses, subject to various basis and at-risk limitations, a passive loss from a trade or business[1508] is deductible only against other passive income[1509] or when the activity that generated the loss is sold;[1510] when a taxpayer disposes of a passive activity with current and suspended passive losses that exceed the gain on disposition, the net passive income and net passive losses from all of the taxpayer's other passive activities should be netted before any excess passive income is applied against the current and suspended passive losses from the disposed of activities, and any excess losses from

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[1507] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016) ("In conclusion, we AFFIRM the decision of the Tax Court essentially for the reasons set out therein."), rejected a shareholder's argument that S corporation income is not subject to the passive losses because Code § 469 does not directly apply to S corporations, holding:

> Since S corporations and other passthrough entities do not pay tax, section 469 need not identify them as "taxpayers" to whom it applies, because the individual shareholders of an S corporation are the taxpayers to whom section 469 applies. The Court has previously recognized that income and losses from passthrough entities are subject to section 469, even though passthrough entities are not specifically included in the list of "taxpayers" to whom section 469 is applicable. See, *e.g.*, *Harnett v. Commissioner*, T.C. Memo. 2011-191 (applying section 469 to losses attributable to rental properties owned by an S corporation), *aff'd*, 496 Fed. Appx. 963 (11th Cir. 2012); *Dunn v. Commissioner*, T.C. Memo. 2010-198 (analyzing the grouping rules of section 469 with respect to various entities, including an S corporation); *Shaw v. Commissioner*, T.C. Memo. 2002-35 (applying section 469 and section 1.469-2(f)(6), Income Tax Regs., in various contexts, including the context of property leased by an S corporation); *Sidell v. Commissioner*, T.C. Memo. 1999-301 (holding income received via grantor trusts and reported as a passthrough item on taxpayers' Federal income tax returns was subject to section 469). The law is well settled in this area, and in numerous cases the Court has applied the passive loss limitations of section 469 to individuals who receive income from passthrough entities.

[1508] A mortgage or banking activity is a trade or business subject to the passive loss rules. INFO 2009-0229.

[1509] Code § 469(d)(1)(B).

[1510] Code § 469(g)(1), (3). Worthless stock is considered disposed of for purposes of this rule. See fn. 573. A foreclosure on real property subject to recourse debt comprising a taxpayer's entire interest in a passive (or former passive) activity qualifies as a fully taxable disposition for purposes of Code § 469(g)(1)(A), even if the foreclosure triggers cancellation of indebtedness (COD) income that is excluded from gross income under Code § 108(a)(1)(B). CCA 201415002. However, if partnership property is foreclosed upon, the partnership lists the property as an asset on its tax returns, and the partnership is pursuing counterclaims, the foreclosure does not constitute a disposition. *Herwig v. Commissioner*, T.C. Memo. 2014-95 (accuracy-related penalties imposed when taxpayer did not introduce evidence of reasonable cause for taking the position).

Although a QSST's disposition of stock is taxable to the trust (see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets), the trust's disposition is treated as a disposition by the beneficiary for purposes of Code §§ 465 and 469. Code § 1361(d)(1)(C).

the disposed of activity are treated as nonpassive under Code § 469(g)(1)(A).[1511] Losses disallowed by the passive loss rules are suspended and carried into future years.[1512] If the business interest is transferred by gift, any suspended passive losses are permanently lost but added to basis;[1513] for disposition by death, see part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Losses.

Passive income does not include gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.[1514]

The material participation rules are based on the number of hours the taxpayer participates in the activity[1515] and therefore encourage taxpayers to group businesses together as one activity (so that the hours from various activities can be aggregated to meet the necessary threshold).[1516] On the other hand, the complete allowance of a loss on the sale of an activity discourages grouping, since selling only part of the grouped activity will not be a complete disposition.

A passive income generator tends to be viewed favorably, in that it allows passive losses to be deducted. However, given the 3.8% tax on passive investment for high-income taxpayers and trusts,[1517] generating passive income in excess of losses might lead to unfavorable tax results. Thus, taxpayers might seek to transform passive income into nonpassive income, if they can do so without disallowing passive losses or triggering self-employment tax.[1518] Further below is a discussion of when passive income would be recharacterized as nonpassive income, in the IRS' efforts to minimize passive income against which passive losses can be deducted.[1519]

Conversely, although limitations on using net passive losses might not save regular income tax on nonpassive income, an abundance of passive losses can be helpful to the extent that they prevent passive business income from being subjected to the 3.8% tax on net investment income.[1520]

[1511] TAM 9742002. For the impact of Code § 469 on the 3.8% net investment income tax, see part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, particularly the text accompanying fn. 1201.
[1512] IRS Publication 925 explains the passive loss and at-risk rules generally. The IRS' "Passive Activity Loss Audit Technique Guide is at http://www.irs.gov/pub/irs-mssp/pal.pdf, which can also be viewed through http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-Audit-Technique-Guide-ATG-Table-of-Contents.
[1513] Code § 469(j)(6).
[1514] Code § 469(e)(1)(A)(i)(I).
[1515] See part II.K.1.a Counting Work as Participation.
[1516] See part II.K.1.b Grouping Activities.
[1517] See part II.I 3.8% Tax on Excess Net Investment Income.
[1518] See part II.L.1 Income Subject to Self-Employment Tax, including the exclusion of certain types of income from SE tax.
[1519] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.
[1520] See generally part II.I 3.8% Tax on Excess Net Investment Income (NII).

II.K.1.a. Counting Work as Participation in Business under the Passive Loss Rules

II.K.1.a.i. Taxpayer Must Own an Interest in the Business to Count Work in the Business

An individual needs to own an interest in an activity for the individual's work to count as participation.[1521] When counting hours that a taxpayer performs services in real property trades or businesses during a taxable year, personal services performed as an employee count only if the employee is a 5% owner.[1522]

A taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[1523]

[1521] Reg. § 1.469-5(f)(1) provides:

> *In general*. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

Neither the final regulation nor Reg. § 1.469-5T(f) promulgate other paragraphs that qualify this rule.

The parentheticals at the end of Reg. § 1.469-5T(a)(2), (3) imply that participation is done only by an owner.

To drive home the ownership requirement, Reg. § 1.469-5T(k), Example (6) provides:

> The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (5) to which this example refers is Reg. § 1.469-5(k), Example (5):

> In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469-1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to § 1.469-5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation for those years were determined without regard to § 1.469-5T(a)(5). Under § 1.469-5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to § 1.469-5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under § 1.469-5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to § 1.469-5T(a)(5) for five of the last ten immediately preceding taxable years.

[1522] *Calvanico v. Commissioner*, T.C. Summary Opinion 2015-64, citing Code § 469(c)(7)(D)(ii) and Reg. § 1.469-9(c)(5), cross-referencing Code § 416(i)(1)(B).

[1523] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid and applied it to count activity through a C corporation that was subject to Code § 469 even though the regulation was promulgated in the context of grouping activities

The owner in an interest in an organization may materially participate in the activities of a wholly owned subsidiary of the organization.[1524]

II.K.1.a.ii. Material Participation

An individual shall be treated as materially participating in an activity for the taxable year if and only if:[1525]

(1) The individual participates in the activity for more than 500 hours during such year;[1526]

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year, <u>if the owner is not a limited partner</u>;[1527]

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year,[1528] <u>if the owner is not a limited partner</u>;[1529]

(4) The activity is a significant participation activity[1530] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours, <u>if the owner is not a limited partner</u>;[1531]

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together. Presumably it reached that result because grouping of activities is mandatory to a certain extent; see Reg. § 1.469-4(d)(5)(i), which provides:

> *In general*. A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section....

Williams v. Commissioner, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), reaffirmed the *Schwalbach* holding that Reg. § 1.469-4(a) is valid.

[1524] Letter Ruling 201029014.

[1525] Reg. § 1.469-5T(a). *Mordkin v. Commissioner*, T.C. Memo. 1996-187, rebuffed a taxpayer's claim that the quantitative tests in the following bullet points are invalid.

[1526] Reg. § 1.469-5T(a)(1).

[1527] Reg. § 1.469-5T(a)(2).

[1528] Hiring a management company undermines this test if any management company employee works more than the owner, as was the case in *Schumann v. Commissioner*, T.C. Memo. 2014-138. The taxpayer satisfied this test in *Kline v. Commissioner*, T.C. Memo. 2015-144; having a variety of employees (and documenting the hours they worked) helped assure that no employee's work exceeded the work of the taxpayer and spouse (see part II.K.1.a.iii Spousal Participation).

[1529] Reg. § 1.469-5T(a)(3).

[1530] Reg. § 1.469-5T(c) provides that an activity is a significant participation activity of an individual if and only if such activity is a trade or business activity (within the meaning of Reg. § 1.469-1T(e)(2)) in which the individual participates for more than 100 hours during the taxable year and would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to the significant participation activity rules.

[1531] Reg. § 1.469-5T(a)(4). To better understand how to apply the significant participation test, consider the following: Assume T, an individual, has $500,000 in taxable income for the taxable

(5) The individual materially participated in the activity (determined without regard to this bullet point) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;[1532]

(6) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year;[1533] or

(7) Based on all of the facts and circumstances,[1534] the individual participates in the activity on a regular, continuous, and substantial basis during such year, if the owner is not a limited partner.[1535]

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year, and is the sole owner of S corporations 1, 2, and 3, which are engaged in trade or business Activities 1, 2, and 3 respectively. Business 1 has at least one full-time employee. T participates 400 hours in Activity 1, 90 hours in Activity 2, and 90 hours in Activity 3, which is the same kind of trade or business as Activity 2, but is a different business. If T does not group Activity 2 with Activity 3, then the material participation test is not satisfied, and the net income from Activity 1 is nonpassive (see part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, particularly fns. 1689-1694) and the net loss from Activity 1 and net income or loss from Activities 2 and 3 are passive. If T groups Activity 2 with Activity 3, then the significant participation activity is satisfied, and all of the income or loss from Activities 1, 2, and 3 is nonpassive.

[1532] Reg. § 1.469-5T(a)(5).

[1533] Reg. § 1.469-5T(a)(6) refers to Reg. § 1.469-5T(d), which provides:

> *Personal service activity*. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in-
>
> (1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or
>
> (2) Any other trade or business in which capital is not a material income-producing factor.

[1534] The rule incorporated by reference here, Reg. § 1.469-5T(b)(2), does not specify the facts and circumstances but applies the following rules in determining the facts and circumstances: The fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision other than the passive loss rules shall not be taken into account in determining whether such individual materially participates for purposes of the passive loss rules. Furthermore, an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under this "facts and circumstances" rule unless, for such taxable year:

- no person (other than such individual) who performs services in connection with the management of the activity receives prohibited compensation (wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered) in consideration for such services, and
- no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

Finally, the individual must participate in the activity for more than 100 hours during the taxable year. Grouping may push the taxpayer over this threshold. *Wade v. Commissioner*, T.C. Memo. 2014-169, is a great example of the founder letting others run the business on-site, yet continuing to participate:

> With Ashley [taxpayer's son] there to handle day-to-day management, Mr. Wade became more focused on product and customer development. He did not have to live near

Note that some of the tests above apply only if the owner is not a limited partner.[1536] These differences arise from the statutory prohibition against limited partners being treated as materially participating except as provided in regulations.[1537] A member in an LLC is not inherently a limited partner.[1538] Proposed regulations would treat an interest in an entity as an interest in a limited partnership as a limited partner if:[1539]

- The entity in which such interest is held is classified as a partnership for Federal income tax purposes under the check-the-box regulations; and

- The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.

Furthermore, an individual is not treated as holding an interest in a limited partnership as a limited partner for the individual's taxable year if that individual also holds an interest in the partnership that is not an interest as a limited partner, such as a state-law general partnership interest, at all times during the entity's taxable year;[1540] thus, being a general partner and a limited partner causes the partner's entire partnership interest to be

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> business operations to perform these duties, so petitioners moved to Navarre, Florida. After the move he continued to make periodic visits to the facilities in Louisiana and regularly spoke on the phone with plant personnel.
>
> In 2008 TSI and Paragon began struggling financially as prices for their products plummeted and revenues declined significantly. Mr. Wade's involvement in the businesses became crucial during this crisis. To boost employee morale, he made three trips to the companies' industrial facility in DeQuincy, Louisiana, during which he assured the employees that operations would continue. He also redoubled his research and development efforts to help TSI and Paragon recover from the financial downturn. During this time Mr. Wade invented a new technique for fireproofing polyethylene partitions, and he developed a method for treating plastics that would allow them to destroy common viruses and bacteria on contact. In addition to his research efforts, Mr. Wade ensured the companies' financial viability by securing a new line of credit. Without Mr. Wade's involvement in the companies, TSI and Paragon likely would not have survived.

[1535] Reg. § 1.469-5T(a)(7).

[1536] Reg. § 1.469-5T(e) defines a "limited partnership interest" and allows limited partners to be treated as materially participating if they qualify under Reg. § 1.469-5T(a)(1), (5), or (6).

[1537] Code § 469(h)(2).

[1538] A member in an LLC is not treated as a limited partner merely by reason of having limited liability. *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Ore. 2000); *Garnett v. Commissioner*, 132 T.C. 368 (2009); *James R. Thompson v. U.S.*, 87 Fed. Cl. 728, 734 (2009), *acq.* in result only, AOD 2010-002; *Hegarty v. Commissioner*, T.C. Summary Opinion 2009-153. *Newell v. Commissioner*, T.C. Memo. 2010-23 reasoned:

> … [T]he parties stipulated that petitioner husband handled the day-to-day operations of Pasadera, including hiring and firing employees, negotiating loan agreements and other contracts, overseeing construction, administering membership programs, and reviewing, approving, and signing all checks. As the managing member of the L.L.C., petitioner husband functioned as the substantial equivalent of a general partner in a limited partnership.

[1539] Prop. Reg. § 1.469-5(e)(3)(i).

[1540] Prop. Reg. § 1.469-5(e)(3)(ii).

treated as a general partner for purposes of the passive loss rules but does not *per se* subject the person's interest as a limited partner to self-employment tax.[1541]

II.K.1.a.iii. Spousal Participation

Any participation by a person's spouse in an activity (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) is considered participation by that person in that activity.[1542]

However, working to help a spouse's business does not establish the taxpayer as engaging in his own trade or business.[1543] Accordingly, consider documenting and compensating the spouse's services or making the spouse a co-owner.

Finally, although spousal attribution applies with respect to the material participation requirements even if they do not file a joint return,[1544] they do not allow for spousal attribution for purposes of meeting the other requirements to be treated as a "real estate professional" that a taxpayer perform more than one half of his or her personal services and more than 750 hours in real estate trades or businesses if they file separate returns.[1545]

II.K.1.a.iv. Period of Participation

A taxpayer's participation in a partnership or S corporation is determined for the taxable year of the entity (and not the taxpayer's taxable year).[1546]

II.K.1.a.v. What Does Not Count as Participation

However, not all work counts as participation for purposes of the material participation test:

- Work done in connection with an activity is not treated as participation in the activity if not only that work is not of a type that is customarily done by an owner of such an activity but also one of the principal purposes for the performance of

[1541] See part II.L.3 Self-Employment Tax: Limited Partner, especially fn. 1840.
[1542] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).
[1543] *DeGuzman v. U.S.*, 147 F. Supp. 2d 274, (D. N.J. 2001). The husband attempted to prove that he was a real estate professional and asserted that time he spent cleaning his wife's office should count toward that. Given that neither of them owned the property (she was leasing it form an unrelated third party), his hours could not count as participation generally (see part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business); furthermore, his not having been hired by the landlord undermined his claim that his work was part of a trade or business of providing real estate services.
[1544] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).
[1545] *Oderio v. Commissioner*, T.C. Memo. 2014-39. See Reg. § 1.469-9(c)(4) and the flush language at the end of Code § 469(c)(7)(B).
[1546] Reg. § 1.469-2T(e)(1). The same test applied to determine whether a partner is treated as a general partner or a limited partner; see text accompanying fn. 1540.

such work is to avoid the disallowance, under Code § 469 and its regulations, of any loss or credit from such activity.[1547]

- Work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the activity's day-to-day management or operations.[1548] "Investor" work includes:[1549]
    - Studying and reviewing financial statements or reports on operations;
    - Preparing or compiling summaries or analyses of the finances or operations for the individual's own use; and
    - Monitoring the finances or operations in a non-managerial capacity.

[1547] Reg. §§ 1.469-5T(f)(2)(i) and 1.469-5T(k), Example (7) (work as an office receptionist did not count because that was not the type of work typically done by the owner of the business, which was a football team). Note that the regulations do not expressly exclude the work from material participation if the performance of such work is to avoid the characterization of the income as net investment income under Code § 1411. Therefore, it appears that work that is not of a type that is customarily done by an owner of such an activity does count towards material participation, even if its principal purpose is to avoid the characterization of the income as net investment income under Code § 1411, so long as no principal purpose is to avoid the passive loss rules. Reg. § 1.1411-5 refers to Reg. § 1.469-5T(a) but does not say that the application of Reg. § 1.469-5T(f)(2)(i) is to be modified.

[1548] Reg. § 1.469-5T(f)(2)(ii)(A) provides:

> *In general*. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

When an individual is involved in day-to-day management or operations, does investor work done in furtherance of such management/operations count, or does all of the investor work count, without needing to differentiate between work done purely as an investor from investor work done to conduct such management/operations? All the investor work counts, once the court finds that the individual is involved in day-to-day management or operations. *Assaf v. Commissioner*, T.C. Memo. 2005-14; *Tolin v. Commissioner*, T.C. Memo. 2014-65; and *Lamas v. Commissioner*, T.C. Memo. 2015-59.

[1549] Reg. § 1.469-5T(f)(2)(ii)(B). *Lapid v. Commissioner*, T.C. Memo. 2004-222, held:

> While Mrs. Lapid testified that she spent many hours every night studying and tracking her investments, the evidence she submitted shows that she was actually just reviewing financial statements and reports on operations. Because the regulation specifically defines such monitoring as investment activity, we cannot include that time in calculating whether she met the material participation standard in three of the safe harbors she is aiming for. This is true despite our belief that Mrs. Lapid did indeed spend a lot of time tracking her properties….
>
> Unable to count the hours that Mrs. Lapid spent on investment activity, the petitioners' claim to the loss on their hotel condos quickly collapses. Though we believe that the Lapids did at least occasionally visit the condos, the record is devoid of any evidence that they spent anywhere near 500 hours doing so. That the hotels did the routine onsite work of property management undermines the Lapids' ability to show any significant amount of time that would count as "participation" in the activity. And they completely failed to compare the time they spent with the time spent by individuals actually onsite.

- Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public. Thus, for example, a member of a law firm who provides legal services to a client regarding a general partnership engaged in research and development, is not, if he invests in such partnership, treated as materially participating in the research and development activity by reason of such legal services.[1550]

II.K.1.a.vi. Proving Participation

One needs to use reasonable means to establish participation:[1551]

- "Reasonable means" may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

- Although contemporaneous daily time reports, logs, or similar documents are preferable,[1552] they are not required if the extent of participation may be established by other reasonable means;[1553] however, failure to keep good records can lead to

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[1550] Committee Reports for Senate Bill 99-313, P.L. 99-514.

[1551] Reg. § 1.469-5T(f)(4). Part VIII of T.D. 8175 provides:

> H. *No Recordkeeping Requirements*
>
> Notwithstanding the quantitative tests set forth in the regulations, § 1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calendars, and narrative summaries.

However, the cases below impose a heavy burden of proof on those who do not keep contemporaneous records and impose penalties if recordkeeping is inadequate.

[1552] *Schumann v. Commissioner*, T.C. Memo. 2014-138, held that, while not necessarily required:

> … we cannot overemphasize the importance of keeping thorough, contemporaneous time records rather than making estimates after the fact.

If one reconstructs time, the reconstruction needs to include details, as that court pointed out:

> Petitioner did not keep a contemporaneous log or an appointment calendar tracking his real estate activities, but he prepared a narrative summary of his activities. The summary, however, provides a broad description of the work performed at each property rather than a detailed description of the work that petitioner performed personally.

[1553] *Montgomery v. Commissioner*, T.C. Memo. 2013-151. In holding for the taxpayer, *Leland v. Commissioner*, T.C. Memo. 2015-240, included the following footnote 3:

> Respondent's main objection to petitioner's reconstructed logs was that they were not prepared contemporaneously with the activity. Sec. 1.469-5T(f)(4), Temporary Income Tax Regs., 53 Fed. Reg. 5727 (Feb. 25, 1988), does not require contemporaneous records, and we are satisfied that petitioner has established material participation through other reasonable means. Respondent did not dispute petitioner's inclusion of travel time in his reconstructed logs. The facts of this case establish that petitioner's travel time was integral to the operation of the farming activity rather than incidental. *See Shaw v. Commissioner*, T.C. Memo. 2002-35. We are also satisfied that petitioner's purpose in

penalties.[1554] Note, however, that reconstructing participation[1555] might lead one to make serious flaws in compiling the documentation.[1556] The court will not respect a

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traveling long distances to and from Turkey, Texas, was not to avoid the disallowance, under sec. 469 and the regulations thereunder, of any loss or credit from the farming activity. *See* sec. 1.469-5T(f)(2)(i), Temporary Income Tax Regs., *supra*.

Hailstock v. Commissioner, T.C. Memo. 2016-146, approved the full-time efforts of a taxpayer who did not engage in any other work, cautioning that the taxpayer should keep better records for future audits:

> Petitioner satisfies the facts and circumstances test in section 1.469-5T(a)(7), Temporary Income Tax Regs., *supra*, because of her credible testimony and the substantial amount of money and time devoted to each rental property. Petitioner testified credibly and in detail about her duties in operating her real estate rental business. We find petitioner's narrative summary convincing because she owned numerous rental properties and conducted her business as a "one-man operation" without being otherwise employed. As previously discussed, petitioner spent well in excess of 40 hours each week doing work related to numerous rental properties (i.e., researching prospective properties, maintaining properties, supervising work orders, finding tenants, securing leases, and continuing education related to rental real estate). The record before the Court indicates that petitioner received sizable amounts of rental income during the taxable years in issue and used substantial amounts of her own resources to facilitate the rental operation. Petitioner's testimony is further buttressed by respondent's concession that she "rented and incurred expenses in connection with the parcels of real property located at 1515 Ruth Avenue, 1516 Ruth Avenue, 1809-1811 Fairfax Avenue, 1805-1807 Fairfax Avenue, 1112 Race Street, 1619 Fairfax Avenue, 2541 Hemlock Street, 1923 Dana Avenue, 1517 Ruth Avenue, 140 Mulberry Avenue, 1668 California Street, 1729 Kinney Avenue, 1823 Fairfax Avenue and 1407 Race Street." Although we caution petitioner to construct contemporaneous time logs for her future real estate endeavors, we find her detailed and credible testimony to be a "reasonable means" of proof. See sec. 1.469-5T(f)(4), Temporary Income Tax Regs. On the basis of petitioner's testimony and the record as a whole, we conclude that petitioner did materially participate in each rental property reported on her reconstructed Schedule E for the taxable years in issue.[5] Because she has proven that she "materially participated" in operating each of her rental properties from 2005 to 2009, petitioner easily meets the 750-hour requirement of section 469(c)(7)(B)(ii). Accordingly, petitioner qualifies for the real estate professional exception under section 469(c)(7) for each of the taxable years in issue, and therefore her Schedule E losses are not subject to the passive loss limitations imposed by section 469.
>
> [5] As held above, 201 Mulberry Avenue and 9103 Brehm Road do not qualify as rental properties for any of the taxable years in issue and therefore are not aggregated to meet the 750-hour requirement of sec. 469(c)(7)(B)(ii).

[1554] *Williams v. Commissioner*, T.C. Memo. 2014-158 (taxpayer "made no attempt to keep contemporaneous records showing what amount of time he spent on the airplane, nor did he provide any appointment books, calendars, or narrative summaries corroborating such time"). *Schumann v. Commissioner*, T.C. Memo. 2014-138, imposed 20% negligence penalties:

> Petitioner did not call either of his tax return preparers to testify. Petitioner did not keep books and records adequate to substantiate his status as a real estate professional. We think petitioner acted without reasonable cause and did not act in good faith.

[1555] Reconstructing hours spent includes correcting or supplementing a log. *Flores v. Commissioner*, T.C. Memo. 2015-9, found a lack of credibility when the taxpayer admitted that various calendar entries overstated time spent. The taxpayer claimed to have a second calendar but did not produce it early enough in the proceedings to have it admitted into evidence. The court upheld a 20% accuracy-related penalty.

[1556] For example, a taxpayer, who claimed as a contemporaneous record a 2008 calendar printed in 2009, incurred a 20% accuracy-related penalty. *Hassanipour v. Commissioner*, T.C.

Memo. 2013-88. Another taxpayer's attempt to reconstruct activity led to contradictions about when he worked where, again incurring a 20% accuracy-related penalty. *Bartlett v. Commissioner*, T.C. Memo. 2013-182, pointing out:

> While the regulations permit some flexibility with respect to the evidence required to prove material participation, we are not required to accept post-event "ballpark guesstimates," nor are we bound to accept the unverified, undocumented testimony of taxpayers. See, e.g., *Lum v. Commissioner*, T.C. Memo. 2012-103; *Estate of Stangeland v. Commissioner*, T.C. Memo. 2010-185.

Similarly, *Adeyemo v. Commissioner*, T.C. Memo. 2014-1, characterized an after-the-fact spreadsheet reconstruction of time spent as an impermissible "ballpark guesstimate":

> The first problem is that the times and activities listed in the spreadsheet are not consistent with either the Adeyemos' testimony or their documentary evidence. Mr. Adeyemo testified that the activities listed in the spreadsheet were derived from his memory as well as from documentary evidence such as receipts, phone bills, the logbook, and newspaper ads. To the extent that the spreadsheet entries are purportedly derived from documentary evidence, the record does not establish a credible link between the spreadsheet and the underlying documents. For example, most entries include a general reference to a batch of receipts or phone bills. However, the references are too vague and the receipts too disorganized for us to trust that the spreadsheet is corroborated by the underlying documents….

Harnett v. Commissioner, T.C. Memo. 2011-191, in which the taxpayer claimed to spend at least 750 hours and more than half of his time managing real estate, illustrates some issues:

> Petitioner did not maintain a contemporaneous log of time spent participating in his real estate activities. In 2008, in preparation for respondent's audit, he attempted to reconstruct the time he spent in his real estate activities. He claims to have spent months going through his records to arrive at these reconstructed estimates, but petitioners have not demonstrated the evidentiary basis or methodology for these reconstructions. At trial petitioner testified that on the basis of these reconstructions he estimated spending 1,270 hours managing his real estate properties in 2003, 1,421 hours in 2004, and 1,648 hours in 2005. As discussed in more detail below, the contemporaneous records that petitioners have offered into evidence do not credibly support these estimates....
>
> Although petitioner spent some time dealing with his various properties during the years at issue and attempting to sell some of them, primarily through agents and brokers, we are not convinced that he performed more than 750 hours of services with respect to these properties during any year at issue. By 2003 petitioner had ceased to rent these properties to any significant extent and was looking to liquidate at least some of them. He was in ill health and had important duties at the bank. The properties were widely dispersed geographically. To a great extent he relied upon various agents, brokers, lawyers, and contractors as well as his wife, Robert Goldie, and Jeana Hopkins to deal with these properties.
>
> Petitioners suggest that because petitioner owned so much real estate, which they say was worth over $30 million, he necessarily must have spent at least 750 hours each year managing these properties. Yet petitioner also testified that during the years at issue he spent only about 10 hours a month working at the bank. Considering that for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation, this testimony strains credibility. But if this testimony is to be believed, we see no reason to think that managing his mostly dormant real estate holdings would have required petitioner to spend anywhere near 750 hours each year. And if the testimony is not to be believed, petitioner's lack of credibility on this score further erodes his credibility about the hours he claims to have spent on his real estate activities.

Almquist v. Commissioner, T.C. Memo. 2014-40 rejected calendars allegedly compiled from an original notebook where the taxpayer could not find the original notebook:

"postevent 'ballpark guesstimate.'" [1557] However, reconstructing participation is acceptable when corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials.[1558]

> Petitioners contend that this Court should look past the fact that petitioners did not provide any supporting documentation of the hours Mr. Almquist worked, should ignore petitioners' calendar and first log, and should look only to the second log in determining whether Mr. Almquist is a real estate professional. We again emphasize that the Court was not provided any of the purported supporting documentation or email and was provided only petitioners' self-serving testimony.
>
> We are not required to accept such self-serving testimony, and we are not willing to rely on that testimony to establish petitioners' position. See *Tokarski v. Commissioner*, 87 T.C. 74, 76-77 (1986); see also *Chapman Glen Ltd. v. Commissioner*, 140 T.C. __ (slip op. at 45 n.24) (May 28, 2013). Without any supporting documentation, the second log, created by petitioners over a year after the work was completed, is nothing more than "a postevent 'ballpark guesstimate". See *Moss v. Commissioner*, 135 T.C. at 369.

[*Chapman Glen Ltd. v. Commissioner* is found at 140 T.C. 294.]

Makhlouf v. Commissioner, T.C. Summary Opinion 2017-1, held:

> We conclude that the hours shown on the Weston spreadsheet are inflated, duplicative, and implausible on their face. Few if any entries are supported by contemporaneous record-keeping.

[1557] *Hudzik v. Commissioner*, T.C. Summary Opinion 2013-4, which also imposed penalties:

> Petitioner's counsel contended that petitioner acted with reasonable cause and in good faith by listing both properties on Schedules E, following the instructions on TurboTax, and reading and attempting to follow IRS publications. While section 469 and its regulations cover a highly complex area of the tax code, petitioner's recordkeeping seems to have greatly inflated the number of hours spent in the activity in order to satisfy the statute and the regulations. We conclude that petitioner did not act with reasonable cause and in good faith and that petitioner is liable for accuracy-related penalties under section 6662(a) for taxable years 2006, 2007, and 2008.

Calvanico v. Commissioner, T.C. Summary Opinion 2015-64 (sloppy contemporaneous notes led to reconstruction efforts that were not credible and more like ballpark estimates; penalty imposed).

[1558] *Tolin v. Commissioner*, T.C. Memo. 2014-65. In setting the stage for its ultimate conclusion that the taxpayer materially participated, the court described the taxpayer's efforts and IRS' response:

> At trial petitioner introduced a narrative summary in which he describes the work he performed in connection with the thoroughbred activity and estimates the time he spent performing such work for each of the years at issue. He prepared the summary with the assistance of his attorney in preparation for trial, using telephone records, credit card invoices, and other contemporaneous materials. For each year petitioner claims time for the following work done in connection with the thoroughbred activity: preparing and distributing promotional materials; telephone conversations with his associates, advisors, and potential customers; business trips to Louisiana; registering his horses for State and national awards; reviewing and placing mortality insurance on [the horse]; reviewing and paying bills; recordkeeping; and continuing education. [footnote omitted] Cumulatively, petitioner contends that he participated in the thoroughbred activity for 891 hours in 2002, 862 hours in 2003, and 937.5 hours in 2004.
>
> While the narrative summary is a postevent review of petitioner's claimed participation in the thoroughbred activity, the parties stipulated his performance of many of the activities described therein, and a significant amount of credible third-party witness testimony and objective evidence indicates that it is an accurate depiction of his thoroughbred activity

Hiring a management company tends to undermine one's own participation.[1559]

II.K.1.b. Grouping Activities

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

> during the years at issue. [citations omitted] Respondent primarily disputes the time petitioner claims he spent performing the activities described in his narrative summary, arguing that his estimates are unreliable because the summary was prepared solely for purposes of litigation and is based in large part on petitioner's "unreliable memory". Respondent further argues that a substantial amount of petitioner's work was undertaken in his capacity as an investor in the thoroughbred activity and thus does not qualify as participation. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., supra.
>
> …we conclude that petitioner participated in the thoroughbred activity for more than 500 hours in each year.
>
> ….
>
> The remaining hours of participation petitioner needs to satisfy the "more than 500 hours" test … are easily accounted for by his preparation and mailing of the promotional breeding packages (the voluminous contents of which were stipulated by the parties) and the miscellaneous administrative tasks he completed. See *Harrison v. Commissioner*, T.C. Memo. 1996-509.
>
> Respondent nevertheless argues that a great deal of the work upon which petitioner relies to satisfy the "more than 500 hours" test should not qualify as participation because petitioner performed it in his capacity as an investor in the thoroughbred activity. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*. We reject this argument. Petitioner was directly involved in the day-to-day management and operations of the thoroughbred activity; therefore, any investor work he completed qualifies as participation for purposes of section 469. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*; see also *Assaf v. Commissioner*, T.C. Memo. 2005-14. On the basis of his satisfaction of the more-than-500-hours test of section 1.469-5T(a)(1), Temporary Income Tax Regs., *supra*, we conclude that petitioner was a material participant in the thoroughbred activity in 2002.

Note that the tax and penalties at stake were under $60,000; it seems that the taxpayer needed to go to a lot of effort to fight that. However, the taxpayer was a practicing lawyer (1,000-1,200 hours per year) and might have needed the win to protect his credibility.

[1559] *Schumann v. Commissioner*, T.C. Memo. 2014-138 ("In addition, petitioner's use of several rental agencies to help find prospective tenants, show his properties, and market his properties suggests that he did not materially participate in the rental of his properties."). In rejecting a taxpayer's claim of material participation, *Madler v. Commissioner*, T.C. Memo. 1998-112 commented:

> Petitioners have offered no evidence to indicate that they personally approved of tenants, decided rental terms, approved of expenditures for repairs and capital improvements, or in any way participated in the management of the unit in a significant and bona fide sense. It appears that VDS, rather than petitioners, performed all significant management activities. Moreover, we do not consider petitioner's ability to terminate the contract with VDS as active participation per se; the legislative history of section 469 explains that taxpayers must themselves genuinely exercise independent discretion and judgment.

However, continuous, active marketing (including booking reservations) and spending a block of 10 days annually was enough to establish material participation for condominiums in Hawaii, even though a local property manager checked in customers and managed maid service. *Pohoski v. Commissioner*, T.C. Memo. 1998-17.

II.K.1.b.i. Grouping Activities – General Rules

When grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of Code § 469, a taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[1560]

To meet these participation rules, one or more trade or business activities[1561] or rental activities[1562] may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss

[1560] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid.

[1561] Reg. § 1.469-4(b)(1) provides that, for purposes of the grouping rules, "trade or business activities" are activities, other than rental activities or activities that are treated as incidental to an activity of holding property for investment, that:

- (i) Involve the conduct of a trade or business (within the meaning of section 162);
- (ii) Are conducted in anticipation of the commencement of a trade or business; or
- (iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

For purposes of the 3.8% tax on net investment income, the IRS takes the position that grouping cannot transform an investment activity into a trade or business. See text accompanying fn. 1160.

[1562] Reg. § 1.469-4(b)(2) provides that, for purposes of the grouping rules, one refers to the definition of rental activities under Reg. § 1.469-1T(e)(3). Reg. § 1.469-1T(e)(3)(i) provides that, generally, an activity is a rental activity for a taxable year if:

- (A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and
- (B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, Reg. § 1.469-1T(e)(3)(ii) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if, for such taxable year:

- (A) The average period of customer use for such property is seven days or less;
- (B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;
- (C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);
- (D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;
- (E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or
- (F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

rules.[1563] A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.[1564] The factors listed below, not all of which are necessary to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules:[1565]

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Total lack of interdependence precludes grouping.[1566]

In determining groupings, generally all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests; the reality of control, not its form or mode of exercise, is determinative.[1567] In applying this rule:

- Two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this rule if and only if the sum of the common-ownership

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[1563] Reg. § 1.469-4(c)(1). The IRS' checklist for grouping entities is at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Exhibit-8-1-Activities-Grouping-Entities. Its Audit Techniques Guide explains the grouping rules at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules.

[1564] Reg. § 1.469-4(c)(2). In TAM 201634022, a surgeon did not group with his medical practice his interest in a surgical center. The TAM permitted the non-grouping:

> We conclude that the facts and circumstances of this case, as presented and analyzed under the five-factor test of § 1.469-4(c), suggest that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units. We also conclude that the facts and circumstances, as presented, do not support a determination that the taxpayers' grouping of the interests in X, Y, and P as separate activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f). We further conclude that the facts as presented do not support a determination that H acquired his interest in P and treated it as a separate activity apart from X and Y with a principal purpose of circumventing the underlying purpose of § 469, for purposes of § 1.469-4(f). Therefore, we conclude that the Commissioner does not have authority to regroup the taxpayers' interests in X, Y, and P as a single activity under § 1.469-4(f) to prevent tax avoidance.

[1565] Reg. § 1.469-4(c)(2). *Lamas v. Commissioner*, T.C. Memo. 2015-59, held that all five factors were satisfied when two businesses with similar ownership operated from the same office.

[1566] *Williams v. Commissioner*, T.C. Memo. 2014-158.

[1567] Reg. § 1.469-4T(j)(1).

percentages of any five or fewer persons (not including pass-through entities) with respect to such undertakings exceeds 50%; the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage in any such undertaking.[1568]

- If, without regard to this sentence, an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this test as part of a single common-ownership group in determining the activities of such taxpayer.[1569]

- A person's ownership percentage in an undertaking or in a pass-through entity shall include any interest in such undertaking or pass-through entity that the person holds directly and the person's share of any interest in such undertaking or pass-through entity that is held through one or more pass-through entities (but a beneficiary does not get included by reason of a trust's ownership).[1570]

- A person's ownership percentage in a pass-through entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related person (applying Code § 267(b) or 707(b)(1)) owns (determined without regard to this sentence) in such pass-through entity or in such undertaking;[1571] however, the common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of the preceding sentence, two or more such persons own the same interest in any such undertaking (the "related-party owners") by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.[1572]

Grouping is subject to the following limitations:[1573]

- A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and:[1574]

[1568] Reg. § 1.469-4T(j)(2)(ii).
[1569] Reg. § 1.469-4T(j)(2)(iii).
[1570] Reg. § 1.469-4T(j)(3)(i). In applying this pass-through test, Reg. § 1.469-4T(j)(3)(ii) provides that:

- A partner's interest in a partnership and share of any interest in a pass-through entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding Code § 707(c) guaranteed payments) of such partnership.
- A shareholder's interest in an S corporation and share of any interest in a pass-through entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.
- A beneficiary's interest in a trust or estate and share of any interest in a pass-through entity or undertaking held through a trust or estate shall not be taken into account.

[1571] Reg. § 1.469-4T(j)(3)(iii)(A), (C).
[1572] Reg. § 1.469-4T(j)(3)(iii)(B).
[1573] Reg. § 1.469-4(d).

- The rental activity is insubstantial in relation to the trade or business activity;
  - The trade or business activity is insubstantial in relation to the rental activity;[1575] or
  - Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.[1576]

- An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.[1577]

- Generally, a taxpayer that owns an interest as a limited partner or a limited entrepreneur,[1578] in certain activities described in the at-risk rules,[1579] may not group that activity with any other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules.[1580]

[1574] Reg. § 1.469-4(d)(1).

[1575] *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held that running golf courses provided as an amenity to apartment complexes, but open to the public for a fee, constituted an insubstantial activity, even though golf revenue might have approached 20% of revenue from operations. The gold courses facilitated apartment rentals and sometimes helped overcome neighborhood opposition to the apartments being built.

[1576] If this proportionality cannot be achieved, consider using the structure provided in part II.E Recommended Structure for Entities, especially part II.E.7 Real Estate Drop Down into Preferred Limited Partnership, assigning disproportionate preferred profits interest related to the disproportionate ownership of the real estate.

[1577] Reg. § 1.469-4(d)(2)

[1578] As used here, a limited entrepreneur is a person does not actively participate in the management of a farm. Code § 464(e)(2).

[1579] Code § 465(c)(2)(A) treats as a separate activity under the at-risk rules: film or video tape, Code § 1245 property which is leased or held for leasing, a farm, oil and gas property (as defined under Code § 614), or geothermal property (as defined under Code § 614). However, Code § 465(c)(2)(B)(i) treats as a single activity all of a partnership's or S corporation's activities with respect to Code § 1245 (generally depreciable personal property) properties that are leased or held for lease and are placed in service in any taxable year of the partnership or S corporation. Also, Code § 465(c)(2)(B)(ii) treats as a single activity a trade or business (i) in which the taxpayer actively participates, or (ii) that is carried on by a partnership or an S corporation if 65% or more of the entity's losses for the taxable year are allocable to persons who actively participate in the management of the trade or business. This is a general overview, and one needs to look to the regulations under Code § 465 for a more accurate description.

[1580] Reg. § 1.469-4(d)(3). The IRS audit guide at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules described the rule as follows (emphasis in original):

- The IRS may issue additional guidance prohibiting grouping.[1581]

The undertaking is generally the smallest unit that can constitute an activity, and it may include diverse business and rental operations.[1582] Note that:

- Business and rental operations conducted at the same location and owned by the same person are generally treated as part of the same undertaking; conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person.[1583]

- However, operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated; and operations, that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location, are treated as part of the undertaking or undertakings that the operations support.[1584]

- Furthermore, if the undertaking includes both rental and nonrental operations, the rental operations and the nonrental (including short-term rentals of real property, such as hotel-room rentals) operations generally must be treated as separate undertakings, unless more than 80% of the income of the undertaking determined under the usual rule is attributable to one class of operations (i.e., rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of certain exceptions.[1585]

- Also, oil and gas wells that are subject to a certain working-interest exception as separate undertakings.[1586]

- The IRS would likely treat a portfolio of mortgages as a single trade or business activity which includes making, holding, or servicing the portfolio of mortgages, so

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Limited partners involved in motion pictures, videotapes, farming, exploring or exploiting oil and gas, and exploring or exploiting geothermal deposits may group with another activity **only if it is in the same line of business**.

[1581] Reg. § 1.469-4(d)(4). Rev. Proc. 2007-65, Sec. 4.09, treats certain wind farms as separate activities. The last time I checked, treatises had not mentioned any other guidance issued under this regulation.

[1582] Reg. § 1.469-4T(a)(3)(i). Reg. § 1.469-4T(b)(2)(ii)(A) defines "business and rental operations" as all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

- Such endeavors involve the conduct of a trade or business (within the meaning of Code § 162) or are conducted in anticipation of such endeavors becoming a trade or business;
- Such endeavors involve making tangible property available for use by customers; or
- Research or experimental expenditures paid or incurred with respect to such endeavors are deductible research or experimental expenditures.

[1583] Reg. § 1.469-4T(a)(3)(ii).

[1584] Reg. § 1.469-4T(a)(3)(iii).

[1585] Reg. § 1.469-4T(a)(3)(iv).

[1586] Reg. § 1.469-4T(a)(3)(v).

that fact that one or more of the mortgages go into foreclosure likely will not allow the company to deduct its passive losses.[1587]

When separate entities are involved:[1588]

- A C corporation subject to Code § 469, an S corporation, or a partnership (a "section 469 entity") decides how to group its activities.

- Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities. For example, an owner may group an activity conducted through one entity with an activity conducted through another entity.[1589]

- A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

Although generally each undertaking in which a taxpayer owns an interest is treated as a separate activity of the taxpayer, additional rules may either require or permit the aggregation of two or more undertakings into a single activity, if the activity is a trade or business, professional service, or rental real estate undertaking:[1590]

- Trade or business undertakings include all nonrental undertakings other than certain oil and gas undertakings and certain professional service.[1591]

- An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity, except for small interests held by passive investors in such undertakings, unless such interests are held through the same pass-through entity.[1592]

- Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business or if the undertakings are vertically integrated.[1593]

- All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule; however, if each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests.[1594]

[1587] INFO 2009-0229.
[1588] Reg. § 1.469-4(d)(5)(i).
[1589] Reg. § 1.469-4(c)(3), Example (2).
[1590] Reg. § 1.469-4T(a)(4)(i).
[1591] Reg. § 1.469-4T(a)(4)(ii)(A).
[1592] Reg. § 1.469-4T(a)(4)(ii)(B). "Pass-through entity" means a partnership, S corporation, estate, or trust. Reg. § 1.469-4T(b)(2)(i).
[1593] Reg. § 1.469-4T(a)(4)(ii)(B).
[1594] Reg. § 1.469-4T(a)(4)(ii)(B).

- However, professional service undertakings (nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) are similar, however, if more than 20% (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20% of its gross income from persons who are customers of the other undertaking.[1595]

- Also, the rules for aggregating rental real estate undertakings are generally elective, permitting taxpayers to treat any combination of rental real estate undertakings as a single activity or to divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings.[1596]

- Taxpayers may also elect to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking, subject to certain consistency requirements; moreover, if a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (i.e., material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.[1597]

For business and rental operations of consolidated groups of corporations and publicly traded partnerships, a consolidated group is treated as one taxpayer in determining its activities and those of its members, and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership.[1598]

Subject to certain exceptions,[1599] business and rental operations that constitute a separate source of income production are required to be treated as a single undertaking that is separate from other undertakings.[1600] For this purpose, business and rental operations shall be treated as a separate source of income production if and only if such operations are conducted at the same location[1601] and are owned by the same

[1595] Reg. § 1.469-4T(a)(4)(iii).
[1596] Reg. § 1.469-4T(a)(4)(iv).
[1597] Reg. § 1.469-4T(a)(4)(v).
[1598] Reg. § 1.469-4T(a)(5).
[1599] Notwithstanding that a taxpayer's interest in leased property would be treated as used in a single rental real estate undertaking under this rule, the taxpayer may, in certain circumstances, treat a portion of the leased property as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. Reg. § 1.469-4T(k)(2)(iii). Also, special rules apply to an oil or gas well. Reg. § 1.469-4T(e).
[1600] Reg. § 1.469-4T(c)(1).
[1601] For this purpose, Reg. § 1.469-4T(c)(2)(iii) provides:

(A) The term "location" means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations person[1602] and income-producing operations[1603] owned by such person are conducted at such location.[1604] If the rule described in this paragraph would require treatment as a single undertaking that is separate from other undertakings, generally its rental operations[1605] and its operations other than rental operations are treated as two separate

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that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

In determining whether a location is the location with which business and rental operations are most closely associated for purposes of (D) above, Reg. § 1.469-4T(c)(3) provides the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(iv) The extent to which such operations involve products or services that are commonly provided together;

(v) The extent to which such operations serve the same customers;

(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;

(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(ix) The extent to which such operations depend on each other for their economic success; and

(x) Whether such operations are conducted under the same trade name.

[1602] For this purpose, Reg. § 1.469-4T(c)(2)(v) provides that business and rental operations are owned by the same person if and only if one person is the direct owner of such operations. "Person" means and includes an individual, a trust, estate, partnership, association, company or corporation. Code § 7701(a)(1). In applying this rule, two partnerships owned by the same individuals are considered separate persons. Reg. § 1.469-4T(d)(4), Example (5)(ii).

[1603] For this purpose, Reg. § 1.469-4T(c)(2)(iv) provides that "income-producing operations" means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of):

(A) The production of property at such location;

(B) The sale of property to customers at such location;

(C) The performance of services for customers at such location;

(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or

(E) Any other transactions that involve the presence of customers at such location.

[1604] Reg. § 1.469-4T(c)(2)(i).

[1605] Generally, such an undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith. However, the undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith are not treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. Also, undertakings,[1606] the income and expenses that are reasonably allocable to an undertaking is taken into account in determining the income or loss from the activity or activities that include such undertaking,[1607] and an undertaking is treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity.[1608]

Finally, grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[1609]

II.K.1.b.ii. How to Report Grouping

Generally, a taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity.[1610]

If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer shall file a written statement with the taxpayer's original income tax return for that taxable year.[1611] If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities.[1612] Until the taxpayer makes a change to the

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such an undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers are not treated as rental operations. Reg. § 1.469-4T(d)(3).

[1606] Reg. § 1.469-4T(d)(1)(i). However, this rule requiring treatment as separate undertaking does not apply for any taxable year in which the rental operations, considered as a separate activity, would not constitute a rental activity, less than 20% of the gross income of the overall undertaking is attributable to rental operations, or less than 20% of the gross income of the overall undertaking is attributable to operations other than rental operations. Reg. § 1.469-4T(d)(2).

[1607] Reg. § 1.469-4T(d)(1)(ii), which is applied after considering the text accompanying fn. 1606.

[1608] Reg. § 1.469-4T(d)(1)(iii), which is applied after considering the text accompanying fn. 1606.

[1609] See fns. 1655-1656.

[1610] Rev. Proc. 2010-13, Section 4.02, which further provides:

> This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

[1611] Rev. Proc. 2010-13, Section 4.03, which provides reporting requirements similar to those of Section 4.02.

[1612] Rev. Proc. 2010-13, Section 4.04, which provides reporting requirements similar to those of Section 4.02, but also provides:

> If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

grouping as described in the preceding sentences of this paragraph, a taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made before taxable years beginning on or after January 25, 2010.[1613]

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity as described in any of the above paragraphs, then each trade or business activity or rental activity will be treated as a separate activity.[1614] However, a timely disclosure is deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.[1615]

Partnerships and S corporations are not subject to the above requirements:[1616]

> Instead, partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. The partner or shareholder is not required to make a separate disclosure of the groupings disclosed by the entity under §§ 4.02, 4.03, and 4.04 of this revenue procedure unless the partner or shareholder (1) groups together any of the activities that the entity does not group together, (2) groups the entity's activities with activities conducted directly by the partner or shareholder, or (3) groups the entity's activities with activities conducted through other section 469 entities. Pursuant to § 1.469-4(d)(5)(i), a shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

[1613] Rev. Proc. 2010-13, Sections 4.06 and 5.
[1614] Rev. Proc. 2010-13, Section 4.07.
[1615] Rev. Proc. 2010-13, Section 4.07. Furthermore:

> If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the disclosures required by this revenue procedure. Although the default rule established by this section 4.07 will generally result in unreported activities being treated as separate activities, the Commissioner may still regroup a taxpayer's activities to prevent tax avoidance pursuant to § 1.469-4(f). This revenue procedure provides alternative relief for untimely filing of the disclosures required by this revenue procedure; therefore, relief for untimely disclosures under § 301.9100 of the Procedure and Administration Regulations is not available pursuant to § 301.9100-1(d)(2).

[1616] Rev. Proc. 2010-13, Section 4.05.

The instructions to Form 1120S seem to me to be quite vague.[1617] All I can discern is:[1618]

> To allow shareholders to correctly apply the passive activity loss and credit limitation rules, the corporation must do the following.
>
> 1. If the corporation carries on more than one activity, provide an attached statement for each activity conducted through the corporation that identifies the type of activity conducted (trade or business, rental real estate, rental activity other than rental real estate, or investment)….

The instructions do not address the consequences of the corporation's failing to attach such a statement.[1619] Has the S corporation implicitly elected to group if it fails to attach such a statement? Or has it failed to comply with the instructions and deemed not to have grouped?[1620] An S corporation that discovers that it has not addressed this issue should be able to cure it, if it makes the required disclosure on the income tax return for the year in which the S corporation first discovers the failure to disclose.[1621]

II.K.1.b.iii. Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income

The enactment of the 3.8% tax on net investment income provides an opportunity for taxpayers to revisit their groupings. The preamble to the proposed regulations under Code § 1411 provides:[1622]

> Section 1.469-4(e)(1) provides that, except as provided in §§ 1.469-4(e)(2) and 1.469-11, once a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The Treasury Department and the IRS have determined on prior occasions that taxpayers should be given a "fresh start" to redetermine their groupings. The enactment of section 1411 may cause taxpayers to reconsider their previous grouping determinations, and therefore the Treasury Department and the IRS have determined that taxpayers

[1617] Page 10 of the 2014 instructions discusses grouping but don't say how to do it.

[1618] Page 11 of the 2014 instructions, heading, "Passive Activity Reporting Requirements."

[1619] Nor did the IRS' Audit Guide for grouping, which pre-dates Rev. Proc. 2010-13, last time I looked. The Audit Guide was at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules and http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Exhibit-8-1-Activities-Grouping-Entities.

[1620] Rev. Proc. 2010-13, Section 4.07 provides:

> Except as provided in § 4.05, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with this revenue procedure, then each trade or business activity or rental activity will be treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules of section 469.

Section 4.05 is what provides that partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065 or 1120S. If the partnership or S corporation does not comply with the instructions, does that kick the entity out of the safe harbor and require treatment as separate activities?

[1621] See fn. 1615.

[1622] Part 6.B.1.(b)(4) of the preamble.

should be given the opportunity to regroup. Thus, the proposed regulations provide that taxpayers may regroup their activities in the first taxable year beginning after December 31, 2013, in which the taxpayer meets the applicable income threshold in proposed § 1.1411-2(d) and has net investment income (as defined in proposed § 1.1411-4). The determination in the preceding sentence is made without regard to the effect of the regrouping. Taxpayers may regroup their activities in reliance on this proposed regulation for any taxable year that begins during 2013 if section 1411 would apply to such taxpayer in such taxable year. A taxpayer may only regroup activities once pursuant to § 1.469-11(b)(3)(iv)(A), and any such regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

> The regrouping must comply with the existing requirements under § 1.469-4. For example, § 1.469-4(e) provides that taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years. On January 25, 2010, the Treasury Department and the IRS published Revenue Procedure 2010-13 (2010-4 IRB 329), which requires taxpayers to report to the IRS their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities for purposes of section 469 and § 1.469-4. Thus, the disclosure requirements of § 1.469-4(e) and Revenue Procedure 2010-13 require taxpayers who regroup their activities pursuant to proposed § 1.469-11(b)(3)(iv) to report their regroupings to the IRS. See § 601.601(d)(2).

The final regulations[1623] allow an individual, estate, or trust to regroup in the first taxable year beginning after December 31, 2013, in which Code § 1411 would apply to such taxpayer, if the taxpayer has net investment income[1624] and such taxpayer's income exceeds the applicable thresholds.[1625]

The preamble to the final regulations explains:[1626]

> The final regulations retain the requirement that regrouping under § 1.469-11(b)(3)(iv) may occur only during the first taxable year beginning after December 31, 2012, in which (1) the taxpayer meets the applicable income threshold under section 1411, and (2) has net investment income. The Treasury Department and the IRS believe that the interaction between section 1411 and section 469 justifies the section 1411 regrouping rule, and that, if a taxpayer does not have a section 1411 tax liability, the reason for allowing the regrouping does

[1623] Reg. § 1.469-11(b)(3)(iv).
[1624] As defined in Reg. § 1.1411-4.
[1625] Reg. § 1.469-1(b)(3)(iv)(B) refers to the modified adjusted gross income (as defined in Reg. § 1.1411-2(c)) of an individual (as defined in Reg. § 1.1411-2(a)) exceeding the applicable threshold in Reg. § 1.1411-2(d) or the adjusted gross income of an estate or trust (as defined in Reg. § 1.1411-3(a)(1)(i)) exceeding the amount described in Reg. § 1.1411-3(a)(1)(ii)(B)(2).
[1626] T.D. 9644. The first sentence quoted here appears to be erroneous, in that, as fn. 1623 notes, the final regulations allow regrouping in the first taxable year beginning after December 31, 2013, rather than the first taxable year beginning after December 31, 2012. The mention of December 31, 2012 might have been in light of taxpayers being able to rely on the proposed regulations to regroup in their 2013 returns.

> not apply. The Treasury Department and the IRS acknowledge that, in the case of regrouping elections by partnerships and S corporations, one commentator's implied assertion is correct that imposition of section 1411 on a passthrough entity's owner(s) is the same change in law that precipitated the proposed regulation's allowance of regrouping in the first instance. However, if the Treasury Department and the IRS were to expand the scope of the regulations to allow regrouping by partnerships and S corporations, then taxpayers with no tax liability under section 1411 indirectly would be allowed to regroup. Accordingly, the final regulations do not adopt this suggestion.
>
> However, after considering the comments, the Treasury Department and the IRS agree with the commentators' concerns regarding the potential unfairness to taxpayers who become subject to section 1411 after adjustments to, for example, income or deduction items after an original return has been filed. Therefore, the final regulations allow a taxpayer to regroup under § 1.469-11(b)(3)(iv) on an amended return, but only if the taxpayer was not subject to section 1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed tax under section 1411 for that taxable year. This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination.
>
> However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to section 1411 in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings. The final regulations contain two exceptions to such voided elections. First, the final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to section 1411 in such year. Second, if the taxpayer is subject to Section 1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping. The final regulations provide four new examples on the amended return regrouping rules. Furthermore, § 1.1411-2(a)(2)(iii) of the final section 1411 regulations also contains a similar rule applicable to section 6013(g) elections.

The preamble quoted above acknowledges that, if a passive activity is held through a partnership or an S corporation, any grouping is done first at the entity level, and those entities are not described above.

Practice Tips:

- If a partnership has a bunch of long-term leases, consider converting the partnership into an investment trust,[1627] such as a Delaware statutory trust,[1628] so that each owner can separately engage in regrouping.

[1627] See part II.D.4.a Investment Trusts. For example, all of the partners might contribute their partnership interests into an investment trust, and the partnership would dissolve as a matter of

- If it is later determined that a regrouping was invalid because the NII tax would not otherwise have applied, a new election would need to be made on a subsequent return. As noted above, a taxpayer can amend such a subsequent return to make the regrouping election.[1629] Consider whether a regrouping election might be reaffirmed each year in case the initial regrouping was invalid; this would be worthwhile only if reaffirming the regrouping does not take much work.

For more about regrouping, see Kirk and Satchit, "Peeling The Onion: Passive Loss Regrouping in Light of Section 1411," *Business Entities (WG&L)* (March/April 2015).

II.K.1.b.iv. Is Grouping Advisable?

Grouping undertakings together as a single activity means that an undertaking is not treated as disposed of, thereby freeing suspended losses, until all undertakings in that grouped activity are disposed of.[1630]

Also, grouping might dilute the personal service aspects of an undertaking, throwing it out of the favorable rules for material participation that apply to personal services activities.[1631]

Grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.[1632]

II.K.1.c. Attributing Material Participation from Business Entities to Their Employees and Vice Versa (Including Limited Partnership with Corporate General Partner)

When the same individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an individual, this work can cause not only the individual but also the corporation to materially participate.[1633] Note that a special provision applying the passive loss rules to certain C corporation owners mandates the result regarding the corporation's participation.[1634]

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state law (if it is a general partnership) or by the entity that was a partnership filing the appropriate termination documentation. The trust itself would be a limited liability entity. However, it would have to be carefully structured so that the trust's activity does not rise to the level of a partnership. The partners would need to group that activity with other activities in which the partners engaged to satisfy the appropriate tests. When done to avoid the 3.8% tax on net investment income, this would require threading a very fine needle, in that the trust would be taking the position that it is not engaged in a trade or business (to satisfy the requirements described in part II.D.4.a Investment Trusts) and its owners would argue that their interest in the trust, when combined with their other activities, rises to the level of a trade or business (to satisfy the requirements described in part II.I.8.c Application of 3.8% Tax to Rental Income).

[1628] See fn. 443.

[1629] Reg. § 1.469-11(b)(3)(iv)(C)(2).

[1630] For more information on dispositions, see fn. 1510.

[1631] See text accompanying fn. 1533.

[1632] See fn. 1655. Real estate professionals have a separate aggregation election available.

[1633] Reg. § 1.469-5T(k), Example (1).

[1634] Code § 469(h)(4) provides:

When an individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an employee of the corporate general partner, this work can cause not only the corporation but also the individual to materially participate.[1635]

When an individual is the sole limited partner and works in the partnership's business as an employee of the corporate general partner, but that individual does <u>not</u> own the corporate general partner, this work can cause the individual to materially participate but will not affect the corporation's material participation.[1636]

These examples are consistent with the idea that an individual receives credit for participation in any capacity.[1637]

II.K.1.d. Applying Passive Loss Rules to a Retiring Partner under Code § 736

Except as described below, any Code § 707(c) payment to a partner for services or the use of capital, including any Code § 736(a)(2) payment (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), constitutes a payment for services or as the payment of interest, respectively, under the passive loss rules and not as a distributive share of partnership income.[1638]

If any gain or loss is taken into account by a retiring partner or a deceased partner's successor in interest as a result of a Code 736(b) payment,[1639] the gain or loss constitutes passive activity gross income or deduction only to the extent that the gain or loss would have been passive activity gross income or deduction of the retiring or deceased partner if it had been recognized at the time the liquidation of the partner's interest began.[1640]

If a Code § 736(a) payment is made in liquidation of a retiring or deceased partner's interest and that person takes into account any income as a result of the payment that is attributable to the portion (if any) of the payment that is allocable to the partnership's unrealized receivables[1641] and goodwill, the percentage of the income treated as passive shall not exceed the percentage of passive income that would be included in the income

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> *Certain closely held C corporations and personal service corporations*. A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if-
>
> (A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or
>
> (B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

See Reg. § 1.469-1T(g).

1635 Reg. § 1.469-5T(k), Example (2).

1636 Reg. § 1.469-5T(k), Example (2) (variation mentioned in the final sentence).

1637 See fn 1521.

1638 Reg. § 1.469-2(e)(2)(ii).

1639 See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

1640 Reg. § 1.469-2(e)(2)(iii)(A).

1641 Within the meaning of Code § 751(c).

that person would have recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest began.[1642]

For some background, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

II.K.1.e. Rental Activities

Generally, "passive activity" also includes any rental activity.[1643]

II.K.1.e.i. What Is Rental?

Generally, an activity is a rental activity for a taxable year if:[1644]

- During that taxable year, tangible property is used by customers or held for use by customers, and
- The gross income attributable to the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, regulations exclude from treatment as rental the use of tangible property for a taxable year if, for that taxable year:[1645]

- The average period of customer use for such property is seven days or less;[1646]

[1642] Reg. § 1.469-2(e)(2)(iii)(B)(1). For purposes of this test, calculate the portion (if any) of a Code § 736(a) payment allocable to a partnership's unrealized receivables and goodwill using the principles of Reg. § 1.736-1(b) for determining the portion of a payment made under Code § 736 treated as a distribution under Code § 736(b). Reg. § 1.469-2(e)(2)(iii)(B)(2). Reg. § 1.736-1(b)(3) provides:

> To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

Recognizing this exception, the Preamble to Prop. Reg. § 1.1411-7 (net investment income tax) (12/02/2013), Fed. Reg. Vol. 78, No. 231, pp. 72451 et seq., provides:

> Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").

[1643] Code § 469(c)(2). An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013).

[1644] Reg. § 1.469-1T(e)(3)(i).

[1645] Reg. § 1.469-1T(e)(3)(ii).

- The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

- Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);[1647]

- The rental of such property is treated as incidental to a nonrental activity of the taxpayer;

- The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

- The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under the following exception:[1648]

[1646] To facilitate finding a short rental period, instead of having the lease begin the date of signature or deposit, provide that lease begins with delivery and concludes with the return of the property, the latter which was successfully done in *Moreno v. U.S.*, 113 A.F.T.R.2d 2014-2149 (D. La 5/19/2014).

[1647] Reg. § 1.469-1T(e)(3)(ii)(C), referring to extraordinary personal services under Reg. § 1.469-1T(e)(3)(ii)(C), which provides:

> *Extraordinary personal services*. For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

In rejecting taxpayers' claim that they provided "extraordinary personal services" under the regulation, *Johnson v. U.S.*, 116 A.F.T.R.2d 2015-5486 (D. N.C. 2015), 117 A.F.T.R.2d 2016-947 (4th Cir. 2016), *cert. den*. 10/3/2016:

> None of the unsubstantiated evidence proffered by plaintiffs would support a finding that their rental homes in either Illinois or South Carolina offered services that were "akin to those services offered by a hospital or school, where the prime concern of the tenants is the receipt of services, whether medical, teaching, or, [this] case, legal[, financial, and psychological]." *Assaf*, 2005 WL 209726 4. The only statement provided by someone other than plaintiffs merely reveals that the "services" promised were provided; such "services" included the provision of continental breakfast items, furniture, and laundry facilities, which, as discussed above, do not constitute extraordinary personal services. The only "services" which would differentiate plaintiffs' rental homes from typical rental properties were the counseling services allegedly provided, and plaintiffs have simply failed to proffer anything more than their own conclusory statements to support a finding that the occupants' use of their property was incidental to their receipt of counseling services provided by Johnson.

[1648] Reg. § 1.469-1T(e)(3)(vii).

- If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity.

- Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a guaranteed payment under Code § 707(c) is not income from a rental activity under any circumstances.

- The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

II.K.1.e.ii. Self-Rental Converts Rental to Nonpassive Activity

A taxpayer's net rental income for the year from an item of property is treated as nonpassive if the property is rented for use in a trade or business activity in which the taxpayer[1649] materially participates[1650] for the taxable year.[1651]

[1649] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), held that, if a passthrough entity holds real estate, the passthrough entity's owners, not the passthrough entity itself, must materially participate.

[1650] See parts II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business and II.K.1.a Counting Work as Participation, as well as the rest of part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules. In *Schumann v. Commissioner*, T.C. Memo. 2014-138, a taxpayer who took substantial salary from his operating business could not prove that he did not materially participate in the business (because he wanted his rent to be passive income), despite his testimony that "his income tax reporting for both years was 'tax provisioning' and that he did not actively provide services to either company in exchange for the wages and payments reported on his tax returns."

[1651] Reg. § 1.469-2(f)(6) provides:

> *Property rented to a nonpassive activity*. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property-
>
> (i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of § 1.469-5T) for the taxable year; and
>
> (ii) Is not described in § 1.469-2T(f)(5).

The cross-reference to Reg. § 1.469-2(e)(2) is puzzling, because Reg. § 1.469-2(e)(2)(i) is reserved and Reg. § 1.469-2(e)(2)(ii) related to partnership redemptions. *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), ignored this cross-reference when holding that Reg. § 1.469-2(f)(6) is valid and applying it in to treat rental to a professional service corporation as nonrental. *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), followed *Schwalbach* in holding that Reg. § 1.469-2(f)(6) is valid.

Reg. § 1.469-2T(f)(5) is discussed in part II.K.1.e.v Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive.

This test applies to the item of property, ignoring any grouping elections that might apply to that item of property.[1652]

"Rented for use in a trade or business activity" does not include rental to an activity that is itself rental.[1653]

II.K.1.e.iii. Real Estate Professional Converts Rental to Nonpassive Activity

Below is a discussion of the real estate professional exception, followed by certain rules in aggregating real estate activities.

II.K.1.e.iii.(a). Scope and Effect of Real Estate Professional Exception

A real estate activity is not *per se* a passive activity if the taxpayer[1654] is a real estate professional described as follows:

- more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, <u>and</u>
- such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses[1655] in which the taxpayer materially participates (and personal services do not count unless the person is a 5% owner).[1656]

See fns. 1123 and 1160 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income.

[1652] *Carlos v. Commissioner*, 123 T.C. 275 (2004); *Veriha v. Commissioner*, 139 T.C. 45 (2012) (defining "item of property" for purposes of this rule); *Dirico v. Commissioner*, 139 T.C. 396 (2012); see also *Samarasinghe v. Commissioner*, T.C. Memo. 2012-23 (same result, but I'm not sure whether the taxpayer grouped the item with other rental properties or merely tried to use passive loss to offset this income).

[1653] *Dirico v. Commissioner*, 139 T.C. 396 (2012). In approving the deduction of rental losses against rental income, the Tax Court did not hold against the taxpayer the taxpayer's misreporting of rental income as ordinary business income.

[1654] Including a trust, per *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014) (rejecting the IRS' contention that only individuals - not trusts - could be real estate professionals). The petition, reply, and briefs are at
http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.
CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[1655] "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Code § 469(c)(7)(C). A holding company that raised capital to invest in real estate projects (owned by other entities) but neither owned any rental real property nor performed any management or operations functions is not considered a Code § 469(c)(7)(C) real property trade or business. *Coastal Heart Medical Group v. Commissioner*, T.C. Memo. 2015-84.

[1656] Code § 469(c)(7)(B). For purposes of this test, personal services performed as an employee shall not be treated as performed in real property trades or businesses unless (and when) the employee is a 5-percent owner in the employer. Code § 469(c)(7)(D)(ii); Reg. § 1.469-9(c)(5). Both of these provisions refer to Code § 416(i)(1)(B)(i), which defines 5-percent owner to mean:

CCA 201504010 held as follows, with the first holding intended to be totally positive:

1. A real estate agent who brings together buyers and sellers of real property may be engaged in a real property brokerage trade or business under § 469(c)(7)(C) [even though the licensed agent was not licensed as a broker].

2. A mortgage broker who is a broker of financial instruments is not in a real property brokerage trade or business within the meaning of § 469(c)(7)(C).

Note that being a real estate professional merely treats the activity as not *per se* passive; the taxpayer's rental activity still must satisfy the usual nonrental rules for being a nonpassive activity.[1657]

The IRS often succeeds when attacking those who hold full-time jobs (a job is considered a "trade or business")[1658] who claim that they were also real estate professionals, collecting not only tax but also a 20% accuracy-related penalty.[1659]

For more insight into what is a real estate trade or business, see part II.I.8.c.iii Rental as a Trade or Business, in the context of the tax on net investment income (NII), including a detailed excerpt from the preamble to the final NII regulations.

See also part II.G.23 Real Estate Dealer vs. Investor.

II.K.1.e.iii.(b). Aggregating Real Estate Activities for a Real Estate Professional

A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides

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> (I) if the employer is a corporation, any person who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or
>
> (II) if the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.

Stanley v. U.S., 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held:

> The Court has already set out the evidence of record substantiating Roy's ownership of the stock, and the Court does not find that the word "outstanding" imposes some additional requirement that the stock be readily transferable or not at risk of forfeiture that would operate to prevent Roy from claiming ownership for purposes of 26 U.S.C. § 469(c)(7)(D)(ii).

An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013). See generally Reg. § 1.469-9.

[1657] *Gragg v. U.S.*, 118 A.F.T.R.2d 2016-5364 (9th Cir. 8/4/2016), citing *Perez v. Commissioner*, T.C. Memo. 2010-232, as confirming its interpretation of Reg. § 1.469-9(e)(1), which provides:

> Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity.

[1658] Reg. § 1.469-9(c)(5).

[1659] See part II.K.1.a.vi Proving Participation.

personal services, and a real property trade or business might consist either of one or more than one such trade or business; a taxpayer's grouping of activities under Reg. § 1.469-4 does not control the determination of the taxpayer's real property trades or businesses for purposes of this test.[1660] Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of this test, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.[1661] If a business includes significant activities not defined as real property trades or businesses, the taxpayer will need to segregate the time spent on real property trades or businesses from other activities to determine whether the taxpayer satisfies this test.[1662]

A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity, which election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer.[1663] This election applies to rental real estate interests held through passthrough entities.[1664] *Schumann v. Commissioner*, T.C. Memo. 2014-138, pointed out:

> For the purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is considered separately with respect to each rental property, unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity. Sec. 469(c)(7)(A); sec. 1.469-9(e)(1), Income Tax Regs. A taxpayer makes the election by "filing a statement with the taxpayer's original income tax return for the taxable year." Sec. 1.469-9(g)(3), Income Tax Regs. The statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). *Id.*

The deadline above may be extended.[1665] An election to treat all of a taxpayer's interests in rental real estate as a single activity is binding for subsequent tax years, absent changed circumstances.[1666]

[1660] Reg. § 1.469-9(d)(1).
[1661] Reg. § 1.469-9(d)(2).
[1662] Failure to segregate led to the taxpayer losing *Cantor v. Commissioner*, T.C. Summary Opinion 2014-103 (company installed glass in vehicles and residences, and residential work was not necessarily part of constructing, reconstructing, etc. a home); see also *Langille v. Commissioner*, 108 A.F.T.R.2d 2011-7254 (11th Cir. 2011) (law practice does not count as real estate professional work, and taxpayer failed to even introduce evidence that work done at law firm was real estate work rather than legal work), *aff'g* T.C. Memo. 2010-49.
[1663] Reg. § 1.469-9(g)(1).
[1664] Reg. § 1.469-9(h)(1).
[1665] Rev. Proc. 2011-34, § 4.01 may provide relief if the taxpayer meets all of the following requirements:

(1) the taxpayer failed to make an election under § 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in § 1.469-9(g);
(2) the taxpayer filed consistently with having made an election under § 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the

For purposes of the real estate professional rule described above, if a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest,[1667] the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation.[1668] However, the preceding sentence does not apply if the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year.[1669]

Except for the limited partnership rule provided above, the IRS explained aggregation under the real estate professional rules as follows:[1670]

> [T]he first step here is to determine whether TP is a qualifying taxpayer under section 469(c)(7)(B). Pursuant to § 1.469-9(d), TP has reasonably determined under the particular facts and circumstances that TP has a combined real property trade or business for purposes of Treas. Reg. § 1.469-9(d) that includes Property 1, Property 2, and the real property development trade or business. Under Treas. Reg. § 1.469- 5T(a)(1), because TP spends more than 500 qualifying hours on this real property trade or business, TP materially participates in this real property trade or business. Therefore, time spent on Property 1, Property 2, and the real property development trade or business may count towards meeting the qualifications of section 469(c)(7)(B). Because TP owns an interest in rental real estate and more than one-half of the personal

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> election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years;
>
> (3) the taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions;
>
> (4) the taxpayer has reasonable cause for its failure to meet the requirements in § 1.469-9(g).

[1666] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165, 181 n. 17 (2014).

[1667] Referring to a limited partnership interest within the meaning of Reg. § 1.469-5T(e)(3).

[1668] Reg. § 1.469-9(f)(1), which continues the thought:

> Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in § 1.469-5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

See part II.K.1.a.ii Material Participation for a list of material participation tests, including describing which ones do not apply to limited partners.

[1669] Reg. § 1.469-9(f)(2).

[1670] CCA 201427016. Questions about the CCA are to be directed to Benjamin Weaver or Jaclyn Goldberg of the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 317-6850. For a summary of the CCA, see Miles, "Interplay of the Rental Real Estate Grouping Election and Real Estate Professional Exception," *Journal of Accountancy*, p. 62 12/1/2014. *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), involved successful rental grouping.

services performed in trades or businesses by TP during the taxable year are performed in real property trades or businesses in which TP materially participates, and TP performs more than 750 hours of services during the taxable year in real property trades or businesses in which TP materially participates, TP is a qualifying taxpayer within the meaning of Treas. Reg. § 1.469-9(b)(6). Thus, section 469(c)(2) does not apply to any rental real estate activity of TP. Instead, a rental real estate activity of TP is not a passive activity for the taxable year if TP materially participates in the activity.

Next, once it is determined that TP is a qualifying taxpayer, we must determine whether TP materially participates in TP's rental real estate activities to determine whether these are passive activities. In accordance with section 469(c)(7)(A)(ii), because TP has not made an election under Treas. Reg. § 1.469-9(g), Property 1 and Property 2 are treated as separate rental real estate activities. Thus, TP must demonstrate material participation in Property 1 and Property 2 separately. In other words, TP must separately meet one of the tests in Treas. Reg. § 1.469-5T(a) for each of Property 1 and Property 2. Further, pursuant to Treas. Reg. § 1.469-9(e)(3), TP's participation in the real property development trade or business is disregarded in determining whether TP materially participates in Property 1 and Property 2. If, for example, TP meets one of the tests in § 1.469-5T(a) for Property 1, but not for Property 2, Property 1 will be a nonpassive activity for the taxable year, and Property 2 will be a passive activity for the taxable year.

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

II.K.1.e.iv. Active Rental Subject to AGI Limits

A natural person, with adjusted gross income within certain limits,[1671] is not subject to the passive loss rules with respect to that portion of the passive activity loss (or the deduction equivalent of the passive activity credit) for any taxable year, up to $25,000,[1672] which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).[1673]

An estate might receive this benefit for its taxable years ending less than two years after the date of the decedent's death.[1674]

II.K.1.e.v. Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive

A taxpayer's net rental income for the year from an item of property shall be treated as nonpassive if:[1675]

[1671] Code § 469(i)(3) includes the limits and which credits are not subject to them.

[1672] Code § 469(i)(2), subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.

[1673] Code § 469(i)(1) , subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.

[1674] Code § 469(i)(4); Reg. § 1.645-1(e)(2)(i), (3)(i) (election to treat revocable trust as an estate).

- Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

- The taxpayer's use of the item of property in an activity involving the rental of the property began less than 12 months before the date of the disposition of such property;[1676] and

- The taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value[1677] of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

II.K.1.f. Royalty as a Trade or Business

Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if that person created such property or performed substantial services or incurred substantial costs with respect to the development or marketing of such property.[1678]

Generally, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.[1679] However, a person has performed substantial services or incurred substantial costs for a

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[1675] Reg. § 1.469-2(f)(5), the heading to which reads, "Net income from certain property rented incidental to development activity."

[1676] Reg. § 1.469-2(f)(5)(ii) provides:

(A) *In general*. For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which-

(1) The taxpayer owns an interest in the property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

[1677] Reg. § 1.469-2(f)(5)(iii) provides:

Services performed for the purpose of enhancing the value of property. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to-

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

[1678] Reg. § 1.469-2T(c)(3)(iii)(B)(1).

[1679] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(i).

taxable year with respect to the development or marketing of an item of intangible property if:[1680]

- The expenditures reasonably incurred by that person in that taxable year with respect to the development or marketing of the property exceed 50% of the gross royalties from licensing such property that are includible in that person's gross income for the taxable year; or

- The expenditures reasonably incurred by that person in that taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25% of the aggregate capital expenditures (without any adjustment for amortization) made by such person with respect to the property in all such taxable years.

If a taxpayer acquires an interest in an entity after the entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income (but not net royalty loss) for the year from that item of property is nonpassive.[1681]

II.K.1.g. Working Interest in Oil and Gas Property

"Passive activity" does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity[1682] which does not limit the liability of the taxpayer with respect to such interest.[1683]

If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a nonpassive loss, then any net income from such property

[1680] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). In applying this test, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed. Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). Also, in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying these rules to such entity and not to any holder of an interest in such entity. Reg. § 1.469-2T(c)(3)(iii)(B)(3)

[1681] Reg. § 1.469-2T(f)(7)(i).

[1682] Reg. § 1.469-1T(e)(4)(v)(A) precludes holding a working interest in a limited partnership in which the taxpayer is not a general partner, a corporation, or any other entity "that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions)," which presumably would encompass LLCs and LLPs. Indemnification agreements inside partnership agreements don't count; see Reg. § 1.469-1T(e)(4)(v)(C), Example (1). Being liable for a fractional portion of all liabilities suffices to provide liability, even without joint and several liability; see Reg. § 1.469-1T(e)(4)(v)(C), Example (2). A limited partner who is also a general partner is considered to have liability with respect to the interest as a limited partner as well; see Reg. § 1.469-1T(e)(4)(v)(C), Example (3).
Note that an indemnification agreement, a stop loss arrangement, insurance, or any other combination of contractual rights does not constitute a prohibited entity. Reg. § 1.469-1T(e)(4)(v)(B).

[1683] Code § 469(c)(3)(A); see Reg. § 1.469-1T(e)(4) for more details.

(or certain replacement property) for any succeeding taxable year shall be treated as nonpassive income.[1684]

The rules described above apply without regard to whether the taxpayer materially participated in the activity.[1685] On the other hand, if a taxpayer holds the working interest through a limited liability entity, then the exception does not apply, but the working interest might nevertheless be a trade or business in which the taxpayer materially participates or for some other reason is nonpassive.

"Working interest" means a working or operating mineral interest in any tract or parcel of land.[1686]

II.K.1.h. Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income

II.K.1.h.i.(a). Overview of Rules Recharacterizing PIGs as Nonpassive Income

Originally, passive income generators (PIGs) had the favorable characteristic of being able to be sheltered by passive losses without having any unfavorable characteristics. Now, the 3.8% tax makes PIGs unfavorable to the extent that their income exceeds passive losses.[1687] Those seeking to avoid passive income will be happy to learn that the IRS adopted rules limiting PIGs, as described below.

Although significant participation activities can be considered nonpassive, a taxpayer might not meet all of the requirements to make them nonpassive.[1688] If that's the case, but all significant participation passive activities net to become a PIG, a special rule

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[1684] Code § 469(c)(3)(B); see Reg. §§ 1.469-2(c)(6) and 1.469-2T(c)(6)(iv), Example (3).

[1685] Code § 469(c)(4).

[1686] Reg. § 1.469-1(e)(4)(iv), referring to Reg. § 1.612-4(a), which addresses intangible drilling and development costs incurred by an operator but does not provide a quick explanation of what a working interest is. CCA 200952054 reasons:

> Section 1.469-1(e)(4)(iv) of the Income Tax Regulations provides that for purposes of § 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of § 1.612-4(a)). Thus, the regulations under § 469 define working interest in oil or gas property, for purposes of § 469(c)(3), by reference to the depletion rules set forth in §§ 611-614 and the regulations thereunder.
>
> In general, § 611 provides for a reasonable allowance for depletion in the case of mines, oil and gas wells, and other natural deposits. Section 614 defines the term "property," for purposes of computing the allowance for depletion, as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 1.614-1(a)(2) provides that the term "interest" means an economic interest in a mineral deposit. Mineral deposit is defined in § 1.611-1(d)(4) as referring to minerals in place. Section 1.611-1(d)(5) defines minerals to include ores of metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits. That section further states that "minerals" includes all of the minerals and other natural deposits subject to depletion.
>
> Thus, the exception provided by § 469(c)(3) for any working interest in any oil or gas property is limited to a working interest in natural deposits of oil and gas.

[1687] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income.

[1688] See fns. 1530-1531 and accompanying text, found in part II.K.1.a.ii Material Participation.

converts the net passive income into nonpassive income for purposes of the passive loss rules[1689] and for purposes of the 3.8% tax on net investment income.[1690] "Significant participation passive activity" means any trade or business activity[1691] in which the taxpayer significantly participates[1692] for the taxable year but in which the taxpayer does not materially participate[1693] for such year.[1694]

Land rentals generally are treated as nonpassive: If less than 30% of the unadjusted basis of the property used or held for use by customers in a rental activity during the taxable year is depreciable, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as nonpassive.[1695]

An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity shall be considered as nonpassive to the extent of the lesser of the taxpayer's equity-financed interest income[1696] from the activity for such year and the taxpayer's net passive income from the activity for such year.[1697] An activity is an equity-financed lending activity for a taxable year if the activity involves a trade or business of lending money and the average outstanding balance[1698] of the liabilities incurred in the activity[1699] for the taxable year does not exceed 80% of the average outstanding balance of the interest-bearing assets[1700] held in the activity for such year.[1701]

[1689] Reg. § 1.469-2T(f)(2)(i). The Example at the end of Reg. § 1.469-2T(f)(2) clarifies its application.
[1690] Reg. § 1.1411-5(2)(i).
[1691] Within the meaning of Reg. § 1.469-1T(e)(2), which cross-references to Reg. § 1.469-1(e)(2), which in turn cross-references to Reg. § 1.469-4(b)(1), which is reproduced in fn. 1561 within part II.K.1.b.i Grouping Activities – General Rules. It all boils down to engaging or preparing to engage in a Code § 162 "trade or business" or incurring Code § 174 research or experimental expenditures, but does not include "rental activities or activities that are treated as incidental to an activity of holding property for investment."
[1692] Within the meaning of Reg. § 1.469-5T(c)(2), which defines significant participation as more than 100 hours during the taxable year.
[1693] Within the meaning of Reg. § 1.469-5T, which is described in part II.K.1.a Counting Work as Participation.
[1694] Reg. § 1.469-2T(f)(2)(ii). Reg. § 1.469-2T(f)(2)(iii) provides an example.
[1695] Reg. § 1.469-2T(f)(3).
[1696] The taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing (a) the excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity, by (b) the average outstanding balance for such year of the interest-bearing assets held in the activity. Reg. § 1.469-2T(f)(4)(iii). The net interest income from an activity for a taxable year is (a) the gross interest income from the activity for such year, reduced by (b) expenses from the activity (other than interest on liabilities used in this test) for such year that are reasonably allocable to such gross interest income. Reg. § 1.469-2T(f)(4)(iv).
[1697] Reg. § 1.469-2T(f)(4)(i).
[1698] The average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer. Reg. § 1.469-2T(f)(4)(vii).
[1699] Liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. Reg. § 1.469-2T(f)(4)(vi). In the case of an activity

The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under the above bullet points shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of these bullet points.[1702]

Also, generally, if a taxpayer acquires an interest in a development entity after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as nonpassive income.[1703]

II.K.1.h.i.(b). Tax Trap from Recharacterizing PIGs as Nonpassive Income

The government appears to have whipsawed business owners whose income is recharacterized as nonpassive when the activity itself remains classified as passive. Tax credits that are subject to the passive loss rules do not appear to be creditable against such income. Below is a discussion of which credits are subject to this rule, how these rule works, and planning tips.

A credit is suspended if it "arises in connection with the conduct of an activity that is a passive activity for such taxable year"[1704] and is described in subpart D of part IV of subchapter A or in subpart B (other than Code § 27(a)) of such part IV.[1705] The regulation describing the credits omits credits enacted after the regulations were promulgated, so be careful to focus on the statutory provisions.[1706] Subpart D includes any Code section numbered 38 (general business credit) and higher but is less than 46. Subpart B includes any Code section numbered 27 and higher but is less than 31. At the time I wrote this sentence, Code § 38(b) enumerated 36 credits, so always check Code § 38 in addition to making sure the credit does not fall within Subpart B or D.

Note that the regulation refers to arising "in connection with a passive activity" and does not refer to whether the activity's income is passive. "Passive activity means "a trade or

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conducted by an entity in which the taxpayer owns an interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower. Reg. § 1.469-2T(f)(4)(vi).

[1700] Interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers. Reg. § 1.469-2T(f)(4)(v).

[1701] Reg. § 1.469-2T(f)(4)(ii)(A). Liabilities incurred principally for the purpose of increasing the percentage of the average outstanding balance of the interest-bearing assets shall not be taken into account in computing such percentage. Reg. § 1.469-2T(f)(4)(ii)(B).

[1702] Reg. § 1.469-2T(f)(8).

[1703] Reg. § 1.469-2T(f)(7).

[1704] Reg. § 1.469-3T(b)(1)(i)(A).

[1705] Code § 469(d)(2)(A).

[1706] Sutton & Howell-Smith, ¶ 3.01[1] Credits Subject to Limitation, *Federal Income Taxation of Passive Activities* (WG&L) (detailed commentary). For a list of credits subject to this rule, see CCH's *Tax Research Consultant*, BUSEXP: 33,252, Credits Subject to Passive Activity Limitation (simple list).

business activity … in which the taxpayer does not materially participate for such taxable year" or certain rental activities.[1707]

An enumerated credit is suspended except to the extent that it is allocable to "regular tax liability"[1708] generated "by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions…."[1709]

Reg. § 1.469-2T(f):

> sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder).

Note that the income is recharacterized, but the classification as a "passive activity" is not altered. Thus, an enumerated credit appears to remain passive, even if its income is recharacterized as nonpassive.

This observation holds true for significant participation activities (highlighting added):[1710]

> An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year … exceeds the taxpayer's passive activity deductions from all such activities for such year.

Thus, any enumerated credit that arises from a purely[1711] significant participation activity would appear to be a passive credit that cannot be used to offset tax on that activity's income that year.

The analysis above appears to be confirmed by reading IRS Form 8582-CR, in which one calculates allowable passive credits, allowing them only against tax on passive income shown on IRS Form 8582. The instructions to IRS Form 8582 say not to report income from significant participation activities on IRS Form 8582.

I have not found any article, treatise, or government pronouncement directly addressing this issue. Until then, I assume the analysis above is correct.

[1707] Reg. § 1.469-1T(e)(1)(i).

[1708] Reg. § 1.469-3T(d)(2) refers the definition of "regular tax liability" in Code § 26(b), which in turn refers to tax determined under Chapter 1, subject to some exceptions from Chapter 1. Chapter 1 include Code sections numbered at least 1 and less than 1401.

[1709] Reg. § 1.469-3T(d)(1)(ii). Reg. § 1.469-2T(c)(1) provides:

> Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

[1710] Reg. § 1.469-2T(f)(2)(i).

[1711] Note, however, that significant participation activities may be aggregated to constitute material participation. See fns. 1530-1531 and accompanying text, found in part II.K.1.a.ii Material Participation.

Note, however, that passive credits are suspended, not lost. If a passive credit is not allowable one year, it is suspended and carried to the next year.[1712] Consider a taxpayer with income and credits from a significant participation activity. If sufficient amounts of suspended passive credits accumulate, the taxpayer might consider intentionally flunking the significant participation test one year and paying net investment income tax but generating passive income against which current and suspended credits may be taken. Whether such a strategy would work depends on the characteristics of the particular credit and taxpayer's tax posture for that year, factors that would need to be analyzed if the situation arises. In other words, I would not suggest counting on using this strategy but would suggest exploring it when planning to obtain credits that are such to the passive activity rules.

Some credits are in lieu of a deduction. When considering the use of credits, those who run businesses subject to these rules might consider the tax characteristics of each owner to decide whether the owners can actually use the credits.

Note that materially participating would prevent these issues from arising, as well as providing other benefits.[1713] Furthermore, one who significantly participates but cannot work more than 500 hours can avoid this trap by not hiring anyone else who works for more than that person.[1714]

II.K.1.i. Former Passive Activities

The preamble to the final regulations governing the 3.8% tax on net investment income[1715] describe the following regarding former passive activities:[1716]

> Losses disallowed by section 469 stem from (1) expenses incurred in the passive activity or (2) a sale of a portion of the passive activity or property used in the activity, in excess of passive income from any source. Section 1.469-1T(f)(2)(i) and (ii) require taxpayers to trace disallowed losses back to the activities giving effect to the deductions from the activity giving rise to the net loss. When a taxpayer disposes of a partial interest in a passive activity or disposes of assets

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[1712] Code § 469(b). The suspended credit is then re-tested each year. Reg. § 1.469-3T(b)(1)(ii), referring to Reg. § 1.469-1T(f)(4), which refers to Reg. § 1.469-1(f)(4). Reg. § 1.469-1(f)(4)(i) provides:

> (i) ***In general***. In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under § 1.469-1T(f)(2) or (f)(3) (the loss activity)—
>
> (A) The disallowed deductions or credits is [sic] allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and
>
> (B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

[1713] Such as allowing losses in a down year or satisfying the rule that treats as materially participating any taxpayer who participating for more than 500 hours in 5 of the most recent 10 years. See parts II.K.1.a.ii Material Participation and II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[1714] See part II.K.1.a.ii Material Participation, particularly fns. 1528-1529.

[1715] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1716] T.D. 9644.

used within a passive activity, any losses realized from the disposition are treated as arising from the passive activity and are allocated to that activity. Sections 469(b), (g), and § 1.469-1(f)(4) provide that, generally, passive losses that are disallowed in the current year carry forward to the succeeding tax year and remain suspended until the taxpayer has sufficient passive income to offset those losses or otherwise disposes of the entire activity in a fully taxable transaction with an unrelated party.

In cases where a taxpayer materially participates in an activity that was formerly a passive activity, the deductions produced by the activity in the current year are not subject to section 469. However, the carryover (or "suspended") passive losses incurred in prior years when the activity was a passive activity remain disallowed passive losses subject to carryover. Section 469(f)(1)(A) allows the suspended passive losses when the former passive activity produces current-year net income (even though that income is technically from a nonpassive activity). To the extent the taxpayer has passive losses allocable to a former passive activity in excess of the current year nonpassive income from that activity (the section 469(f)(1)(A) amount), section 469(f)(1)(C) allows excess passive losses to offset net passive income from other passive activities of the taxpayer. Any suspended passive losses not allowed by section 469(f)(1)(A) or (C) remain suspended and are carried over to the following year.

Section 469 does not alter the character or nature of the items that make up the suspended passive loss. If the suspended losses are attributable to operating deductions in excess of operating income, such suspended losses retain that character as deductions described in section 62(a)(1) or 62(a)(4) when ultimately allowed by section 469. To the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character as section 165 losses when they are ultimately allowed by section 469.

For special rules that the 3.8% tax on net investment income applies to former passive activities,[1717] see fn. 1140.

II.K.1.j. Publicly Traded Partnerships

The passive loss rules apply separately with respect to items attributable to each publicly traded partnership.[1718]

II.K.1.k. Conclusion Regarding General Rules Relating to Passive Activities

The above discussion is by no means comprehensive. These rules have developed for some 20 years, and there is no substitute for consulting with a CPA who has worked with these rules in preparing tax returns. Even experts need to adjust to a paradigm shift, from PIGs being only good to now looking for a way to avoid PIG status to the extent that income from PIGs exceeds passive losses. The author would welcome comments clarifying the analysis in this part II.K.1 or suggesting any additional points.

[1717] See part II.I.8.a.vii Former Passive Activities.
[1718] Code § 469(k).

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates

A trust or estate participating might be important not only to prevent the passive loss rules from suspending a loss but also to prevent the 3.8% tax on net investment income from applying to the trust's business income. For details on the net investment income tax, see part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income. See also parts II.J.13 Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not, II.J.14 Application of 3.8% Tax to ESBTs, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

Grantor trusts are taxed to their deemed owners and generally are not cover further in this part II.K.2. Further below are discussions of current law and how to plan for estates and nongrantor trusts in light of it.[1719] Here is an overview of regulatory developments:

From when the Code § 469 passive loss rules were enacted until when the Code § 1411 tax on net investment income (NII) was enacted, the application of the passive loss rules to estates and nongrantor trusts generally was ignored. This idea was ignored because the issues were those of timing of deductions, estates and nongrantor trusts with excess deductions could not use them, and the suspending passive losses until sales occurred generally was favorable. However, the NII tax changed the paradigm, causing taxpayers to ask the government for guidance, to which the government responded by asked for comments on what those rules should look like.

Before discussing the comments, one needs to provide context to the government's general approach. The proposed regulations under Code § 1411 initially addressed the general application of the passive loss rules (not yet focusing on trusts) in a manner biased in favor of the government: the proposed regulations would have left taxpayers with income that was nonpassive for Code § 469 but passive for Code § 1411. This approach was inconsistent with the scant legislative history of Code § 1411, and pressure was applied (in a process in which I was not involved) that caused the final regulations to back away from that approach and simply apply Code § 469 (with certain pro-taxpayer exceptions) and let the Code § 1411 consequences fall where they may.

My understanding is that the government will be looking at comments on trust participation as purely Code § 469 issues and let the Code § 1411 consequences fall where they may. It has been suggested that Code § 469 comments that tend to favor characterizing income as nonpassive in the hands of an estate, nongrantor trust, or beneficiary would be an unwarranted boon for taxpayers. However, my understanding is that the government is concerned about what might if it adopts regulations with Code § 1411 in mind, Code § 1411 later gets repealed, and the government has shot itself in the foot under Code § 469 by making it difficult to characterize income as nonpassive. Thus, regulations under Code § 1411, not Code § 469, would be the appropriate place to address any concerns the government might have about the impact of Code § 469 regulations on Code § 1411.

[1719] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

Making fair rules for how trusts can materially participate will be a complex task. Fiduciary arrangements can be grantor trusts (in which case the trust is disregarded and the deemed owner is taxed), estates, or nongrantor trusts. Trustees can be individuals or entities. A trust might have one trustee or multiple trustees. Each trustee might have different skills or knowledge of the beneficiaries' needs, leading to slicing and dicing of trustees' authority and duties. Furthermore, the level of fiduciary duties varies according to state law and the document that created the trust.

Here is a description of comments by certain major groups, all of which I participated in varying degrees:

- AICPA comments were first.[1720] They pointed to taxpayer-friendly case law.

- The ABA's Section on Taxation submitted highly technical comments, which, among other matters, explored the relationship between the passive loss and the fiduciary income tax system.[1721]

- The American College of Trust & Estate Counsel (ACTEC), whose task force I chaired, focused on the fiduciary nature of a trust and explored how the government might handle the evolving roles of trustees.[1722]

ACTEC proposed that work in a business activity be considered work attributable to a trust in determining its material participation if performed by a person who is a qualifying fiduciary. To qualify under ACTEC's proposal, the person must hold a substantial related fiduciary power and personally owe fiduciary duties to the beneficiaries with respect to the power.

One set of comments (not mentioned above) suggested varying the rules depending on who serves (and perhaps how many people serve) as trustee. Considering those factors would punish trusts that do not conform to those comments' ideas of how trusts should be administered. In contrast, ACTEC's comments treat all trustees and trust arrangements the same, focusing on whether fiduciary duties are owed with respect to the work that is performed.

ACTEC's comments mention what little law there is and recommend changes to the law. When one needs a logical framework for trusts that have more than one trustee, when distributions are made to a beneficiary, or when my planning suggestions do not work

[1720] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.
[1721] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.
[1722] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

out or were not followed, ACTEC's comments would form the basis for a well-reasoned argument about how the passive loss rules should be applied.

II.K.2.b. Participation by an Estate or Nongrantor Trust

II.K.2.b.i. Participation by a Nongrantor Trust: Authority

Regulations do not address participation by a nongrantor trust.[1723] The legislative history provides:[1724]

> 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.

"Fiduciary" means a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[1725] The term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[1726] A mere agent is not a fiduciary; for example, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[1727]

The IRS has litigated whether one should test based only on actions directly by the trustee or whether actions by others, such as an agent, should be considered.

In *Mattie K. Carter Trust v. United States*,[1728] the IRS argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

[1723] Note that participation of the activity of the deemed owner of a grantor trust would be a matter if that individual's personal participation. Thus, for example, this discussion in this section would not apply to a revocable trust. The rules for the Code § 1411 tax on passive business income expressly recognize this treatment of grantor trusts; see fn. 1075.
[1724] Committee Reports for Senate Bill 99-313, P.L. 99-514. A footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.
[1725] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.
[1726] Reg. § 301.7701-6(b)(1).
[1727] Reg. § 301.7701-6(b)(2).
[1728] 256 F.Supp.2d 536 (N.D. Tex. 2003).

TAM 200733023 rejected the taxpayer's reliance on *Mattie Carter* and asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Letter Ruling 201029014 involved a trust that owned a partnership interest. The partnership interest was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling failed to mention the *Mattie K. Carter Trust* case or to address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The IRS' Audit Technique Guide discusses the topic as follows:[1729]

> **Trusts Material Participation**
>
> If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S Corporations or LLCs.
>
> The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.[1730]
>
> As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on

[1729] Chapter 6, found by starting with http://www.irs.gov/pub/irs-mssp/pal.pdf or http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-6-Entity-Issues. The footnotes in the excerpt below are direct copies from the IRS' audit guide, although the footnote numbers have been changed from footnote numbers 15-19 to those used below.

[1730] Note that Reg. § 1.469-5T(g) is "Reserved".

a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).

Grantor Trusts: Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

Qualified Subchapter S Trust[1731] **(QSST):** The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;[1732] and,

2. Working interests in oil and gas activities.[1733] Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.

- Partnership or S corporation with losses.

- Entity with an EIN and address a long distance from the trust or trustee.

- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.

- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.

[1731] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.
[1732] Reg. § 1.469-1T(e)(6).
[1733] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).

- Copies of Schedule K-1s from related entities.

- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S Corporations.

- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S Corporation.

- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law:

- The **Senate Report**[1734] clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.

- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, "Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S Corporation's activity is a passive activity with respect to the beneficiary."

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[1735]

> Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.
>
> In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:

[1734] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.

[1735] The footnotes below use my numbering rather than the numbering used in the report. The report is at http://www.regulations.gov/contentStreamer?objectId=090000648127f7c2&disposition=attachment&contentType=pdf.

(a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[1736]

(b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.[1737]

(c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.[1738]

It explained its recommendations as follows:

> The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.
>
> Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust*[1739] found the trust to be analogous to a closely held C corporation and concluded that "the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]." The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust's other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.
>
> The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the "snippet" of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust's participation in a

[1736] See Temp. Reg. § 1.469-5T(a)(1)-(5).
[1737] See Temp. Reg. § 1.469-5T(a)(7).
[1738] Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).
[1739] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

> business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation's Explanation, but did not find it helpful.
>
> In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation.[1740] The IRS Audit Technique Guide for Passive Activity Loss (the "ATG"), addresses material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.[1741]
>
> The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

Although neither the Audit Technique Guide nor the above comments focus on whether the trustee's participation is in the trustee's fiduciary capacity, TAM 201317010 did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y

[1740] In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. See also PLR 201029014 (July 23, 2010). A person "required to hold and conserve the property, or the proceeds of the sale thereof, for future distribution" to others is a trustee. Rev. Rul. 61-102; see also Rev. Rul. 74-273. So is a person with "certain discretionary powers of administration and management with regard to the property ….[who] could vote at any stockholders' meeting; approve or oppose any reorganization or refinancing proposal; invest earnings in government obligations; retain counsel; exercise or sell conversion or subscription rights; hold the property in its own name or in a street name; and petition the court with respect to any other disposition concerning the property it considered to be in the best interest of the unknown owner." Rev. Rul. 69-300. A bank was not a fiduciary when it held an estate's money during litigation over the estate, paid interest, but performed no administrative duties for the estate. Rev. Rul. 82-177.

[1741] TAM 200733023 (Aug. 17, 2007).

and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

Because this issue has a big impact on the 3.8% tax on net investment income,[1742] the Treasury Department and IRS are considering whether issue formal guidance at some point, even though they did not issue guidance when they finalized the regulations they issued in December 2012.[1743]

[1742] See part II.I 3.8% Tax on Excess Net Investment Income (NII), particularly part II.I.8 Application of 3.8% Tax to Business Income.

[1743] The preamble to the final regulations issued in T.D. 9644 stated:

F. Material participation of estates & trusts

Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.

Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.

A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.

The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study

Meanwhile, the Tax Court held that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trust was able to count the trustees' participation.[1744] However, rather than simply disregarding the LLC (which was a disregarded entity for income tax purposes) and holding that the trustees were working for the trust (for income tax purposes), instead the court focused on the trustee's duty to the trust when working for the LLC.[1745] That focus might open the door for an attack on the premise of TAM 201317010 that a trustee who acts as an individual is not also serving as a trustee.

Since then, the AICPA,[1746] ABA Section on Taxation,[1747] and ACTEC[1748] have made formal comments to the government.

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by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

[1744] *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[1745] The court said:

> Even if the activities of the trust's non-trustee employees should be disregarded,[15] the activities of the trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]
>
> [15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.
>
> [16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[1746] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues

Some have suggested that the trustee's participation in the business will cause the trust to be taxed as a business entity. For trusts created for traditional estate planning purposes, that concern is not justified. See part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.[1749]

Consider giving a beneficiary who participates in the activity a role as a trustee, whose authority is limited to acting on behalf of the trust with respect to investments that need to be tested under the passive activity rules. Depending on the state, one might be able to use a nonjudicial settlement agreement to not only add a special trustee for this purpose but also protect the trustee from liability.[1750] Note that the legislative history refers to ***an*** executor or fiduciary, not ***the*** executor or fiduciary, implying that material participation by any one co-trustee will cause a trust to be treated as materially participating in an activity.

At first glance, it might seem an easy matter simply to designate as a special trustee an employee of the business. Note, however, that the special trustee must be participating on behalf of the trust and not merely on his or her own behalf. The trustee's work on behalf of the trust as an investor in an activity is not treated as participation in the activity unless the trustee is directly involved – on behalf of the trust - in the day-to-day management or operations of the activity.[1751] Consider these issues:

- What activities would an owner of that entity typically perform?
- Does the company want the individual to be protecting the trust's interests rather than the company's?[1752]

5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1747] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1748] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1749] Particularly fn. 1767.

[1750] Section 111 of the Uniform Trust Code, found at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf; RSMo § 456.1-111. Subsection 4 authorizes a nonjudicial settlement agreement to interpret the terms of the trust, approve a trustee's report/accounting, direct a trustee to refrain from performing a particular act, grant a trustee any necessary or desirable power, accept a trustee's resignation, appoint a trustee, determine a trustee's compensation, transfer a trust's principal place of administration, and resolve the liability of a trustee for an action relating to the trust.

[1751] See part II.K.1.a.v What Does Not Count as Participation.

[1752] See part III.A.4.c.iii Advising Clients about the UPAIA Section 505 Changes regarding the trustee's fiduciary duties to beneficiaries when the trustee is active in the business.

- As an active participant in running the business, the trust might have fiduciary duties to the other owners that it might not have as a passive owner. The trust might already have duties to other owners if the trust has a controlling interest, but being active in the business would tend to strengthen these duties to others. If the business entity is an LLC, these duties to other owners might be more easily reduced than perhaps for other types of entities, depending on applicable state law.

- Because the trustee is participating on behalf of the trust rather than for his or her own benefit, should the trust be compensated for the trustee's services and then pay the trustee itself, rather than the trustee receiving compensation directly from the company? If so, then the trustee needs to consider whether the trustee is an employee or independent contractor (generally the latter) and the related employment taxes and insurance.

- Because the trust itself is participating in a trade or business, it might subject itself to Form 1099 filing requirements for payments it makes.

- A very significant purpose of using a business entity is to protect its owners from liability. However, to the extent that the trust is directly involved in the business activity, it would subject itself to liability for the trustee's actions or omissions as the trust's agent. The trust may form an LLC that it wholly owns to provide those services and have the trustees provide those services through the LLC;[1753] if run in a financially responsible manner, the LLC might shield the trust from liability for managing the business.

Additionally, consider the trust's legal rights as an owner. If the entity is a corporation, to what course of action could a trustee commit a trust with respect to stock the trust owns other than voting it and selling it? Note that the trustee's actions as an investor do not count in determining material participation.[1754]

Generally, under corporate law a shareholder cannot act on behalf of a corporation. All the shareholders can do is elect directors. Directors then make strategic decisions (often not more than 100 or 500 hours' worth) and delegate the daily running to the officers (who are by definition employees). So generally a trust as a shareholder in a corporation has no authority to participate in the business' affairs. TAM 201317010 does not seem to understand this inherent limitation and appears geared toward businesses that are wholly owned by trusts.

Given that the IRS is reading the legislative history in a manner that makes it difficult for a trust to materially participate in its role as a shareholder, one might consider the following if the entity is an S corporation:

- Many states have "close corporation" statutes or other statutes that allow shareholders to directly run a corporation, much like an LLC is run by its

[1753] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).
[1754] See part II.K.1.a.v What Does Not Count as Participation.

members.[1755] They also have built-in buy-sell provisions, some of which might protect a corporation's S election (once in place).

- Consider an LLC or limited partnership taxed as an S corporation,[1756] with an operating agreement or partnership agreement that has distributions following S corporation single-class-of-stock rules rather than capital accounts, and either a limited liability partnership registration in place to protect the general partner (making the partnership an LLLP)[1757] or having the limited partnership do business through an LLC subsidiary. Generally, for an existing corporation, a merger into the new entity (LLLP or the LP's LLC subsidiary) would be required.[1758]

In either case, if all the S corporation stock the trust has is old-and-cold nonvoting stock, do a Code § 1036 tax-free swap for voting stock, giving enough voting stock to constitute adequate and full consideration (using a formula transfer). The holder of the voting stock would file a gift tax return adequately disclosing the transaction as a non-gift.

Also, consider having the entity pay the trust for services rendered managing the business, issuing IRS Form 1099-MISC to the trust.[1759] The trust would report the management income and expense on Schedule C or C-EZ.[1760] Trusts do not pay self-employment tax. After taking a reasonable profit on the payment, the trust would compensate the trustee for services rendered. Unlike most trusts, because the trust is now engaging in a trade or business, the trust would issue IRS Form 1099-MISC to the trustee for those services, and the trustee would report the income in his/her Form 1040, Schedule C, and pay self-employment tax;[1761] however, the IRS did not object when a

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[1755] See fn 548 and accompanying text regarding close corporation statutes as providing protection against creditors. Such statutes are in the minority. Of the states that do not have close corporation statutes, almost all of them have buried in their corporate law provisions allowing the shareholders to bypass the board of directors and directly run part or all of the business. A chart of states in an article co-authored with Richard Barnes was published March/April 2015 in *Probate & Property*, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/6131013_1.pdf; links supporting this chart were prepared by a summer associate in 2014 and are found in my firm's internal document number 5977514, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/5977514_7.pdf.

[1756] As described in part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, certain regulations might lead one to believe that an S election does not shield LLC owners from self-employment tax; however, those regulations appear to be obsolete. For those who are concerned about those regulations, a limited partnership would be the preferred state law entity, to obtain the self-employment tax exclusion available to limited partners, which is described in part II.L.3 Self-Employment Tax: Limited Partner.

[1757] See parts II.C.10 Limited Partnership and II.C.11 Limited Liability Partnership Registration.

[1758] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[1759] For Thompson Coburn LLP personnel – see document number 5879530.

[1760] For an ESBT, management fee income is not part of the S portion, because it is not a K-1 item. Reg. § 1.641(c)-1(d)(1), (2). The same answer applies to QSSTs. Reg. § 1.1361-1(j)(7), (8).

[1761] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 1091, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles. However, the Rev. Rul. modifies that position when the trustees carry on a trade or business:

trust formed its own LLC (disregarded for income tax purposes) to manage the business, which LLC reported on Forms W-2 (instead of Form 1099-MISC) compensation that the LLC paid the trustees.[1762]

Does changing the individual's participation from being a direct employee to serving as a trustee affect that person's material participation as an individual? No – although the IRS takes the position that work a trustee's work as an individual does not count as participation by the trust, work done as a trustee apparently counts towards the trustee's participation as an individual.[1763] Consider, however, any impact on employee benefits.

Example (1). Executor who receives a flat fee for administering the estate. A, a nonprofessional fiduciary, receives a flat $10,000 for administering the estate of B. B's gross estate is valued at $150,000 and includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which B's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth $150,000 he would have been entitled to $7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received $10,000 instead of $7,500 in commissions, the excess, or $2,500, is regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this $2,500 as earnings from self-employment. The remaining $7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than $7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.

Example (2). Executrix who receives a special fee for handling the estate's business. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, $5,125 (based upon a percentage of the value of the assets distributed) and $500, in addition, for the operation of the drugstore. Under these circumstances, only the $500 commission for the operation of the drugstore constitutes earnings from self-employment. The $5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.

Example (3). Coexecutor who does not participate in the operation of the estate's business. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D, who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

[1762] *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The court did not mention this nuance, but the facts described somewhere in the petition, reply, and briefs mentioned that Forms W-2 were issued; see http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

[1763] See fn. 1521 in part II.K.1.a.ii Material Participation.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[1764] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[1765] and a QSST's mandatory income requirement does not do violence to the estate planning goals. However, the trustee's participation will become important again if the stock or business assets are sold.[1766] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity. See part II.D.1 Trust as a Business Entity.

However, if the beneficiaries did not create the trust, the trust will not be considered a business entity merely because the trustee engages in business operations.[1767]

[1764] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[1765] Because a QSST is a grantor trust deemed owned by the beneficiary, the beneficiary's participation, not the trustee's, is what counts. See text accompanying fns. 1075-1076. Although normally participating in owner-type activities is required to avoid the passive loss rules, regulations governing the 3.8% tax do not mention this issue and therefore do not appear to impose that requirement for avoiding the 3.8% tax. See part II.K.1.a.v What Does Not Count as Participation. For more planning tips involving how to meet the participation requirements and qualify for an exclusion from the 3.8% tax, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[1766] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax. This is important only for net investment income tax purposes, as a complete disposition of a passive activity removes the passive loss restrictions for that activity. Code § 469(g).

[1767] I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The last major pre-1997 case, *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), *acq*. 1987-2 C.B. 1, held:

> We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)….
>
> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules

Generally, income retains its character when flowing from a nongrantor trust to a beneficiary.[1768] Therefore, income's character as passive or nonpassive at the trust level also controls at the beneficiary's level.

In support of this, note that private letter rulings have held that passive rental income earned by a pooled income fund was passive income in the hands of its beneficiaries.[1769]

In grouping passive activities, a beneficiary's beneficial interest in a trust's ownership of an activity cannot be grouped; all grouping is done at the trust level.[1770]

Regarding applying the passive loss rules to the beneficiary's share of directly apportionable deductions (such as depreciation, depletion, and amortization), the IRS instructs taxpayers:[1771]

> Any directly apportionable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the estate or trust. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.
>
> To assist the beneficiary in figuring any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of directly apportionable deductions derived from each trade or business, rental real estate, and other rental activity.

However, some commentators suggest that depreciation deductions flow through to the beneficiaries separately only to the extent allowed after applying the passive loss rules

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[1768] See fn. 1083, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and fns. 1418-1419, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

[1769] Letter Rulings 200608002 and 200608003 held:

> … the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Letter Ruling 8806065 took a similar position.

[1770] See fn. 1570.

[1771] 2013 Form 1041 Instructions, page 38, explaining how to prepare line 9 of Schedule K-1 issued to the beneficiaries. The instructions also refer to depletion and amortization. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

at the trust level.[1772] The best reconciliation I can come up with is the following example: Suppose the trust has $100 rental income before depreciation and $60 depreciation, for $40 net income; therefore, the depreciation is fully deductible under the passive loss rules applied at the trust level. The rental income and depreciation deductions are separately stated on the trust's K-1s to beneficiaries.

On the other hand, a source that CPAs often use for tax preparation states:[1773]

> When net passive income less depreciation results in a net passive loss, a PAL limitation applies at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary and the depreciation allocated to the trust exceeds the passive income, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level if the allocated depreciation exceeds the income at both the trust and beneficiary levels.

It appears that more than one approach might be defensible. Consider the strategic consequences:

- If the beneficiary can deduct the depreciation currently, then separately applying the passive loss rules based on the beneficiary's participation seems beneficial. However, if the deduction does not offset net investment income, query whether it would have been better to deferred the deduction until it can be deducted against NII.

- If the beneficiary cannot deduct the depreciation currently, consider the effect of suspending the passive losses. When can one credit the beneficiary for a disposition of the passive activity, freeing that activity's losses from suspension?[1774] If the trust sells the asset, incurs gain because depreciation reduced the trust's basis in the property, and the gain is trapped inside the trust, then the depreciation deductions (suspended or not) do not offset the gain.[1775]

[1772] Sutton & Howell-Smith, ¶ 15.03 Application of Passive Loss Limitations at the Entity Level, *Federal Income Taxation of Passive Activities* (WG&L) (referring to the position the AICPA took in the late 1980s); Schmolka, "Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)," *N.Y.U. Tax Law Review*, vol. 58, p. 191 (2005).

[1773] Key Issue 7E: Reporting Passive Activity Information to a Beneficiary, *1041 Deskbook* (PPC) (2015). See also Key Issue 7D: Passive Loss Limitations Generally Determined at the Entity Level, *1041 Deskbook* (PPC) (2015).

[1774] Code § 469(g). For more about Code § 469(g), see fn. 1510.

[1775] For further discussion of mismatches along these lines, see Abbin (WTAS), § 811 Real Estate Investment Passive Activity Concerns, *Income Taxation of Fiduciaries and Beneficiaries* (2013), arguing that passive loss rules limit the extent to which a trust passes depreciation deductions to the beneficiaries.

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules

Electing small business trusts have a special tax regime that divides the trust into a grantor trust portion, a nongrantor trust S corporation portion, and a nongrantor trust non-S corporation portion.[1776]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[1777] allow an individual and a C corporation that the individual owns to combine their participation even though they are separate taxpayers.[1778]

Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purpose other than administratively,[1779] they would not aggregate their income and loss in determining allowable passive losses and then disaggregate their income and loss in determining taxable income. Given uncertainty regarding how ESBTs treat net operating losses (NOLs),[1780] it's a good thing that this separate treatment applies.

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling

Because grantor trusts are ignored for income tax purposes,[1781] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[1782]

A grantor can count her work in a business for only that part of the year in which she is treated as owning an interest in the business.[1783] If, when grantor trust status terminates, she has not yet worked sufficient hours in the current year (and does not qualify for participation based on participation in prior years),[1784] then consider making sure she keeps at least some ownership in the business after turning off grantor trust status, so that she can count the hours she works later that year. If necessary, the trustee might divide the trust and leave a small portion of the trust as a grantor trust.

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Losses

If an interest in the activity is transferred by reason of the death of the taxpayer, losses generally are allowed to the extent such losses are greater than the excess (if any) of

[1776] See part III.A.3.e.ii.(b) ESBT Income Taxation.
[1777] See part II.K.1.b Grouping Activities.
[1778] Reg. § 1.469-4(a), (d)(5)(ii).
[1779] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 3591.
[1780] See fn. 3597.
[1781] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[1782] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.
[1783] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[1784] See part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules, especially part II.K.1.a.ii Material Participation.

the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[1785] Let's turn this recitation of the Code's rule into common sense: Suspended losses reduce basis, but without the person incurring the losses receiving a benefit from that lost basis. If the owner disposes of the interest during life in a taxable disposition, the suspended losses are allowed, and the tax system has broken even. If the owner dies holding the interest, then the question is what it takes to get the basis restored on account of the suspended losses. To the extent that there is a basis step-up, the suspended losses have not caused a tax detriment, so those losses do not need to be taken to make up for lost basis; therefore, the losses are disallowed to that extent. However, if the suspended losses exceed the basis step-up, then the excess losses should be allowed.

The corollary is that losses are allowed on the decedent's final income tax return to the extent that the transferee does not receive a basis step-up at death, which would make beneficiary grantor trusts[1786] (including QSSTs),[1787] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[1788] That also might apply to irrevocable grantor trusts taxed to the settlor[1789] - "might" because the statute requires that the interest be "transferred by reason of the death of the taxpayer;" arguably the grantor's death would qualify, but for trust deemed owned by settlor legally the transfer to the trust preceded the deemed owner's death. So, in the latter case, the trust might consider selling the interest to an otherwise identical nongrantor trust – triggering the losses and increasing the basis – to make sure that the benefits of the losses offset their detriment (in that the losses reduced basis).

Code § 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to inject some fairness, added to the basis of the partnership interest.

Suppose an estate is terminating, using fractional pick-and-choose funding. At first, a Code § 469(j)(12) basis increase in the partnership interest might not appear to generate a Code § 743 basis step-up because, lacking a pecuniary aspect, there is no sale or exchange, and therefore the transfer is not "by sale or exchange or upon the death of a partner." Perhaps the termination of the estate might be attributed to the partner's death? This seems uncertain, however, because the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem. On the other hand, a trust's or estate's distribution of a partnership interest probably does trigger Code § 743 basis adjustments, so a Code § 743 adjustment seems to be available after all.[1790] For more thoughts on planning for Code § 469(j)(12) and evaluating its impact, see Sutton & Howell-Smith, ¶15.07. Treatment of Suspended Passive Losses Upon Distribution of Activity by an Estate or Trust, *Federal Income Taxation of Passive Activities* (WG&L).

[1785] Code § 469(g)(2).
[1786] See part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.
[1787] See part III.A.3.e QSSTs and ESBTs.
[1788] FSA 200106018.
[1789] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[1790] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good

II.K.3.a. Why Being Passive Can Be Good

Particularly when significant business interests are passed to the next generation, being passive can have good results, if the business has a significant net loss.

Suppose the taxpayer has a relatively modest income, other than what the business generates. Deducting a net loss will offset income in the lower tax brackets. This is especially true if the loss is so large that it generates a net operating loss (NOL) carryover under Code § 172. Another concern is the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses.[1791]

However, in profitable years, the business income might be taxed in the highest tax bracket. The owner might save more taxes by offsetting the income in a later, high-tax-bracket year, than by deducting the loss in the lower tax brackets.

If and to the extent that the loss is passive and the taxpayer does not have passive income against which to offset it, the loss is suspended and carried forward.[1792] Thus, instead of offsetting income in lower brackets in the year in which the loss is generated, it offsets income in a later year that would otherwise push the taxpayer into a higher bracket.

Being passive does cause income to constitute net investment income (NII)[1793] subject to the 3.8% tax on net investment income.[1794] However, for taxpayers who have income below the NII thresholds,[1795] that impact might be small or none. If the NII tax impact is significant, compare (a) the possible income tax savings if income and loss years tend to fluctuate significantly, to (b) the extra cost of NII tax; I am not suggesting that being passive will usually be better – merely that one should consider it when planning.

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year

One might increase planning flexibility in the planning described in part II.K.3.a Why Being Passive Can Be Good by engaging in significant participation (more than 100 hours)[1796] rather than material participation (more than 500 hours).[1797] If suspending the loss becomes important and one sees the loss coming (or perhaps is experiencing losses and expects them next year), one might cut back one's work.

[1791] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3597.
[1792] See the introduction to part II.K.1 Passive Loss Rules Generally.
[1793] See part II.I.8 Application of 3.8% Tax to Business Income.
[1794] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[1795] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[1796] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 1691-1694.
[1797] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 1526) is usually what people consider, it is not the only way to materially participate.

Material participation might be difficult to impossible to turn off:

- One might have worked too many hours in the year before one realizes that being passive is desirable.

- One might have worked too many hours in a prior year to turn it off.

  - An individual is deemed to materially participate if the individual materially participated in the activity (determined without regard to this sentence) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.[1798]

  - An individual is deemed to materially participate if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.[1799]

Suppose an activity is passive when it generates losses and active when it generates income. The suspended passive losses offset active income from the same activity,[1800] and the active income avoids the 3.8% NII tax.[1801]

If one is leaning toward using significant participation instead of material participation, consider:

- Not being able to turn off material participation might be good, if the taxpayer stops working in the business and continues to generate business income.

- Part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

[1798] See part II.K.1.a.ii Material Participation, especially fn. 1532.
[1799] See part II.K.1.a.ii Material Participation, especially fn. 1533.
[1800] See part II.K.1.i Former Passive Activities.
[1801] See part II.I.8 Application of 3.8% Tax to Business Income.

II.Q.6. Contributing a Business Interest to Charity

II.Q.6.a. General Concepts

Contributions to public charities can work well, although any income from an S corporation K-1 or from the sale of S corporation stock constitutes unrelated business income subject to tax (regardless of the nature of the corporation's assets).[2567] Contributions of closely-held business interests to private foundations can be deducted only to the extent of the contributed property's basis.[2568] One might consider whether the entity should make the contribution instead of the owner making a contribution.[2569]

To increase the deduction for C corporation stock, consider contributing it to a charitable remainder unitrust (CRUT),[2570] in which the donor's retained interest is worth only the 10% minimum.[2571] After the CRUT sells the stock, it will have cash, and the donor can contribute his or her unitrust interest to the charity. Thus, 90% of the donation will be of an interest in cash, valued without discounts and without the basis limitation, but it should be done more than one year after the contribution was made to the CRUT to make the unitrust interest be a long-term capital asset. Also, if the sale turns out to generate fewer proceeds than expected, the donor might decide to keep part or all the unitrust interest.[2572]

Charitable remainder trusts cannot hold stock in an S corporation;[2573] however, an S corporation may donate property to a charitable remainder trust.[2574] Also, generally they should not hold an interest in an entity taxed as a partnership, if the partnership has business income[2575] or debt-financed income,[2576] because their unrelated business taxable income is taxed at 100%.[2577]

[2567] See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity.

[2568] Code § 170(e)(1)(B)(ii).

[2569] See parts II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership and II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. For a comparison of S corporations donating business assets compared to donating S corporation stock when the donor owns all of the S corporation, see text accompanying fn. 2723.

[2570] A CRUT may begin life as an income-only unitrust and then switch to a trust that pays the unitrust without regard to income (a "flip" unitrust). Reg. § 1.664-3(a)(1)(i)(c). A flip CRUT is often used when the assets contributed do not generate enough income to pay the unitrust. For those clients who have sufficient liquidity, rather than doing a flip CRUT they might consider doing a straight CRUT and then contribute cash to the CRUT so that it has enough money to pay them, thereby obtaining an additional charitable deduction with respect this additional gift to the CRUT.

[2571] Code § 664(d)(1)(D) requires the actuarial value of the charitable remainder interest to be at least 10% of the value of the property contributed to the trust.

[2572] A donation may not be made too close to a sale, as described in part II.Q.6.e Assignment of Income.

[2573] Code § 1361(e)(1)(B)(iii).

[2574] See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

[2575] Code § 512(a)(1), referring to Code § 513. However, note that Code § 512(b) excludes various items, such as interest and dividends, as well as real estate rental income. For more on UBTI, see part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fns. 2606-2613 and the accompanying text, some of which goes beyond the context of a partnership interest.

Contributions of business interests can cause self-dealing issues (although bequests might be less likely to cause self-dealing issues)[2578] and might be subject to rules limiting the period in which a charity may own a significant part of a closely-held business.[2579]

Generally, the donor should contribute either all of the donor's interest in the business or an undivided interest in every right the donor has, including voting and other noneconomic rights.[2580] However, donating nonvoting stock and keeping voting stock would work.[2581]

II.Q.6.b. Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity

When a partner transfers a partnership interest, any reduction in liabilities allocated to that partner is considered sale proceeds.[2582]

Similarly, if contributing a partnership interest results in the partner being relieved of liabilities[2583] (even nonrecourse liabilities)[2584] previously allocated to that partner, the donor has made a bargain sale.[2585]

[2576] Code § 512(b)(4), referring to Code § 514.

[2577] Code § 664(c)(2)(A).+

[2578] Code § 4941. For example, Reg. § 53.4941(d)-2 mentions the sale or exchange of property, leasing, lending, furnishing of goods, services, or facilities, payment of compensation, or transfer or use of the income or assets of a private foundation as acts of self-dealing. However, Letter Ruling 201407023 held that the distribution from the donor's estate, revocable trust, or spouse's estate and retention by Foundation of non-voting units in an LLC following the death of the survivor of the donor's and the donor's spouse will not constitute indirect acts of self-dealing pursuant to Reg. § 53.4941(d)-1(b)(5)-(b)(6) and therefore will not violate Code § 4941 even though the LLC's sole assets will be the note and income generated by a note issued by the donor's daughter. See also Letter Rulings 200635017 and 201446024.

[2579] Code § 4943.

[2580] See part II.Q.6.g Charitable Partial Interest Prohibition.

[2581] See fn. 2641 part II.Q.6.g Charitable Partial Interest Prohibition. But donating voting stock and keeping the voting rights would not work. See fn. 2639.

[2582] Rev. Rul. 74-40, quoted in full in fn. 3037, found in part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. See also Rev. Rul. 77-402 (similar result when grantor trust status terminates with respect to a partnership interest), discussed in fn. 3949, found in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts.

[2583] See part II.C.2 Allocating Liabilities (Including Debt).

[2584] Letter Ruling 9533014 commented:

> We also note certain other consequences of the proposed transaction. A proposes to transfer to Y by gift an interest in X. The transfer of a partnership interest subject to nonrecourse liabilities to a charitable remainder trust is treated as a sale or exchange for purposes of section 1011(b) of the Code. See section 1.1001-2(c), Example (4) of the regulations; Rev. Rul. 75-194, 1975-1 C.B. 80; *Guest v. Commissioner*, 77 T.C. 9 (1981), *acq.*, 1982-1 C.B. 1. Under sections 752(d) and 1011(b) of the Code, the amount of A's share of partnership liabilities at the time of the transfer corresponding to the partnership interest transferred constitutes an amount realized by A. Consequently, in determining A's gain, A's basis must be apportioned as required by section 1011(b) of the Code and 1.1011-2(b) of the regulations. It is not known whether section 751 of the Code applies to the transfer to require that part of the gain be treated as ordinary income (e.g., through the application of the recapture rules of section 1250). If section 751 applies, the

Also, the amount of any charitable contribution is reduced by the amount of gain which would not have been long-term capital gain[2586] if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).[2587] Although the sale of a partnership interest generally is taxed as a capital gain[2588] (which might be long- or short-term), certain underlying assets might convert part or all of the gain to ordinary income.[2589] However, the partnership's holding of certain assets that otherwise might have severe limitations on deductions[2590] does not appear to taint the deduction for the partnership interest.[2591]

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amount of the charitable contribution may be reduced under section 170(e)(5) (applying to contributions of ordinary income property). In determining whether a charitable contribution is allowable, section 170(e)(5) is to be applied without regard to section 1011(b) and the amount by which the contributed portion of the property must be reduced is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange. See section 1.1011-2(a)(1) of the regulations. Finally, we note that although the liability is nonrecourse, the charity must take the liability into account in determining the net fair market value of the trust assets for calculating the unitrust amount.

[2585] Rev. Rul. 75-194 includes the following facts and conclusion:

> L became a limited partner in a partnership on its formation in 1971. In 1974, L contributed his entire limited partnership interest to a charitable organization described in section 170(c) of the Internal Revenue Code of 1954. On that date all of the partnership liabilities were liabilities on which neither L, the other partners, nor the partnership had assumed any personal liability. Also on that date, L's proportionate share of the value of the partnership assets was greater than his proportionate share of the partnership liabilities and because of partnership losses L's adjusted basis for his partnership interest was less than his proportionate share of the partnership liabilities. At the time of the contribution the partnership had no unrealized receivables or inventory items described in section 751.
>
> [Citations to Code §§ 170(a), 741, 752(c), 752(d), and 1011(b) and to Reg. §§ 1.170A-1(c), 1.752-1(e), 1.752-1(e), 1.170A-4(c)(2)(iii), 1.170A-4(c), and 1.1011-2 (including Reg. § 1.1011-2(a)(3)) follow.]
>
> Since the value of L's share of the partnership assets at the time he transferred his partnership interest exceeded his share of partnership liabilities at that time, a charitable contribution deduction is allowable under section 170 of the Code, subject to the reductions and limitations set forth therein. At the same time, pursuant to sections 752(d) and 1011(b), the amount of L's share of partnership liabilities at the time of the transfer constitutes an amount realized by L. Based on the foregoing, a bargain sale within the meaning of sections 170 and 1011(b) has occurred.
>
> Accordingly, in the instant case, L has a recognized gain on the transfer equal to the excess of the amount realized by L over that portion of the adjusted basis of L's partnership interest (at the time of the transfer) allocable to the sale under section 1011(b) of the Code. Since the partnership had no unrealized receivables or appreciated inventory items described in section 751, the gain is considered a gain from the sale of a capital asset under section 741.

[2586] Determined without regard to Code § 1221(b)(3).

[2587] Code § 170(e)(1)(A).

[2588] Code § 741.

[2589] See parts II.Q.8.b.i.(e) Code § 751 – Hot Assets and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), the latter including in fn. 2866 the sale of partnership interests to a controlled corporation.

[2590] Code § 170(e)(1)(B) reduces the deduction regarding contributions:

II.Q.6.c. Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust

Letter Ruling 9705013 approved a charitable remainder trust (CRT) investing in an in an investment partnership. However, contributing a partnership interest to a CRT is very complex and might not be worthwhile if the partnership operates a business or has significant debt-financed property. Below are some issues.

First is a possible gain on sale, as described in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity, especially fn. 2584.

Second, a charitable remainder trust (CRT) pays a 100% tax on any unrelated business taxable income (UBTI).[2592] The beneficiary also pays tax on this income (along with the rest of the CRT's income) when distributed to the beneficiary.[2593] A gift of any partnership interest that has significant debt risks significant UBTI – a risk that is probably too high for a CRT, given this 100% tax.[2594] One might avoid the UBI issue if the donor keeps part of the partnership interest and contractually assumes the burden of

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(i) of tangible personal property—
 (I) if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or
 (II) which is applicable property (as defined in paragraph (7)(C), but without regard to clause (ii) thereof) which is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which the donee has not made a certification in accordance with paragraph (7)(D),
(ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(F),
(iii of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property, or
(iv) of any taxidermy property which is contributed by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting

[2591] The flush language of Code § 170(e)(1), provides that, for purposes of applying Code § 170(e)(1) to the charitable contribution of stock in an S corporation, rules similar to those in fn. 2589 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer. If the rules of Code § 170(e)(1)(B) looked through the partnership, presumably they would also look through an S corporation, which they do not.

[2592] Code § 664(c)(2)(A); Reg. § 1.664-1(c). The latter refers to UBTI "as defined in section 512, determined as if part III, subchapter F, chapter 1, subtitle A of the Internal Revenue Code applied to such trust.

[2593] Code § 664(b); Reg. § 1.664-1(c). The latter provides, "Such excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary."

[2594] See part II.Q.6.d Unrelated Business Income, especially fns. 2614-2623.

the partnership's debt;[2595] whether that idea is practical or too complex depends on the situation.

[2595] The TAM's holding regarding the escrow fund to reallocate nonrecourse debt, which was described in fn. 2615, together with its reference to Code § 752 (see fn. 2614). See 735 T.M. *Private Equity Funds*, part VIII.H.1., suggesting:

> A fund that allows its tax-exempt investors to replace their share of any fund level debt with a capital contribution should allocate the debt to the other investors. *See* TAM 9651001 (applying § 752 to determine portion of partnership debt allocable to tax-exempt partner).

For the assumption of liabilities when transferring a partnership interest to which liabilities have been allocated, see fn. 3950, found in part III.B.2.f Income Tax Concerns When Removing Property from the Estate Tax System.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[3] Nonassumed Debt, direct the reader to GCM 39486 (1986), in which the IRS internally had asked:

> If an organization exempt from tax under section 501(a) is a limited partner in a partnership that lends money under or acquires wrap-around mortgages, are the wrap-around mortgages debt-financed property of the exempt organization?

Relying on Rev. Rul. 75-99, the GCM concluded:

> A wrap-around mortgage acquired by the partnership as an investment solely by advancing its own funds is not debt-financed property merely because the wrap-around note is for an amount in excess of the funds advanced by the partnership.

Rev. Rul. 75-99 involved the following:

> An unincorporated trust, qualifying as a real estate investment trust under section 856 of the Internal Revenue Code of 1954, invested in a "wrap-around" loan. In the "wrap-around" loan in this case a party owning real estate encumbered by a senior mortgage executed a note to the trust for the total of the unpaid principal balance of the senior mortgage, plus cash advanced by the trust. The borrower also executed a mortgage to the trust encumbering the real estate described in the senior mortgage. The trust agreed to look solely to the mortgaged property for the payment of the "indebtedness" and agreed not to seek or obtain any deficiency or other money judgment in respect thereof. The borrower received from the trust that sum by which the principal amount of the "wrap-around" loan exceeded the unpaid principal balance of the senior mortgage.
>
> The trust is not liable to the senior mortgagee on the underlying note. However, the trust agreed with the mortgagor-owner to make the periodic payments of principal and interest due on the senior obligation, provided, however, that if the mortgagor defaults on its payments on the note to the trust, the trust is relieved of its obligation to make payments on the senior mortgage. For purposes of making payments on the senior mortgage and performing other obligations required under the mortgage, the borrower appointed the trust its attorney-in-fact.
>
> In the "wrap-around" loan in this case, the trust determined that certain property with a 300x dollar senior mortgage bearing interest at 7 percent per annum was of sufficient value to support a "wrap-around" loan to the owner in the amount of 400x dollars at 8 percent per annum. The borrower executed a note, and a mortgage securing the note, in the amount of 400x dollars at 8 percent per annum. The trust advanced 100x dollars to the borrower, the amount by which the "wrap-around" loan exceeded the principal of the senior mortgage. The borrower periodically pays to the trust an amount equal to interest at the rate of 8 percent on the 400x dollar note, together with principal thereon.

Rev. Rul. 75-99 held:

> Section 856(c)(2) and (3) of the Code provides that for a trust to qualify as a real estate investment trust, certain percentages of its gross income must be derived from specified sources, including interest and interest on obligations secured by mortgages on real property.

Consider whether, instead of contributing a partnership interest to a CRT, one might place the partnership interest in a corporation and contribute the corporation to the CRT. Such a corporation is commonly referred to as a blocker. Any partnership liabilities from which the donor is deemed to be relieved might trigger income on formation of the corporation.[2596] The CRT would not receive any UBTI; however, the corporation would pay tax on its share of the partnership's income and on any gain on sale of the partnership. If the partnership has little or no debt-financed property, then the corporation might save little tax and might even cost more tax; if it has much debt-financed property, then the corporation might produce a significant benefit. The benefit of forming the corporation would be taxing income at regular rates instead of 100% while getting the benefit of the deduction of the full value of the corporation (which presumably would be reduced by tax paid on the expected upcoming sale of the partnership interest). However, the corporation's sale of the partnership interest would be subject to income tax at corporate rates, whereas the CRT's sale of a partnership interest it owns directly would defer or avoid income tax on gain on the sale, if and to the extent that the sale would not generate UBTI. Furthermore, if the CRT sold its shares in the corporation, a purchaser would reduce the price to take into account the partnership's built-in gain, especially if the purchaser would have been able to benefit from depreciation or amortization deductions if it had bought the partnership interest directly.[2597] So, the blocker concept, although avoiding UBTI issues, might not save much money, and a donor concerned about UBTI might consider just selling the partnership interest and donating the proceeds.

> For purposes of section 856(c)(2) and (3) of the Code, the indebtedness between the trust and the borrower giving rise to an obligation to pay interest is not the total amount of the "wrap-around" loan. See *Mindlin v. Davis*, 74 So.2d 789 (Fla. 1954). Although the borrower signs a note for 400x dollars, the trust actually loans the borrower 100x dollars. Payments made by the trust on the senior obligation are considered to be made on behalf of the borrower from payments received from the borrower on the 400x dollar note. Accordingly, it is held that only the interest on 100x dollars, the amount of the cash advanced by the trust, is includible in the trust's gross income.

Analogizing, GCM 39486 reasoned:

> Here, as in Rev. Rul. 75-99, there is no indication that the contract between the partnership and the borrower creates a debtor-creditor relationship between the partnership and the lender under the first mortgage. The partnership does not contract with the lender under the first mortgage for liability for repayment of the first mortgage. Thus, it cannot be said, on these facts, that the partnership has "borrowed" the amount of the first mortgage in order to advance the funds to the borrower. Accordingly, there is not any acquisition indebtedness.
>
> The same conclusion is reached by analyzing the property acquired. In this case, the partnership acquires a note secured by an interest in property subordinate to one or more other mortgages or similar interests in the property. The partnership does not acquire the borrower's property that is subject to these senior obligations. Thus, the property acquired is not, in our opinion, subject to any "acquisition indebtedness," rather, the property acquired (the note) is an obligation to pay secured by the borrower's encumbered property. Thus, we think it is clear that a wrap-around note acquired by the partnership solely by advancing its own funds is not debt-financed property.

[2596] See part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[2597] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

Another way a CRT could avoid UBTI from a partnership is to contribute to a blocker any portion of the partnership interest that would generate UBTI. If the partnership interest is about to be sold and the sale itself would not generate UBTI, then the blocker can avoids UBTI on current income without subjecting the sale proceeds to the corporate tax regime. To avoid the prohibition described in part II.Q.6.g Charitable Partial Interest Prohibition, the donor should contribute to the CRT a vertical slice of everything the donor owns in the partnership, and then the CRT contributes to the blocker the portion of the partnership interest that generates UBTI.

In either CRT scenario, the UBTI would be taxed at the corporate level and again when the CRT distributes the dividend to the recipient, rather than being taxed to the donor at the donor's ordinary income tax rates (which usually are higher than corporate rates but lower than corporate rates and capital gain rates combined), so the sale not taking place would increase the annual income tax burden. On the other hand, the charitable deduction might offset this tax disadvantage to a certain extent. Note also that distributions to the recipient, which are based on a percentage (5% or more) of the value of the CRT's assets, would likely be smaller than the annual distributions from the partnership.

Also note that the donor being compensated for services to the partnership or otherwise engaging in transactions with the partnership might be limited by self-dealing rules:[2598] Payment of compensation by a private foundation directly or indirectly to a disqualified person is self-dealing.[2599] One may be a disqualified person with respect to a CRT by being a "substantial contributor" to the CRT[2600] or a trustee of the CRT.[2601] The payment of compensation to a disqualified person by a partnership owned by the CRT is not direct self-dealing because the payment is not being made by the CRT to the recipient. Instead, one would look to rules governing indirect self-dealing[2602] between a disqualified person and an organization controlled[2603] by a private foundation.

Also, if the partnership is unmarketable,[2604] then any required valuation (at initial contribution and annually for a unitrust) must be performed exclusively by an independent trustee or determined by a current qualified appraisal from a qualified appraiser.[2605]

[2598] See Letter Ruling 9533014.

[2599] Code § 4941(d)(1)(D).

[2600] A substantial contributor is the creator of a charitable trust and any donor who gives more than $5,000 to the private foundation if the amount given is more than 2% of the total contributions in the taxable year. Code §§ 4946(a)(2) and 507(d)(2).

[2601] Code § 4946(a)(1).

[2602] Reg. § 53.4941(d)-1(b), which provides the indirect self-dealing rules and various exceptions.

[2603] Reg. § 53.4941(d)-1(b)(5).

[2604] Reg. § 1.664-1(a)(7)(ii) provides:

> *Unmarketable assets*. Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

[2605] Reg. § 1.664-1(a)(7)(i).

II.Q.6.d. Unrelated Business Income

UBTI can arise from the partnership's business operations[2606] or from income generated by acquisition indebtedness. For example, although dividends,[2607] interest,[2608] annuity

[2606] Code § 512(a)(1). Citing Code § 513(a), (c) and Reg. § 1.513-1(a), Letter Ruling 201626004 reasoned:

> Therefore, unless one of the specific exceptions of sections 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if:
>
> (1) it is income from a trade or business;
>
> (2) such trade or business is regularly carried on by the organization; and
>
> (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

The Letter Ruling reviewed Reg. § 1.513-1(c)(1):

> Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried" on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

After reviewing Reg. § 1.513-1(d) for whether an activity is "substantially related (other than through the production of funds) to the purposes for which exemption is granted," it reviewed case law:

> In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court held that a section 501(c)(3) organization's insurance program constituted both the sale of goods and the performance of services and, therefore, was a trade or business for purposes of the tax on unrelated business income. The organization was the group policyholder and administrator of insurance policies offering life, disability and medical coverage. Its activities included compiling a list of its members and soliciting their insurance business.
>
> In *Ohio Farm Bureau Federation, Inc., v, Commissioner*, 106 T.C. 222 (1996), the Tax Court concluded that a covenant not to compete did not constitute a trade or business. The Tax Court declined to treat the absence of activity as equivalent to the affirmative conduct of a trade or business in the context of unrelated business income.

The Letter Ruling addressed a donation of accounts receivable bequeathed to a foundation:

> At the time of Decedent's death, the Company's primary assets were receivables related to legal services provided by the Company in connection with certain lawsuits ("the receivables"). The receivables represent the Company's share of the remaining unpaid balance of the attorney's fees awarded upon settlement of the lawsuits. The fees due to the Company were determined under various settlement agreements and, under the terms of the settlement, payment of fees was deferred over time. Payments are expected to continue for approximately x additional years. The Company's ownership in its share of the attorney's fees payable wholly vested when the lawsuits finally settled, which was prior to Decedent's death. Currently, none of the Estate, the Foundation, or the Company provides any services in relation to the legal services generating the receivables. Furthermore, the Foundation represents that it will not perform any act (including administrative acts) with respect to the receivables other than receiving payments related to satisfaction of the receivables.
>
> The Foundation represents that the receivables:
>
> - Are comprised solely of income from services previously provided by the Company, including Decedent;
> - Are not debt-financed property within the meaning of section 514(b); and
> - Are not gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

The Letter Ruling concluded:

payments,[2609] royalties,[2610] rent from real property or from personal property incidental to the real property rental,[2611] and capital gains (and gain from certain other property) generally do not constitute unrelated business income (UBI),[2612] but if they arise from

However, the Company completed provision of the legal services prior to Decedent's death. The Foundation represents that none of the Estate, the Foundation, or the Company currently provides any services in relation to the receivables and, further, that the Foundation will not perform any act (including administrative acts) other than receiving payments related to satisfaction of the receivables. The Foundation is merely the distributee of the assets of the Estate and the recipient of the payments. The Foundation is performing no activity, similar to the organization in *Ohio Farm Bureau Federation, Inc.*, *supra*, other than receiving payments. The Foundation is neither selling goods nor performing any services in order to receive income from the receivables, unlike the organization in *United States v. American Bar Endowment*, *supra*, that was engaged in a trade or business. See section 513(c); Treas. Reg. Sec. 1.513-1(b). Therefore, the income resulting from the receivables is not unrelated business income within the meaning of section 512(a) and will not be subject to the tax on unrelated business income described in section 511(a).

[2607] Code § 512(b)(1).

[2608] Code § 512(b)(1).

[2609] Code § 512(b)(1).

[2610] Code § 512(b)(2).

[2611] Code § 512(b)(3). See also part II.L.1.a.ii Rental Exception to SE Tax, especially fns. 1823-1824, comparing the rental exception for self-employment tax to the rental exception for UBTI purposes (the latter being set forth in fn. 1823).

[2612] Code § 512(b)(5), which provides:

There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than-

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

Real estate might or might not constitute inventory. See part II.G.11 Future Development of Real Estate, especially fn. 688. Referring to *Malat* cited in that fn., Letter Ruling 201630009 held:

Foundation intends to hold the real estate properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities and intends to continue to hold the properties, at least in the near term. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. Any such decision will be made on a property-by-property basis, taking into consideration the overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. The debt-financed property then they may constitute UBI.[2613] Thus, a partnership holding debt-financed assets can generate UBI not only on annual income but also on the sale of the partnership interest.

TAM 9651001 asserted that gain from the sale of a partnership generated UBI with respect to the partnership's debt that was allocated to the seller,[2614] except to the extent

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real estate properties will be held as income producing properties and not as inventory used in a trade or business.

Reg. § 1.1245-6(b) may override Code § 512(b)(5):

Nonrecognition sections overridden. The nonrecognition provisions of subtitle A of the Code, which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), 512(b)(5) and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

[2613] Code § 512(b)(4), incorporating by reference Code § 514.

[2614] The TAM reasoned:

There is no disagreement concerning the fact that both Partnership and Z held debt-financed property. Sections 702(b) and 512(c)(1) of the Code make it clear that the income of a partnership retains its character in the hands of the partners. Thus, when Partnership and Z received income attributable to debt-financed property, X reported its share of this income as unrelated business income (UBI). The central area of disagreement is the treatment of income received from the sale of a partnership interest by an exempt organization when the interest of the exempt organization was not purchased with borrowed funds, but the property owned within the partnership was purchased by the partnership itself with (or partially with) borrowed funds.

The facts indicate that X reported for each taxable year its distributive share of rental income from Partnership as unrelated debt-financed income. X did not report as unrelated debt-financed income X's gain on the sale of its interests in Partnership and Z, which held debt-financed real estate. Had Partnership and Z instead sold the debt-financed real estate, X's distributive share of gain from the sale would have been reportable as unrelated debt-financed income. X maintains that because X did not borrow directly to purchase its interests in Partnership and Z, gain from the sale of the partnership interests, rather than from the sale of the debt-financed real estate itself held by the partnerships, was not reportable as unrelated debt-financed income. However, whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed real estate.

A partnership can be viewed in two ways under subchapter K: as a separate entity or as an aggregate of its partners. See *Casel v. Commissioner*, 79 T.C. 424, 432-33 (1982). The entity view of partnerships treats each partner as owning no direct interest in partnership assets or operations, but only an interest in the partnership entity itself. The aggregate view treats each partner as the owner of a direct and undivided interest in partnership assets and operations. Subchapter K is an attempt to balance the entity view with the aggregate view to avoid the use of a partnership as a means of obtaining improper tax advantages. The many situations not clearly covered by subchapter K can be resolved by both looking to whether the subchapter applies an entity or aggregate approach in analogous situations and considering the purpose of the particular provision of the Code to be applied.

The House Conference Committee report addressing the enactment of Subchapter K states that, even though Subchapter K takes an entity approach in transactions between a partner and a partnership, "no inference is intended, however, that a partnership is to that the partnership's non-recourse debt was effectively defeased by the establishment of the independently trusteed, fully funded escrow account which is contractually committed to paying interest and principal on the debt.[2615] The TAM was not clear how

be considered as a separate entity for purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Rep. No. 2453, 83d Cong., 2d Sess. 59 (1954).

Example (4) of section 1.514(c)-1(a)(2) of the regulations shows that BOTH debt incurred to acquire a partnership interest AND debt incurred by the partnership to acquire property are included in calculating that portion of a partnership's interest that is subject to acquisition indebtedness. The debt/basis percentage thus calculated for the partnership interest is the same whether the partnership sells the property or the partner sells its partnership interest.

An interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result another. The "aggregate" view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)).

For purposes of the debt-financed property rule of section 514 of the Code, the aggregate approach should be applied with respect to sales of partnership interests consistently with the aggregate approach contemplated in section 512(b)(4) with respect to items of income from debt-financed property that flow through to the partners. Analogously, when a partner sells a partnership interest, section 751(a) requires a "look through" of its partnership interest to determine the character of assets sold and the classification of gain. It would make no economic or policy sense that X should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than have the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. Consequently, X's sales of its interests in Partnership and Z at a gain result in unrelated business income under section 514.

The debt on Partnership's revolving line of credit apparently existed, at least in part, when X acquired its interest in Partnership. Accordingly, X's share, if any, of this liability under section 752 and regulations thereunder constitutes acquisition indebtedness of X, because the indebtedness was effectively incurred by X in acquiring the partnership interest. See section 514(c)(1)(A) of the Code. In addition, X's share under the section 752 regulations of any increases in debt on the revolving line of credit after X acquires its interest in Partnership constitutes acquisition indebtedness to the extent the increases were incurred to acquire or improve property within the meaning of section 514(c)(1)(A), (B), or (C).

Because the debt with respect to X's interest in Z was incurred before July 18, 1984, the effective date for application of this exception to organizations such as X, the exception provided in section 514(c)(9)(A) of the Code is not applicable. See P.L. 98-369. In addition, X has not shown that it meets the specific requirements of section 514(c)(9)(B).

[2615] The TAM reasoned:

Even though the properties of Z are collateral on the prior loan of Y's, the payment of the loan is not an obligation of Z, nor was it an obligation of Venture or a previous obligation of any of the other ventures. Y personally makes the payments and neither the loan nor the payments on it are considered in calculating partnership income. However, even though this is not a debt of Z, X could be at risk of loss of its share of the value of the property if the property should be foreclosed upon. Thus, X, in that case, though not contractually obligated, would in effect be paying on the loan. This risk is eliminated by the UBI was computed. To me, the better view of the TAM's analysis is that one looks through the partnership to see the extent to which the debt constituted acquisition indebtedness with respect to the partnership's assets,[2616] which may extend to treated as UBI a portion of other assets held by the partnership as well,[2617] but would also mean

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> the creation of the independently trusteed, fully funded, escrow account solely for the purpose of paying the loan should Y default. Therefore, the loan, although collateralized by Z property, is not an obligation or liability of Z or X, and the escrow account, which must at all times be maintained a level sufficient to pay off the loan, ensures that even if Y should default neither Z nor X would be at risk of any loss or be required to make any payments. Because neither Z nor X are obligated on the loan, and are not at risk to suffer any loss because of the loan, it is not a debt of either and can be excluded in calculating acquisition indebtedness.

[2616] Andersen Tax LLC, ¶ 20.02[2][c] Sources of UBTI and Exceptions From UBTI Characterization, *Tax Economics of Charitable Giving*, said in a footnote:

> To reach its conclusion, the IRS applied an "aggregate" (*i.e.*, not an entity) approach, so it looked through the partnership to determine if there was debt financing, and treated the situation the same as if the partnership itself sold the assets that had been debt financed.

591 T.M. *Real Estate Transactions by Tax-Exempt Entities*, part II.G.3.f., "Sale of Partnership Interests," states:

> Applying an aggregate view of partnerships, the National Office advised that an interest in a partnership that holds debt-financed property is effectively an interest in the partnership's underlying assets and liabilities. Thus, the National Office deemed the charity to have received unrelated debt-financed income from the sale of its interest in the first partnership.

[2617] 723 T.M. *Publicly Traded Partnerships*, part III.D.2.c. Sale of a Partnership Interest, states:

> Based on the rationale expressed in TAM 9651001,[849] the IRS may attempt to include in a tax-exempt organization's UBTI any gains recharacterized as ordinary income under §751(a) to the extent those gains are attributable to excluded property. In TAM 9651001, the IRS relied in part on §751(a) to justify its application of the aggregate view of partnerships.[850] The IRS also stated that the aggregate view of partnerships is consistent with the treatment of partnerships under § 512(b). This position also would be consistent with the IRS's apparent belief that the same result should occur regardless of whether the tax-exempt organization sold its interest in the partnership or the partnership sold its assets.[851]
>
> [849] *Cf.* Rev. Rul. 89-108, 1989-2 C.B. 100 (gain from sale of partnership interest that is attributable to inventory is not eligible to be reported under installment sale rules because installment method would not be available if selling partner had sold its share of underlying inventory); CCA 200722027 (applying rationale of Rev. Rul. 89-108 to gain attributable to unrealized receivables). See also Rev. Rul. 91-32 (gain on sale of foreign partner's interest in partnership was ECI to extent attributable to U.S. trade or business property of partnership).
>
> [850] It is not clear from the memorandum whether the IRS asserted that § 751(a) treats the transferor as selling an undivided interest in partnership assets rather than a partnership interest. Section 751(a) is merely an income recharacterization rule and should not constitute a basis for deeming a selling partner to have sold an interest in the underlying property of the partnership. The legislative history to the rules regarding transfers of partnership interests is consistent with this approach*.* *See, e.g.*, H.R. Rep. No. 83-1337, at 4096-7 (1954) (stating that § 751(a) was adopted "to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests," but that "[t]he general rule that the sale of an interest in a partnership is to be treated as the sale of a capital asset is retained").
>
> [851] *See* TAM 9651001 ("[a]n anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership

that debt incurred merely to fund operations after the CRT acquires the partnership interest would not generate debt-financed income.[2618] One article suggests that the TAM

> would result another"). For example, if a partnership conducting an unrelated trade or business recognized income from the sale of inventory, § 512(b)(5) would not exclude from a tax-exempt organization's UBTI its distributive share of that income. § 512(b)(5)(A). If, instead, the tax-exempt organization sold its partnership interest, § 751(a) would recharacterize any gain or loss recognized by the organization from the sale that is attributable to the inventory as ordinary income, which then would be included in the tax-exempt organization's UBTI.

Carman, "'Contract Units' As A Work-Around For UBTI," *Journal of Real Estate Taxation* (4th Quarter 2011), stated:

> If an exempt organization is a partner in a partnership that borrows money to make an investment, the unrelated debt-financed income rules are applied to the exempt organization as if the organization borrowed the money and owned the property directly.[9]
>
> [9] Rev. Rul. 74-197, 1974-1 CB 143, TAM 9651001.

In Rev. Rul. 74-197, an exempt organization invested in a general partnership, which borrowed money to acquire investment property. The ruling held that the partnership's borrowing constituted acquisition indebtedness and, accordingly, "the exempt trust's investment activity may result in" UBTI.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests, also approaches the issue on an aggregate basis [footnotes citing to TAM omitted]:

> Importantly, the Service has also ruled that a partner of a partnership is treated as having unrelated debt-financed income on the disposition of a partnership interest that was not acquired with funds borrowed by the tax-exempt organization directly if the partnership itself had acquisition indebtedness with respect to partnership assets. The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that "[t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b))." The Service also made the tax policy argument that "[i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided." The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

[2618] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, commented on the TAM:

> In this technical advice memorandum, the Service also made an important distinction with regard to unsecured debt incurred by the partnership pursuant to a revolving line of credit: namely, that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner. However, the Service also ruled that increases in debt on the revolving line of credit after the exempt organization acquires its partnership interest would constitute acquisition indebtedness only to the extent that the increases were incurred to acquire or improve property within the meaning of Section 514(c)(1)(A), Section 514(c)(1)(B) or Section 514(c)(1)(C). In other words, if the partnership drew down on its line of credit to fund operating expenses, rather than to fund acquisitions of property, increases in the debt incurred on the

may be wrong[2619] but would apply the TAM by referring to the partnership interest rather than looking at the underlying assets,[2620] the latter seeming to be supported by a

revolving line of credit after the exempt organization acquires its interest in the partnership would not constitute acquisition indebtedness.

[2619] Woodhull, "Selling A Partnership Interest Means Complexity For Tax-Exempt Partners," *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), stated that a number of practitioners have questioned whether the IRS position would be upheld if this issue were to be litigated and later argued:

> The IRS also noted that Example 4 of Reg. 1.514(c)-1(a)(2) provides further support for debt-financed UBTI characterization…. According to the IRS, "the debt/basis percentage thus calculated for the partnership interest is the same whether the partnership sells the property or the partner sell its partnership interest."
>
> Notwithstanding the Service's statement in the TAM, Example 4 does not actually state that the debt/basis percentage is the same whether the partnership sells the property or the partner sells the partnership interest. Example 4 in fact provides that "in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage *with respect to its share of partnership income* [emphasis added] for 1972 is 87.5 percent." The conclusion that should be drawn from this example is that portfolio income (interest, rental income, and capital gains) that is reported to a tax-exempt partner on the partner's Schedule K-1 is debt-financed income to the extent of its entire debt/basis percentage. This conclusion in Example 4 is also consistent with Sections 512(c)(1) and 702(b). Both sections, as noted above, attribute the character of the income earned by the partnership to the partners. Furthermore, if the partnership sells its own debt-financed assets, it is clear under Sections 702(b), 512(c)(1), and 512(b)(4) that a portion of the realized gain will be characterized as debt-financed gain to the extent of the debt/basis percentage and that the debt portion of this percentage includes debt incurred to acquire the partnership interest as well as debt incurred by the partnership.
>
> Again, in this situation, the debt-financed gain is reported on the Schedule K-1 issued to the tax-exempt partner. The distinction that appears to be missing from the IRS interpretation of Example 4 in TAM 9651001 is that the above Code sections all relate to income that is earned by the partnership and then allocated and reported on a Schedule K-1 as part of the partner's distributive share. The gain on the sale of a partnership interest is not earned by the partnership and is neither allocated nor reported on the partner's Schedule K-1. Thus, if one looks strictly at the Code and regulations, there is an argument that the "gain" from the sale of the partnership interest that was not acquired with debt should be excluded from characterization as debt-financed UBTI in that the "partnership interest" is not property subject to acquisition indebtedness. The fact that debt is used by the partnership to acquire underlying assets, and that this debt is used to determine the debt/basis percentage of the tax-exempt partner's distributive share of portfolio income allocated by the partnership, does not mean that the proceeds of the partner's sale of its ownership interest are subject to the debt-financed UBTI rules.
>
> The Service's conclusion in TAM 9651001 is that "whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed property." This may be true "economically," but, as discussed above, the Code and regulations do not necessarily support that conclusion. Even when the IRS appears to acknowledge that the "aggregate view" is not clearly supported by Section 514, it still maintains that this approach is suggested by Example 4 and Sections 751 and 512(b), and notes that Congress could not have intended that Section 512(b)(4) could be so easily subverted.

[2620] The article stated:

statement made by a treatise that in other places looks to the aggregate theory.[2621] It's difficult to reconcile the TAM's looking at the aggregate approach and then seeming to

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> Assuming that [the TAM] is a correct interpretation, calculating debt-financed UBTI with respect to the tax-exempt partner's capital gain or loss on the sale of its interest in the partnership will require the partner to:
>
> (1.) Calculate the highest amount of the partnership's indebtedness during the 12-month period ending on the date of the sale, including the partnership's allocable share of any indebtedness in lower-tier partnerships.
>
> (2.) Calculate the tax-exempt partner's allocable share of that indebtedness. Assuming that the debt is nonrecourse debt secured only by the partnership assets, this may be determined by reference to the partner's overall interest in the partnership unless the partnership agreement provides otherwise. If the debt is recourse with respect to one or more partners, it would affect this determination.
>
> (3.) Divide the tax-exempt partner's share of the partnership's indebtedness by the partner's average adjusted basis in the partnership. The partner's average adjusted basis in the partnership is the average of the partner's adjusted basis as of the first day during the tax year of the partner during which it held the interest in the partnership and its adjusted basis as of the date of the sale.
>
> (4.) Multiply the tax-exempt partner's share of the partner's capital gain or loss on the sale of its interest in the partnership by the percentage calculated above. The resulting amount will be debt-financed UBTI to that partner.

It later concluded:

> To determine the portion of the partner's capital gain or loss that is debt-financed UBTI, the tax-exempt partner should multiply its capital gain realized from the sale of the partnership interest as calculated above by the debt/basis percentage, the numerator of which is the partner's share of the highest amount of the partnership's debt during the 12-month period preceding the sale, and the denominator of which is the partner's average adjusted basis in the partnership during the tax year in which the sale took place.

[2621] Compare from fn. 2618 & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, stating that:

> the Service [took the positon] that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner.

with fn. 2617, Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests:

> The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that "[t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b))." The Service also made the tax policy argument that "[i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided." The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

turn around and apply an entity approach.[2622] This uncertainty is not the only way in which the TAM's position creates serious tax issues for exempt organizations that acquire partnership interests for investment purposes.[2623]

II.Q.6.e. Assignment of Income

Although the IRS does not attack the donation of marketable securities that a charity sells immediately after the contribution,[2624] it has attempted to treat, as a sale by the donor, the contribution of closely-held stock to a charity, followed by a redemption. After losing,[2625] the IRS ruled:[2626]

> In *Palmer*, the taxpayer had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the taxpayer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation….The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor

[2622] The IRS might have been uncomfortable applying only an entity approach, in light of GCM 39486 (1986), described in detail in fn. 2595, in which debt from a wraparound mortgage was not deemed assumed by the tax-exempt partner..

[2623] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 29.05. Taxation of Pass-Through Income, made that observation, commenting:

> First, the sale of a partnership interest is not a sale of the underlying asset of the partnership, so the result is not necessarily economically the same. Second, the exempt organization may have no control over the timing of the incurrence or repayment of debt by the partnership. This position is problematic because Section 514 uses a twelve-month lookback rule.

[2624] Rev. Rul. 74-53 (no assignment of income where "no express or implied obligation imposed upon the trustee to sell or exchange"). The assignment of income rule came from *Lucas v. Earl*, 281 U.S. 111 (1930), which held that a person who performs services is taxed on the services, even if the person assigns the earnings to another person.

[2625] *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd* on another issue, 523 F.2d 1308 (8th Cir. 1975).

[2626] Rev. Rul. 78-197, followed Letter Rulings 8623007, 9413020, 9452020, 9452026, 9611047, and 200230004. Taxpayers who fall within Rev. Rul. 78-197 are protected from the IRS. *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993), which focused exclusively on legally binding commitments. In that case, the court faulted the IRS' "nonspecific allegations of an informal agreement or understanding between the donees" and other parties, accepting on their face affidavits the taxpayer produced. The court also rejected the IRS' contentions that certain facts caused the assignment of income doctrine to apply:

> In support of respondent's position that the right to sale proceeds had "ripened to a practical certainty" at the time of the contributions, he cites: (1) The September 28, 1993, letter of intent from WCP expressing its intention to purchase all the issued and outstanding stock of NMG; (2) the October 22, 1993, resolution by WCP's board of directors, which authorized its officers to negotiate and enter into the agreement for the purchase of all the issued and outstanding capital stock of NMG; and (3) a valuation report prepared by Houlihan, Lokey, Howard, & Zukin (Houlihan Lokey), which was attached to petitioners' 1993 return and which opined that, as of November 12, 1993, there was little chance the transaction involving WCP would not close on or before December 31, 1993. Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

> only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

An enforceable cause of action under the promissory estoppel theory counted as a legally binding commitment to sell stock.[2627] So did the tender of shares sufficient to bind the shareholders of a corporation being acquired by a taxable merger, even though the acquiring corporation had not legally bound itself to acquire the shares.[2628]

II.Q.6.f. Donor Cannot Retain Too Many Strings Over Contributed Business Interest

CCA 201507018 disallowed a deduction of a partnership interest (referred to as Units) that the charitable Organization immediately sold for a note to a related party for a note:

> In the present case, Partner has claimed a deduction under § 170 for a donation of Units to Organization. However, after Transaction, and within a day of Partner's assignment of Units to Organization, Organization does not hold any rights to Units. Organization holds Note. Further, Partner, through Partner's power to approve of Partnership distributions to Corp, controls when in fact interest payments will be made on Note. Had Partner or Corp contributed Note directly to Organization, a deduction under § 170 would not be allowed because payment of the donation would not have been made within the year and, under

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[2627] *Blake v. Commissioner*, T.C. Memo 1981-579, *aff'd* 697 F.2d 473 (2nd Cir. 1982).

[2628] *Ferguson v. Commissioner*, 108 T.C. 244 (1997), *aff'd* 174 F.3d 997 (9th Cir. 1999), *followed Gail Vento, LLC v. U.S.*, 111 A.F.T.R.2d 2013-1505 (D.C. V.I. 2013). *Ferguson* included some contingencies that the court disregarded. In *Ferguson*, the gift was made September 9, 1988. Here is the timeline for the tender:

> On July 28, 1988, AHC, CDI Holdings, Inc. (CDI), and DC Acquisition entered into the merger agreement. According to the merger agreement, DC Acquisition would be merged into AHC, and AHC would thereupon become a wholly owned subsidiary of CDI as soon as practicable after DC Acquisition had purchased the stock of AHC pursuant to the tender offer. The merger agreement provided that each outstanding share of AHC stock, following the purchase of AHC stock pursuant to the tender offer, would be converted into the right to receive $22.50 a share in cash. On August 3, 1988, DC Acquisition made a tender offer for the stock of AHC at $22.50 a share. By the close of business on August 31, 1988, more than 50 percent of the outstanding shares of AHC stock had been tendered or guaranteed. At that time, despite the various contingencies to be discussed infra, we believe the reality and substance of the merger agreement and the tender offer indicate that the stock of AHC was converted from an interest in a viable corporation to a fixed right to receive cash.
>
> The tender or guarantee of more than 50 percent of the outstanding shares of AHC stock was the functional equivalent to a vote by the shareholders of AHC approving the merger. The terms of the tender offer provided that DC Acquisition, with the acquisition of a majority of AHC stock, could assure that the requisite number of affirmative votes in favor of the merger would be received even if no other shareholder voted in favor of the merger. Therefore, with the exception of the hypothetical possibility that a sufficient number of tendered or guaranteed shares of AHC stock could be withdrawn, DC Acquisition was positioned to proceed unilaterally with consummation of the merger by the close of business on August 31, 1988.

So the conditions to effectuate the merger had been satisfied before the gift, with the chance of the conditions being undone being viewed as remote.

Rev. Rul. 68-174, Note would have been treated as a promise to make a donation, but not an actual donation.

….

Under the terms of the Partnership Agreement, Organization is required to surrender its right as an assignee of Units to Partner on Partner's terms. Further, under the Partnership Agreement, Organization had to obtain the approval of Partner to transfer its interest in Units. Partner, in Partner's sole discretion, could approve or disapprove any transfer. Partner, in exercising this discretion, had no fiduciary duty at the time of Transaction to Organization. If Organization attempted to transfer its interest in Units to a third party, Partner had the power to nullify the transfer. Further, the Special Call Price would become active and the call price provision limits the call price to Organization's contributions which are zero. Accordingly, Partner had the power to nullify the donation to Organization if Organization attempted to transfer its interest in Units without Partner's approval. Further, Organization could not retain its interest in Units without violating its representations to the Service that it would not hold an interest in a Partnership with nonexempt taxpayers. Partnership could call Organization's interest in Units at any time. Based on the above elements of Transaction, Organization was essentially compelled to engage in Transaction.

II.Q.6.g. Charitable Partial Interest Prohibition

Generally, if a taxpayer contributes less than the taxpayer's entire interest in such property, for individual income tax purposes[2629] a charitable income[2630] tax deduction is allowed only to the extent that the value of the interest contributed would be allowable as a deduction if that interest had been transferred in trust. This rule does not apply if the donation is of "the taxpayer's entire interest in the property, such as an income interest or a remainder interest."[2631] However, if "the property in which such partial interest exists was divided in order to create such interest and thus avoid" the partial interest prohibition, the deduction is not allowed.[2632] On the other hand, if the taxpayer donates

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[2629] This provision applies for purposes of Code § 170, which is contributions deducted on a personal income tax return (including contributions through an S corporation or a partnership). It does not apply for the fiduciary income tax deduction under Code § 642(c); see part II.J.4.c Charitable Distributions. However, if and to the extent that the trust has unrelated business taxable income, Code § 170 would apply. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2732-2738. See also part II.Q.6.d Unrelated Business Income.

[2630] Code § 170(f)(3)(A). However, Code § 170(f)(3)(B) excludes from this rule a contribution of a remainder interest in a personal residence or farm, a contribution of an undivided portion of the taxpayer's entire interest in property, and a qualified conservation contribution.

[2631] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, if securities are given to A for life, with the remainder over to B, and B makes a charitable contribution of his remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of B's remainder interest in the securities.

[2632] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer transfers the remainder interest in such

to more than charity all of the taxpayer's partial interests in the aggregate, the partial interest prohibition does not apply.[2633] Nor does it apply "merely because the interest which passes to, or is vested in, the charity may be defeated by the performance of some act or the happening or some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible."[2634] Also, the prohibition does not apply to an undivided portion of a donor's entire interest in property, which "must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[2635] Although the preceding sentences describe income tax rules, similar rules apply for gift tax purposes.[2636]

Rev. Rul. 76-143 held that the partial interest prohibition denied charitable deductions when the taxpayer donated the cash surrender value and retained the right to the death benefit, even if all of the rights were fixed (including making the beneficiary designation irrevocable). The denial applied whether the cash value was fully paid[2637] or was for

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property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

[2633] Reg. § 1.170A-7(a)(2)(ii).

[2634] Reg. § 1.170A-7(a)(3), referring to Reg § 1.170A-1(e), which provides:

Transfers subject to a condition or power. If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible. A is entitled to a deduction under section 170 for his charitable contribution.

[2635] Reg. § 1.170A-7(b)(1)(i).

[2636] Code § 2522(c)(2), incorporating by reference the Code § 170(f)(3)(B) exclusion in fn. 2630; see Reg. § 25.2522(c)-3(c).

[2637] The ruling reasoned:

In *Situation 1*, the gift made by the taxpayer of the right to the cash surrender value of the policy was a gift of less than an entire interest in the property. Furthermore, a gift of this kind is not a gift of a fraction or percentage of each and every substantial interest owned by the donor in such property since the taxpayer retained the right to designate the beneficiary. Even if the taxpayer irrevocably designated the beneficiary prior to making the gift in order to create a remainder interest that would then constitute the taxpayer's entire interest in the property, such division would be regarded as having been made to avoid section 170(f)(3)(A) of the Code and the deduction would not be allowed.

cash value build-up due to the current year's premium.[2638] Now, Code § 170(f)(10) also prohibits various split-dollar and similar arrangements from qualifying for the charitable deduction.

If a donor transfers voting stock but retains the voting rights, Rev. Rul. 81-282 asserted that retaining the voting rights violated the partial interest prohibition.[2639] However, when a donor kept voting and donates nonvoting restricted[2640] stock, the donation did not constitute a partial interest.[2641]

If the owner of the working interest under an oil and gas lease[2642] gives an overriding royalty interest[2643] or a net profits interest[2644] to a charitable organization, Rev.

[2638] The ruling reasoned:

> In *Situation 2*, the gift made by the taxpayer of the right to the cash surrender value of a nonpaid-up life insurance policy was also a gift of less than the taxpayer's entire interest in the property. Since the taxpayer retains the right to designate the beneficiary, and the right to surrender the policy and defeat the college's interest, the gift is not a gift of a fraction or percentage of each and every substantial interest in the property.

[2639] The ruling reasoned:

> The right to vote stock is inherent in the ownership of common stock and, as such, is a property right. This right gives the holder a voice in the management of the corporation and is crucial in protecting the stockholder's financial interest. Therefore, the right to vote the stock of X is a substantial right in that stock. See *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945); and *DuVall v. Moore*, 276 F.Supp. 674 (N.D. Iowa 1967).
>
> While A's retention of the right to vote the stock will not defeat Y's right to dividends or the right to dispose of the stock, and, while the right retained by the donor will not defeat the donee's interest in the transferred property, nevertheless, A has not transferred all substantial rights in the stock to Y. Therefore, A has transferred a partial interest in property to Y within the meaning of section 170(f)(3) of the Code. See Rev. Rul. 76-143.

[2640] Comparing Class A voting to Class B nonvoting:

> The rights of the Class A shares are freely transferable. In contrast, the Class B shares are not transferable except: (1) to the Corporation; (2) in connection with an acquisition of the Corporation; (3) in the case of natural persons, upon death or pursuant to a valid and binding court order mandating transfer; or (4) with the consent of the Corporation's Board of Directors.

[2641] Letter Ruling 201129033, holding:

> In the present case, Donor and Donor's Spouse propose to transfer Class B common stock to Charity. The Class B common stock is a separate property interest apart from the other class of stock in Corporation. Under the facts as presented, the shares of one class of stock do not constitute an interest in the shares of any other class of stock. Therefore, we conclude that for gift tax purposes the plan described above will not result in interests in the same property passing for both charitable and noncharitable purposes within the meaning of § 2522(c)(2).

[2642] The ruling describes a working interest:

> A working interest is the operating interest under an oil and gas lease. It is typically created by a transaction in which the owner of a tract of land, or the owner of the mineral rights to a tract of land, grants the right to exploit the oil and gas under the land, while at the same time retaining a royalty interest in production. Alternatively, the owner of a tract of land, or the owner of mineral rights to a tract of land, may, as in the instant case, retain the working interest and grant a royalty interest to another person. The owner of the working interest has the exclusive right to exploit the oil and gas resources. For federal tax purposes, a working interest is defined as an interest in oil and gas in place that is burdened with the cost of development and operation of the property. *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970).

Rul. 88-37 asserts that the partial interest rule bars the deduction. The ruling viewed the right to control or to participate in control, which a working interest has but which neither an overriding royalty interest nor a net profits interest has, as a substantial right, the retention of which prevents the donated interest from being considered an undivided interest in the donor's property rights.[2645]

After defining an overriding royalty interest (see fn. 2643) and a net profits interest (see fn. 2644), the ruling comments:

> The right to exploit the oil and gas resources under the land is a right inherent in the ownership of a working interest. Even an owner of only a percentage of the working interest has the right to participate in decisions on the exploitation of the oil and gas resources. The owner of an overriding royalty interest or a net profits interest does not have this right.

[2643] The ruling describes an overriding royalty interest:

> An overriding royalty interest is an economic interest in oil and gas in place, created from the working interest. An overriding royalty entitles its owner to a specified fraction of gross production, free of operating and developing costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. The transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income. See Rev. Rul. 67-118, 1967-1 C.B. 163.

[2644] The ruling describes a net profits interest:

> A net profits interest is, for federal tax purposes, an interest in oil and gas in place that is defined as a share of gross production measured by net profits from operation of the property. It is created out of the working interest and has the same duration. Unlike the income accruing to an overriding royalty, the income accruing to the net profits interest is reduced by specified operating and development costs, but the interest bears these expenses only to the extent of its share of the income. Unlike the working interest, the net profits interest is not required to pay out, advance, or become liable for such costs. *Burns v. Commissioner*, 78 T.C. 185, 209 (1982). Like a transfer of an overriding royalty, the transfer of such a net profits interest conveys, for federal tax purposes, a depletable property interest in oil and gas in place. See *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946), 1946-1 C.B. 69; *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946), 1946-1 C.B. 237.

[2645] The IRS reasoned:

> … the donor did not contribute the donor's entire interest in the property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor has retained the right inherent in the ownership of a working interest to control, or, in the case of ownership of a part of the working interest, to participate in the control of, the development and operation of the lease. This right to control or to participate in control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion.
>
> After the transfer, … the contributed interest is a separate property interest for federal tax purposes. However, if the charitable interest is created by dividing a greater interest held by the donor, the application of section 170(f)(3) to deny the charitable contribution deduction is not precluded merely because the contributed interest is a separate property in the hands of the donee and the incidence of taxation on income from the contributed interest is shifted from the donor to the donee. Rev. Rul. 70-477, 1970-2 C.B. 62, for example, holds that for years after the effective date of section 170(f)(3), a contribution of rent-free use of property, even if recognized as a conveyance of property under local law, does not give rise to a deduction under section 170.

Rev. Rul. 2003-28 asserted that the partial interest prohibition applies to patents:

(1) A taxpayer's contribution to a qualified charity of a license to use a patent is not deductible under § 170(a) if the taxpayer retains any substantial right in the patent.[2646]

(2) A taxpayer's contribution to a qualified charity of a patent subject to a conditional reversion is not deductible under § 170(a), unless the likelihood of the reversion is so remote as to be negligible.

(3) A taxpayer's contribution to a qualified charity of a patent subject to a license or transfer restriction is deductible under § 170(a), assuming all other applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170, but the restriction reduces what would otherwise be the fair market value of the patent at the time of the contribution, and therefore reduces the amount of the charitable contribution for § 170 purposes.[2647]

Generally, all the rights to a partnership are considered a single property interest.[2648] It would not appear to be susceptible to being split up as separate assets the way that

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In both Situation 1 and Situation 2, therefore, the contributed interest is less than the taxpayer's entire interest within the meaning of section 170(f)(3) of the Code, and is not an undivided portion of the taxpayer's entire interest. In each case, the partial interest was not transferred in trust and was not in a form that would have resulted in an allowable deduction under section 170(f)(2) had it been transferred in trust.

[2646] The ruling reasoned:

In *Situation 1*, X contributes a license to use a patent, but retains a substantial right, i.e., the right to license the patent to others. The license granted to University is similar to the rent-free lease described in § 1.170A-7(a)(1) and the partial interest in motion picture films described in § 1.170A-7(b)(1)(i), in that it constitutes neither X's entire interest in the patent, nor a fraction or percentage of each and every substantial interest or right that X owns in the patent. As a result, the contribution in Situation 1 constitutes a transfer of a partial interest, and no deduction under § 170(a) is allowable. The result would be the same if X had retained any other substantial right in the patent. For example, no deduction would be allowable if X had contributed the patent (or license to use the patent) solely for use in a particular geographic area while retaining the right to use the patent (or license) in other geographic areas.

[2647] The ruling reasoned:

In *Situation 3*, Z transfers to University all of Z's interests in the patent with the restriction that University cannot transfer or license the patent for a period of 3 years after the transfer. Unlike the conditional reversion in Situation 2, the restriction on transfer or license is not a condition that can defeat the transfer. Thus, Z's contribution is deductible under § 170(a), assuming all other applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170. See Publication 526, Charitable Contributions (describing other requirements for, and limitations on, the deductibility of charitable contributions). Under § 1.170A-1(c), however, the restriction reduces what would otherwise be the fair market value of the patent, and therefore reduces the amount of Z's charitable contribution. If Z had received a benefit in exchange for the contribution, the value of the benefit would further reduce the amount of Z's charitable contribution. See § 1.170A-1(h); Rev. Rul. 67-246, 1967-2 C.B. 104. See also *Singer Co. v. United States*, 449 F.2d 413, 423-424 (Ct. Cl. 1971).

[2648] See part II.Q.8.e.ii.(a) Unitary Basis, citing Rev. Rul. 84-53.

corporate stock would be. Thus, a donor should transfer a vertical slice of all of the donor's interest in the partnership.

Donating an assignee interest and retaining the voting rights might be comparable to Rev. Rul. 81-282[2649] and violate the split-interest prohibition. However, when taxpayers donated all of their interest, which was an interest as a limited partner, but the donees received only an interest as an assignee, the Tax Court[2650] and Fifth Circuit in *McCord* allowed a charitable gift tax deduction for an interest as an assignee.[2651] On the other hand, Judge Swift's concurring opinion in the Tax Court argued that the partial interest prohibition applied to assignee interests. Judge Swift pointed out that the donor transferred the economic rights but not the voting and other noneconomic rights[2652] to charity. The majority and Fifth Circuit did not address the issue, being content with the donor having transferred all of the donor's rights.[2653] Both arguments are correct, but neither pointed out what happened to the donor's voting rights. When a partner transfers all of the partner's interest in a partnership and the transferee is not admitted as a partner, the transferor's voting rights lapse. This lapse then gives others who have the right to vote on those matters a higher proportionate vote. Judge Swift, although pointing out that that the charity did not receive noneconomic rights, did not articulate that the donor's voting rights essentially shifted to the other limited partners. Neither the majority nor the Fifth Circuit addressed this shift; their written opinions did not indicate whether they understood that the shift occurred. Thus, one can point to *McCord* as support for the proposition that one does not need to transfer one's noneconomic rights to a charity to avoid the partial interest prohibition, if one does not retain any noneconomic rights, but the strength of this support is unclear, given the lack of analysis of what happened to the voting rights. To avoid any doubt, one might suggest transferring voting rights as well.

[2649] See fn. 2639.

[2650] *McCord v. Commissioner*, 120 T.C. 358 (2003) (reviewed opinion).

[2651] *Succession of McCord, Jr. v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), allowing the deduction without even mentioning the partial interest rule.

[2652] The majority described certain rights:

> Limited partners generally do not participate in the management of the partnership's affairs. However, limited partners do have veto power with respect to certain "major decisions", most notably relating to voluntary bankruptcy filings. In addition, if any two of the children are not serving as managing partners, class B limited partners have voting rights with respect to certain "large dollar" managerial decisions. Limited partners also have access to certain partnership financial information.

[2653] See fn. 2635, providing that transferring an undivided interest in all of the donor's rights is an exception to the partial interest rules. In *McCord*, the assigned interests also carried with them the right to sell their interests at fair market value for cash, which sale took place shortly after the transfer. Perhaps this quick liquidation made the court more sympathetic to allowing the charitable deduction?

II.Q.7.c. S Corporations Owned by a Trust Benefitting Charity

S corporation stock is a challenging asset for a charity to hold.

Note that a charitable remainder trust can own a partnership but not an S corporation.[2722]

Also see parts II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership and II.Q.6 Contributing a Business Interest to Charity. For a discussion of S corporation contributions to charity, see C. Hoyt, "Charitable Gifts By Subchapter S Corporations and by Shareholders of S Corporation Stock," *ALI-ABA Estate Planning Course Materials Journal* (April 2006).[2723]

The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[2724]

II.Q.7.c.i. Income Tax Trap - Reduction in Trust's Charitable Deduction

II.Q.7.c.i.(a). Contribution Must Be Made from Gross Income

Although trusts can deduct amounts of gross income[2725] paid to charity, the trust must actually receive the income and must be authorized to make the payment to charity.[2726]

[2722] Code § 1361(e)(1)(B)(iii).

[2723] http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.

[2724] Letter Ruling 201441018.

[2725] The amount must be payable out of gross income and not out of corpus. Rev. Rul. 2003-123 pointed out the requirement to trace gross income:

> Under section 642(c), a trust is generally allowed an unlimited charitable deduction for amounts that are paid from gross income for charitable purposes pursuant to the terms of the governing instrument. Because section 642(c) specifically requires that a charitable deduction is available only if the source of the contribution is gross income, tracing of the contribution is required in determining its source. *Van Buren v. Commissioner*, 89 T.C. 1101, 1109 (1987); *Riggs National Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965); *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1108 (1973); see also *Crestar Bank v. Internal Revenue Service*, 47 F. Supp.2d 670 (E.D. Va. 1999).

However, various conventions apply to this tracing rule. Satisfaction of a formula pecuniary bequest that is not allocated income does not qualify for this charitable deduction. Rev. Rul. 68-667. On the other hand, if the trust instrument is silent, a charitable deduction is allowed when applicable state law provides that, where the trust instrument is silent, payments are required to be made first from income of the trust and, if the income is not sufficient, then from its principal. Rev. Rul. 71-285. Thus, the IRS is not looking to trace dollars mechanically but rather looks to whether the income was first earned and then allocated to the contribution.

[2726] Rev. Rul. 2004-5 stated:

> For a trust to claim a charitable deduction under § 642(c) for amounts of gross income that it contributes for charitable purposes, the governing instrument of the trust must give the trustee the authority to make charitable contributions. This requirement is an essential element to qualify the trust to claim a deduction for a charitable contribution made directly by the trust. In the case of a trust's investment in a partnership, the partnership may make a charitable contribution from the partnership's gross income, and that income is never available to the trust. For federal tax purposes, however, the trust

Income included on an estate's K-1 from an S corporation does not support a Code § 642(c) deduction unless the S corporation distributes that income to the estate. This policy is so strong that an estate was not permitted a charitable set-aside deduction with respect to undistributed S corporation income even though the estate was the sole owner of the S corporation and the charity would ultimately receive all of the estate's residue, including the S corporation stock.[2727] An S corporation was able to satisfy this requirement by distributing accounts receivable, which would first be used to satisfy remaining estate liabilities and then either be distributed to or set aside for the estate's sole beneficiary, a private foundation.[2728] If there is a disconnect between cash flow and K-1 items, consider creating an LLC that holds plenty of cash and also holds the partnership or S corporation. That way, the K-1 from the partnership or S corporation can be accompanied by cash. If the pass-through entity is an S corporation, the estate must be the LLC's sole owner so that the LLC can be disregarded for income tax purposes; an LLC taxed as a partnership would not be an eligible S corporation shareholder.[2729]

The extent to which gross income the trust received during the year must be traced to a distribution from the trust to charity is unclear; the IRS appears to believe that, the distribution to charity can be deducted to the extent that the distributed property itself constituted gross income in the current or in any prior year.[2730]

> must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits. Under these circumstances, a trust's deduction for its distributive share of a charitable contribution made by a partnership will not be disallowed under § 642(c) merely because the trust's governing instrument does not authorize the trustee to make charitable contributions.

FSA 200140080 reached the same conclusion, pointing out that the UBTI concerns described below must also be addressed. CCA 200928029 (which appears to have been a quick email) asserted:

> Rev. Rul. 2004-5 does permit trusts to claim charitable contributions made by a partnership of which the trust is a partner, even if the trust instrument does not provide for charitable contributions. However, the Rev. Rul. does not eliminate a second requirement that this charitable contribution be made out of the trust's gross income. Therefore, the contribution of the easement does cannot be claimed as a charitable contribution.

Gross income distributed to charity under an inter vivos power of appointment to distribute to charity satisfies the requirement that the charitable distribution be authorized under the trust agreement. Letter Ruling 200906008.

[2727] *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970), *reh. den.* 430 F.2d 710 [the decision and the denial of rehearing were published together], *cert. den.* 4/5/1971, *reh. den.*, 403 US 912 (1971).

[2728] Letter Ruling 201246003.

[2729] See part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity, especially fns. 111-114, the latter which makes me very confident that a disregarded entity treated as owned by one qualified individual can hold stock in an S corporation so long as the entity continues to be disregarded in that manner.

[2730] CCA 201042023 (trust's charitable contribution deduction should be limited to the adjusted basis of the properties purchased from accumulated gross income). Contradicting the CCA and holding in the taxpayer's favor is *Green v. United States*, 2015 BL 363697, W.D. Okla., No. 5:13-cv-01237, 11/4/15 (trust's charitable contribution deduction are *not* limited to the adjusted basis of the properties purchased from accumulated gross income). *U.S. v. Benedict*, 338 U.S. 692 (1950) ("capital gains which expressly is not to be taken into account in computing taxable net

II.Q.7.c.i.(b). Business Income Limiting Trust Income Tax Deduction

Although normally trusts may deduct all of their gross income that they pay to charity,[2731] this deduction is eliminated to the extent that the trust has unrelated business taxable income (UBTI).[2732] However, in computing the UBTI causing this disallowance, a charitable contribution deduction is allowed, using the percentages that apply to contributions by an individual.[2733] Thus, a partial charitable contribution is allowed to be made out of unrelated business income.[2734] The contribution must be made during the taxable year; the one-year delay permitted by Code § 642(c)(1) does not apply to this deduction.[2735] Furthermore, consider whether the trust also becomes subject to an individual's restrictions[2736] regarding substantiation[2737] and identity of donee.[2738]

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income as also excluded from statutory gross income") denied a deduction under for a contribution of certain capital gains because those gains were excludable from gross income under another provision. The CCA cited that case and *W.K. Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3d Cir. 1944), both of which the *Green* judge rejected as controlling.

See also fn. 2725 (tracing requirement applies but uses accounting conventions rather than actual tracing); Fox, ¶12.04 Requirement That Source of Contribution Be From Gross Income, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L); WTAS LLC, ¶31.09 Source of Payment: Gross Income Only, *Tax Economics of Charitable Giving* (WG&L), citing *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) (charitable contributions by a trust need not be shown to have been paid out of income received in the year in which they were made if, by the terms of the trust, no limitation was prescribed on the source of payment), and its progeny.

Jonathan Blattmachr's 2015 Heckerling materials stated:

> It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of Section 642(c).[23]
>
> [23] See, e.g*., Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), dealing with the predecessor to current Section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See, also, Chief Counsel Advice (CCA) 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property. (Not precedent.) Cf. *Crestar Bank v. Internal Revenue Service*, 47 F.Supp.2d 670 (E.D. Va. 1999); *Freund's Estate v. Commissioner*, 303 F.2d 30 (2nd Cir. 1962); *Sid W. Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (1944); *Estate of Joseph Esposito v. Commissioner*, 40 TC 459 (1963).

[2731] Code § 642(c).

[2732] Code §§ 642(c)(4) and 681. See part II.Q.6.d Unrelated Business Income.

[2733] Code § 512(b)(11); Reg. § 1.512(b)-1(g).

[2734] Reg. § 1.681(a)-2(b).

[2735] Reg. § 1.681(a)-2(a).

[2736] Reg. § 1.681(a)-2(a) provides:

> While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to "unrelated business income", a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section.

Code § 512(b)(11) provides:

> In the case of any trust described in section 511(b) , the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income if the shareholder is an IRA holding bank stock before October 22, 2004 or is a qualified retirement plan (other than an ESOP) or a Code § 501(c)(3) charity; [2739] as mentioned above, Code § 681(a) takes away the Code § 642(c) deduction from trusts (and instead applies the individual percentage limitations) to the extent that they have unrelated business income, determined as if the trust were a Code § 501(c)(3) charity. This is yet another disadvantage of S corporations compared to partnerships, the income from which is unrelated business income only to the extent it fits within the usual unrelated business income (UBI) categories; see part II.Q.6.d Unrelated Business Income. If a trust that owns S corporation stock that is includible in the income beneficiary's estate and has a charitable remainderman, the S corporation might liquidate immediately after the beneficiary's death, to minimize UBTI; one easy way might be to convert the S corporation to an LLC taxed as an S corporation during the planning stage,[2740] then revoke the election to be taxed as a corporation as of the beneficiary's death.

This partial deduction means that the trustee should not distribute all of the UBI to charity, because the trust will need to pay income tax on the UBI that cannot be fully offset by the charitable deduction.[2741] If the trust mandates that all of the income be paid

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> or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Tying in the final piece of statutory authority, Code § 511(b) provides:

> (1) *Imposition of tax*. There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1(e). In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.
>
> (2) *Charitable, etc., trusts subject to tax*. The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

[2737] See part II.J.4.c Charitable Distributions, fn. 1279.

[2738] See part II.J.4.c Charitable Distributions, fn. 1280.

[2739] Code § 512(e), which was added by P.L. 104-188, effective for taxable years beginning after December 31, 1997.

[2740] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Instead of doing a merger or former conversion, the S corporation might transfer all of its assets to the LLC and then liquidate, trying to use the statute of limitations for claims against liquidated companies to avoid claims by creditors from when the S corporation operated a business or otherwise subjected itself to tort liabilities; see part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

[2741] For example, in Reg. § 1.681(a)-2(c), Ex. 3, the trust paid the charity all $31K of its UBI, but it still had $24K of taxable income (based on a 20% charitable deduction limitation). It reserved no cash to pay that tax, a fact not pointed out by the Example.

to charity, the trustee may still allocate the taxes as an expenditure charged against income so that the trustee can pay the taxes.[2742]

Fortunately, these rules do not apply to estates.[2743] If a qualified revocable trust elects to be taxed as an estate, then it should escape this limitation.[2744] These rules also would not apply to QSSTs, because the beneficiary is treated as the owner of the S corporation stock for income tax purposes;[2745] of course, the beneficiary would have the overall charitable deduction contribution limitations, which limitations do not apply to trusts that do not have unrelated business income. An ESBT cannot deduct contributions it makes but can, subject to the rules of this part II.Q.7.c.i, deduct its distributive share of contributions the S corporation makes.[2746]

Once all of this analysis regarding unrelated business income is done at the trust level, presumably it will not be repeated at the charity's level, because the trust does not give the charity a K-1.[2747] When deciding whether to have a business run by a charity itself or by a trust that benefits charity, consider the following:

- If the activity definitely would generate UBTI, run it through the trust. Instead of all of the UBTI being taxed, the trust will be taxed on only the excess UBTI over the charitable deduction.

- If there is substantial authority for the activity not generating UBTI, for example because it is related to the charity's exempt purpose, then perhaps the charity should undertake the activity and report it as not being subject to UBTI.

[2742] Section 506(a)(2) of the Uniform Principal and Income Act.

[2743] Code § 681 and the regulations thereunder apply to trusts; they does not mention estates. Letter Ruling 201246003 authorized a full Code § 642(c) deduction for income from an S corporation set aside for the estate's sole beneficiary, which was a private foundation.

[2744] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

[2745] See fn. 3566.

[2746] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3601.

[2747] Consistent with Code § 663(a)(2), Reg. § 1.663(a)-2 provides:

> Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income private foundations).

Notice 2004-35 provides:

> The Treasury Department and the Internal Revenue Service intend to propose regulations modifying Treas. Reg. § 53.4940-1(d)(2) to provide that a private foundation's net investment income for purposes of section 4940 does not include distributions from trusts and estates. Until further guidance is promulgated, income distributions from trusts and estates will not retain their character in the hands of a distributee private foundation for purposes of determining the foundation's net investment income under section 4940(c).

II.Q.7.c.ii. Private Foundations, Etc.

A private foundation may hold only limited amounts of an S corporation (or similar amounts for other entities, including C corporations and partnerships),[2748] and any excess amounts may be held for only five or so years.[2749] However, if the business entity does not operate a business and instead merely generates investment income, it will not be subject to this rule.[2750]

II.Q.7.c.iii. Cleansing Earnings and Profits from a Prior C Corporation

As discussed above, dividend treatment applies to the extent that a distribution exceeds AAA and is made out of C corporation earnings and profits. This treatment would not apply on liquidation of the corporation.[2751] What happens when a trust that owns an interest in an S corporation has a charity as its beneficiary?

The charitable income tax deduction should offset dividend income received by the trusts from the corporation.[2752] Making an ESBT election should not affect the charitable income tax deduction, because the dividend is not considered part of the S portion.[2753] If the trust's basis in the S corporation stock was determined by reason of purchase, the dividend income reduces the basis of the S stock in determining the gain or loss on the sale that constitutes unrelated business taxable income.[2754]

If distributions exceed AAA and earnings & profits, that excess would be treated as a return of capital,[2755] reducing basis.[2756] Any amount that exceeds basis would be treated as a gain from the sale of stock,[2757] which would be treated as part of the S portion and,

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[2748] Reg. § 53.4943-3(c) applies these rules to partnerships, sole proprietorships, trusts, etc. See Wilson, "Better Late than Never: Incorporating LLCs into Section 4943" (3/31/2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587781 or Thompson Coburn LLP document number 6174131; I am not expressing an opinion on the article's recommendations.

[2749] Code § 4943. The founder might be able to give all of his or her C corporation voting stock to one or more trusts and all of his or her nonvoting stock to charitable remainder trusts. See Letter Ruling 201303021.

[2750] Letter Ruling 201447043, citing Code § 4943(d)(3).

[2751] See Letter Ruling 200402003 regarding an S corporation that merges into a nonprofit corporation.

[2752] Code § 642(c). Code § 512(e)(1) characterizes S corporation items as unrelated business income; however, those items are just items on the K-1 issued by the S corporation, together with any gain or loss on the disposition of the stock in the S corporation. Congress appeared to recognize that distributions of C corporation earnings and profits would escape this tax when it provided for basis reductions with respect to some of that dividend income, as described in the text accompanying fn. 2754; this basis reduction provision was enacted at the same time as the tax K-1 items and gain on the sale of stock. See Conference Report 104-737, reproduced in *RIA Checkpoint* at COMREP ¶13,611.001 S corporations permitted to have 75 shareholders. (Small Business Job Protection Act of 1996, PL 104-188, 8/20/96), P.L. 104-188, Sec. 1316(c), and P.L. 105-34, Sec. 1523(a).

[2753] Reg. §§ 1.641(c)-1(g)(2), 1.641(c)-1(l), Example (1)(iii).

[2754] Code § 512(e)(2). This rule would not apply if the trust acquired its stock by reason of death, since that provision (by way of Code § 1361(e)(1)(C)) refers to Code § 1012, not Code § 1014.

[2755] Code § 1368(c)(3).

[2756] Code § 1368(b)(1).

[2757] Code § 1368(b)(2).

if an ESBT election is in effect, would not be offset by the charitable income tax deduction.

If an amount is intended to be accumulated in the trust, then using AAA is the easiest way.

If an amount is intended to be distributed to charity and it's possible that future distributions will need to be accumulated, then a Code § 1368(e)(3) election should be made to treat the distribution as a dividend from earnings and profits so that AAA is used only for future accumulated distributions.

II.Q.7.c.iv. Using a Charitable Remainder Trust to Avoid Built-in Gain Tax

If an S corporation contributes built-in gain property to a term-of-years (typically 20 years) charitable remainder trust ("CRT") for the benefit of the corporation[2758] and that property is sold for a capital gain, then the sale will not trigger immediate tax. Instead, the CRT's distributions will come first from ordinary income and not from any built-in gain, and during the recognition period distributions will be subject to built-in gain tax only to the extent that capital gain constituting built-in gain is distributed to the S corporation.[2759] The contributed assets must not constitute substantially all of the corporation's assets, since a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[2760] See also part II.D.2 Business Entity as Grantor of Trust.

Also, if and to the extent that sale (or holding) of the asset constitutes unrelated business taxable income (UBTI), this strategy will not work. Any UBTI a CRT earns is subject to a 100% excise tax, in addition to being taxable when distributed to the beneficiary, resulting in an ultimate tax well in excess of 100%.[2761] For example, a so-called "negative basis asset"[2762] generally has significant debt-financed income, and debt-financed income/gain and ordinary business income are UBTI.[2763]

[2758] The term interest must benefit the corporation; if it benefits the shareholders, then the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders for tax purposes and the partners or the shareholders will be treated as the grantors of the trust. Letter Ruling 200203034, citing Reg. § 1.671-2(e)(4), and also holding that the trust would not qualify as a charitable remainder trust.

[2759] Letter Ruling 200644013 focused on whether a contribution of property that had built-in gain accumulated from prior C corporation years would trigger Code § 1374 built-in gain tax. In that ruling, the corporation contributed real estate to a 20-year CRT. Later, but before the end of the Code § 1374 recognition period, the CRT would sell the property and use the sale proceeds to invest in stocks, bonds, and other securities that pay interest and dividends. The IRS declined to rule on whether the corporation would have recognized built-in gain under Code § 1374 on unitrust amounts received by it after the recognition period.

[2760] Reg. § 1.337(d)-4(a)(1).

[2761] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fns. 2592-2593.

[2762] See fn. 3948.

[2763] Code §§ 512, 513, and 514. Consider whether Code § 514(c)(2)(B) might address that concern.

III.A.3. Trusts Holding Stock in S Corporations

Estates, including not only decedents' estates but also bankruptcy estates, are qualified shareholders during a reasonable period of administration.[3454]

The rest of this part III.A.3 deals with trusts.

III.A.3.a. Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures

A wholly owned grantor trust is among the types of trusts that can hold stock in an S corporation. For a description of the types of trusts that qualify, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

Below are discussions of what types of trusts can qualify as wholly owned grantor trusts, what it means to be "wholly" owned, how a trust can fall short, and what step an S corporation should take to avoid a trust falling short if it is at risk for doing so.

III.A.3.a.i. Qualifying as a Wholly Owned Grantor Trust

This part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures discusses a trust that qualifies as a shareholder solely because all of the trust is treated under the grantor trust rules as owned by an individual who is a citizen or resident of the United States.[3455] If a trust has more than one deemed owner but they have substantially separate and independent shares, the trusts are treated as separate trusts[3456] and may separately qualify as wholly owned grantor trusts.[3457]

[3454] Code §§ 1361(b)(1)(B), 1361(c)(3); Reg. §§ 1.1361-1(b)(1)(ii), 1.1361-1(b)(2).

[3455] Implementing Code § 1361(c)(2)(A)(i), Reg. § 1.1361-1(h)(1)(i) provides:

> *Qualified subpart E trust*. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

[3456] Implementing the flush language at the end of Code § 1361(d)(3), Reg. § 1.1361-1(j)(3) includes:

> For purposes of sections 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust.

[3457] In approving a community property trust as an eligible shareholder before and after divorce, Letter Ruling 9729025 held:

> Under the trust agreement, H and W retain the power to revoke TR and revest the trust's property in themselves. Therefore, H and W are treated, under section 676, as the owners of TR until their divorce. Because TR is treated as owned entirely by H and W between d2 and d3, TR is a trust described in section 1361(c)(2)(A)(i).
>
> Under section 663(c) and section 1.663(c)-1(a) of the Income Tax Regulations, shares of a single trust are treated as separate trusts if the trust has more than one beneficiary and the different beneficiaries have substantially separate and independent shares. Section 1.663(c)-3 provides that the applicability of the separate share rule generally depends upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to

If not a foreign trust,[3458] such a grantor trust automatically qualifies as an S corporation shareholder,[3459] and the trust's deemed owner is treated as the shareholder for all tax purposes,[3460] including the 100-shareholder limitation.[3461]

A revocable trust would qualify as a grantor trust taxed to its grantor.[3462] An irrevocable trust might qualify as a grantor trust taxed to the grantor under the normal rules of Code §§ 671-677, to the beneficiary under Code § 678, or to the beneficiary through a QSST election made by the beneficiary.

A trust might be taxable to a beneficiary under Code § 678 if the beneficiary has a withdrawal right with respect to all gifts to the trust (a *Crummey* trust);[3463] whether such

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> divide the trust estate into separate shares for each beneficiary and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income or to do both, separate shares will exist under section 663(c).
>
> Upon the dissolution of H's and W's marriage, the community property held by TR (including the X stock) was divided equally on the trustee's books and each half was treated as the separate property of H and W. As a result, H was entitled to all of the income from his separate share of the trust property and so much of the principal as he directed. Likewise, W was entitled to all of the income from her separate share of the trust property and so much of the income as she directed. Therefore, H's and W's shares of TR are substantially separate and independent shares within the meaning of section 663(c).

I am not sure that I agree with the logic of why the trust qualified while they were married, although ultimately the result was probably correct. The ruling points out that Code § 1361(c)(1) treats spouses as one shareholder for purposes of Code § 1361(b)(1)(A). However, the ruling determined eligibility under Code § 1361(c)(2)(A)(i), so presumably applying the spousal unity rule for purposes of Code § 1361(b)(1)(A) would not have been relevant to the ruling. Therefore, in case the ruling's spousal unity reasoning was incorrect, consider having any community property trusts held as separate and independent shares during life.

[3458] Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.

[3459] Code § 1361(c)(2)(A)(i).

[3460] Code § 671. Grantor trusts may use their deemed owners' social security numbers as their taxpayer identification numbers. Reg. § 1.671-4(b)(2)(A). However, a QSST must file Form 1041 and attach a statement of the items treated as having been received directly by its beneficiary. Reg. § 1.671-4(b)(6). One might consider filing Form 1041 for other grantor trusts as well to get the statute of limitations running on grantor trust treatment.

[3461] Code § 1361(c)(2)(B)(i).

[3462] Code § 676.

[3463] See discussion of IRS Letter Rulings in 730-2nd T.M., S corporations*: Formation and Termination*, II.E.1.b(3), and in *Federal Income Taxation of S corporations* ¶ 3.03[10] (4th ed., Warren, Gorham & Lamont). A trustee-beneficiary's power to make distributions to himself under an ascertainable standard might make the trustee-beneficiary a Code § 678 owner to the extent of that distributions would be authorized under that standard. Letter Rulings 8211057 and 200747002 (Code § 678(a)(2) lapse followed by the beneficiary-trustee being able to make distributions to himself under an ascertainable standard was sufficient to allow the trust to hold stock in an S corporation). For more details, see part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

withdrawal rights impair spendthrift protection requires additional analysis.[3464] Examples of Code § 678 trusts include:

- Grantor creates a "vested" trust for a grandchild, as follows: The grandchild can withdraw the entire gift and all earnings on the gift. This withdrawal right lapses in full after a reasonable interval. The grandchild is the sole beneficiary during his or her life and has a general power of appointment upon death. For income tax purposes, one may treat the trust as deemed owned 100% by the beneficiary.[3465] The gift qualifies for the annual exclusion.[3466] For estate tax purposes, the trust is includible in the beneficiary's estate.[3467] If and to the extent that the gift qualifies for the annual exclusion, the gift is also exempt for generation-skipping transfer (GST) purposes, without using any GST exemption.[3468] If and to the extent that the lapse exceeds the greater of $5,000 or 5% of the trust's assets (subject to coordination with other lapses by that beneficiary),[3469] the beneficiary has made an incomplete gift[3470] and for GST purposes becomes the transferor;[3471] however, because the trust is included in the beneficiary's estate for estate tax purposes, the beneficiary's GST exemption needs to be allocated upon death anyway.

- Grantor makes a gift of less than $5,000 to the trust[3472] and later sells stock in an S corporation to the trust.[3473]

- Decedent bequeaths to a trust over which the beneficiary holds an unlimited withdrawal right, making the trust taxable to the beneficiary under Code § 678(a)(1), building in features that would trigger Code § 678(a)(2) after the withdrawal rights lapse.[3474]

Note that the settlor's grantor trust powers trump any beneficiary's grantor trust powers.[3475]

A beneficiary may also be treated as the owner by making a "QSST" election[3476] to have the grantor trust rules apply. See part III.A.3.e.i QSSTs.

[3464] See parts III.B.2.h.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights.
[3465] See parts III.B.2.h.vi Portion Owned When a Gift Over $5,000 is Made.
[3466] For qualification of withdrawal rights for the annual exclusion and whether an interest in a business entity qualifies for the annual exclusion, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers, especially the paragraph accompanying fn. 3824.
[3467] Code § 2041(a)(2).
[3468] Code § 2642(c).
[3469] Code § 2514(e).
[3470] Reg. 25.2511-2(b).
[3471] See Reg. § 26.2652-1(a)(5), Example (5).
[3472] See part III.B.2.h.v Funding the Trust with Small Gifts.
[3473] See part III.B.2.h.iv Sale to a Beneficiary Grantor Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives.
[3474] See part III.B.2.h.vii Funding the Trust with a Large Initial Gift or Bequest.
[3475] Code § 678(b).
[3476] Code § 1361(d)(1). If the beneficiary dies and the trust continues, with another beneficiary stepping into his or her place, the QSST election remains in place, Reg. § 1.1361-1(j)(9); but, if the trust terminates by reason of the beneficiary's death, then a new QSST election must be filed.

III.A.3.a.ii. How a Trust Can Fall Short of Being Wholly Owned by One Person

If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.[3477] However, for a trust to meet the wholly owned grantor trust rules, one person must be the deemed owner of both income and principal.[3478]

If the grantor's spouse is a beneficiary, the trust is not necessarily deemed wholly owned,[3479] so an additional grantor trust power might be advisable.[3480] The trust might very well cease qualifying as a wholly-owned grantor trust upon separation or divorce,[3481] so that an ESBT election might be necessary after divorce or separation.[3482]

If a trust qualifies as being deemed wholly owned by the beneficiary, consider what might happen if the provision upon which the beneficiary's deemed ownership is based includes some ambiguity.[3483] Also, if the beneficiary does not have a withdrawal right over every gift to the trust and over the income and gains generated by each such gift or if the beneficiary has a withdrawal right that lapses in an incorrect manner, the trust might not be deemed wholly owned by the beneficiary.[3484]

III.A.3.a.iii. Steps an S Corporation Might Take to Avoid a Trust Falling Short of Being a Wholly-Owned Grantor Trust

An S corporation might insist that certain protective measures be taken in case a trust falls short of being deemed wholly owned by one person.

If the trust is intended to be deemed owned wholly by the beneficiary, the beneficiary might file a QSST election, just in case the trust is not deemed wholly owned by the

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Reg. § 1.1361-1(j)(9)(ii), Example (2). One might consider including a clause that, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to Reg. § 1.1361-1(j)(9)(ii), Example (1).

[3477] Reg. § 1.671-3(b).

[3478] Code § 1361(c)(2)(A)(i). Letter Ruling 200226006 held that a trust that was partly a nongrantor trust and partly a grantor trust did not satisfy this rule, even though the grantor trust portion was created by contributing S corporation stock and the nongrantor portion was created by contributing other assets. (Generally I would recommend separating grantor and nongrantor trusts anyway; the facts in that letter ruling were particularly problematic in that the trust appears to be partially a GST-exempt trust and partially a Code § 2036 trust.) This ruling is consistent with Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 3558). Letter Ruling 200942020 approved an irrevocable grantor trust as an S corporation shareholder when it had multiple *Crummey* power holders, holding that Code § 678(b) caused the grantor's deemed owner status to trump the beneficiaries' deemed owner status.

[3479] Letter Ruling 201208013.

[3480] See part III.B.2.g How to Make a Trust a Grantor Trust.

[3481] See fn. 3558, discussing how Reg. § 1.1361-1(k)(1), Example (10), applies Code § 682 to a trust owning stock in an S corporation.

[3482] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation (especially part III.A.3.b.v An Electing Small Business Trust) and III.A.3.e.ii.(a) Qualification as an ESBT.

[3483] See part III.B.2.h.xi Dealing with Code § 678(a)(2) Uncertainty.

[3484] See part III.B.2.h.vi Portion Owned When a Gift Over $5,000 is Made.

beneficiary. A beneficiary cannot elect QSST treatment if the grantor is taxed as the owner; however, a beneficiary make elect QSST treatment if the beneficiary is taxed as the owner.[3485] However, the beneficiary might not want to make the QSST election during any time when the trust is buying stock from the beneficiary, because a QSST election complicates the purchase and might make the process of getting the value of the stock out of the beneficiary's estate take twice as long.[3486]

For a trust deemed owned by its settlor (or a trust deemed owned by its beneficiary where QSST status is undesirable to impractical), the trust might file an ESBT election, just in case the trust is not a wholly-owned grantor trust taxable to only one person. Although estate planners commonly rely on swap powers, they are not foolproof.[3487] A grantor trust may make an ESBT election.[3488] However, grantor trust treatment trumps ESBT taxation.[3489] That doesn't mean that the ESBT election is not technically in effect[3490] - it just means that the election has no current income tax consequences.

These protective measures are not necessarily beneficial to anyone other than the S corporation:

- A grantor trust can use regular income taxation for the first two years after the grantor's death and get more favorable income tax treatment as a regular trust.[3491] Obtaining that more favorable income tax treatment is why one might not want to make an ESBT election when one creates an irrevocable grantor trust.

- Some grantor trusts might qualify as a QSST or an ESBT upon termination of grantor trust status.[3492] The regulations limit how often one can switch back and forth between QSST and ESBT status. Initially making the ESBT election means that, after switching to a QSST once, the trust must wait 36 months before switching back to a QSST or later back to an ESBT again. Absent the initial ESBT election, the beneficiary could make a QSST election upon termination of grantor trust status and later switch to ESBT status with waiting 36 months.

If the sole risk to being wholly owned is the separation or divorce of a beneficiary from the grantor, an irrevocable grantor trust that includes the grantor's spouse as a beneficiary might provide that separation or divorce terminates the spouse's interest. That provision might avoid the need for an ESBT election upon which the S corporation otherwise might have required.

[3485] Reg. § 1.1361-1(j)(6)(iv).
[3486] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).
[3487] Whether a swap power is effective depends on the facts and circumstances, as described in Reg. § 1.675-1(b)(4)(iii). Part III.B.2.g.i Swap Power quotes this regulation and describes why estate planners do not mind relying on it as the sole grantor trust feature. However, to protect an S election, one might want the additional protection that an ESBT election provides.
[3488] Reg. §§ 1.1361-1(m)(2)(v) (general approval for grantor trust to make an ESBT election), 1.1361-1(m)(8), Example (3) (Code § 678 trust may make an ESBT election).
[3489] Reg. § 1.641(c)-1(c). A partial grantor trust is illustrated in Reg. §1.641(c)-1(*l*), Example (1).
[3490] A trust may not make a protective ESBT election. Reg. § 1.1361-1(m)(2)(v) (the same regulation that allows grantor trusts to make ESBT election).
[3491] Code § 1361(c)(2)(A)(ii). See Code § 641(c) for ESBTs' unfavorable income tax treatment.
[3492] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

III.A.3.a.iv. Why to Be Extraordinarily Sensitive to Protecting the S Election

Some people point to the generous relief the IRS provides for inadvertent terminations and decide that going to great lengths to protect the S election is not necessary.[3493]

However, a buyer might be very sensitive to the S election's validity, particularly in a stock sale that is treated as an asset purchase.[3494] Fixing any problems that the buyer's tax counsel perceives to exist (whether or not the problem actually exists) can delay a transaction, during which time other issues might arise that might cause the seller to lose a sale to a strategic buyer at a premium price. I became much more aware of this issue when a transaction worth hundreds of millions of dollars faced a possible delay due to an issue caused by prior counsel and I was asked to obtain a private letter ruling to fix it; I was able to get a private letter ruling in only six weeks from the date of submission, but until I did the client was very nervous about the six-month delay projected by those who insisted on the PLR. If I had not been able to get the PLR that quickly (which I have no assurance of being able to replicate) and that deal had cratered, I wonder what the repercussions would have been to prior counsel and then realized that any of us could be in that situation someday if there is even the slightest concern.

III.A.3.b. Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation

To qualify as S corporation shareholders for any length of time,[3495] generally[3496] an irrevocable trust must either be a grantor trust or an electing small business trust (ESBT). Planning to avoid the 3.8% tax on net investment income[3497] requires additional planning regarding participation in the business; it may be advisable to have the trustee materially participate even if the trust is a grantor trust.[3498]

[3493] See part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections and the related discussion preceding that.

[3494] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

[3495] Trusts can qualify as S shareholders by electing to be taxed as an estate under Code § 645 (which election has a limited duration under Code § 645(b)(2)), by being a continuation of a grantor trust under Code § 1361(c)(2)(A)(ii), or a testamentary trust under Code § 1361(c)(2)(A)(iii) – for the latter, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.iii A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It.

[3496] A voting trust does not have time limits on how long it is an eligible shareholder under Code § 1361(c)(2)(A)(iv).

[3497] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[3498] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

If not a foreign trust,[3499] any of the following trusts may be a shareholder:

III.A.3.b.i. A Trust All Of Which Is Treated Under The Grantor Trust Rules As Owned By An Individual Who Is A Citizen Or Resident of the United States

See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.

III.A.3.b.ii. A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death

Code § 1361(c)(2)(A)(ii). This includes a former QSST.[3500] Generally, such a trust is an eligible shareholder only for the 2-year period beginning on the day of the deemed owner's death. It does not include a trust that did not own the stock during the deemed owner's life and received the stock pursuant to the terms of a will.[3501] However, if the trust is subject to an election under Code § 645, then the trust is taxed as an estate and can hold the stock during the entire period during which the trust is taxable as an estate.[3502] In either such case, the grantor's estate is treated as the owner for purposes of the 100-shareholder limitation.[3503]

Note that, if the grantor's gross estate (for federal estate tax purposes) might be subject to estate tax, it is common for the trustee to hold the S stock for more than two years after the grantor's death. This is done to avoid the trustee incurring personal liability under the tax laws, because a final determination of estate tax might not be made until

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[3499] Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.

[3500] Reg § 1.1361-1(j)(7)(ii) provides:

> If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

[3501] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (i). Query how stock transferred to a revocable trust by reason of a nonprobate beneficiary designation would be handled; it would be best to avoid this and have the trust own the stock directly during the grantor's life.

[3502] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (ii) and 1.645-1(e)(2)(i); Letter Ruling 200529006. An executor or administrator of the shareholder's may consent to a new S election on behalf of a decedent. Rev. Rul. 92-82.

[3503] Code § 1361(c)(2)(B)(ii).

after the two-year period has expired. Therefore, the trustee should consider making a Code § 645 election.[3504]

Even when keeping the S corporation stock in such a trust or estate is permitted, doing so might come at an income tax cost. If the S corporation does not distribute all of its income, part or all its income might be taxed at the highest rate.[3505] One might save significant annual income taxes by distributing the S corporation stock to one or more QSSTs, each of which is taxed at its beneficiary's income tax rate (without regard to how much cash the S corporation distributes),[3506] which might be significantly lower. However, if estate tax is or might be due, consider the risks that the executor takes in distributing property before estate tax is paid in full.[3507]

For additional cash flow issues relating to a trust that was a grantor trust before the deemed owner's death, see also part III.A.3.d Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.b.iii. A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It

Code § 1361(c)(2)(A)(iii). In such a case, the testator's estate is treated as an owner for purposes of the 100-shareholder limitation.[3508] Because a revocable trust that has made a Code § 645 election is treated as an estate, any transfer from that estate by reason of termination of the election or by bequest under that revocable trust is treated as transferred pursuant to the terms of a will.[3509]

III.A.3.b.iv. A Trust Created Primarily To Exercise The Voting Power Of Stock Transferred To It

Code § 1361(c)(2)(A)(iv). In such a case, each beneficiary of the voting trust is treated as the owner for purposes of the 100-shareholder limitation.[3510]

To qualify as a voting trust, the beneficial owners must be treated as the owners of their respective portions of the trust under the grantor trust rules, and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that:[3511]

(A) Delegates to one or more trustees the right to vote;

[3504] For these rules, including ways to extend the time that estate income taxation applies, see part II.J.7 Election to Treat a Revocable Trust as an Estate.
[3505] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.
[3506] See part III.A.3.e.i.(a) QSSTs Generally.
[3507] See generally III.B.3.c.iv Federal Estate Tax Liens.
[3508] Code § 1361(c)(2)(B)(iii).
[3509] Reg. § 1.1361-1(h)(1)(iv)(B).
[3510] Code § 1361(c)(2)(B)(iv).
[3511] Reg. § 1.1361-1(h)(1)(v).

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.[3512]

Let's explore the requirement that the beneficial owners be treated as the owners of their respective portions of the trust under the grantor trust rules.[3513] This is automatic for the settlors of the trust,[3514] but not automatic when the settlors transfer their beneficial interests (voting trust certificates) to others. One treatise suggests making the beneficiaries entitled to distributions, but that might not satisfy the requirement that the trust agreement require payment of distributions to the beneficiaries; therefore, one might consider giving the beneficiaries the right to withdraw any distributions the trust receives from the S corporation, followed by a requirement that the trustee pay to the beneficiaries any such distributions.[3515] It has also been suggested that the voting trust might qualify as an investment trust, in which case a transferee would be treated as a grantor and therefore the trust would automatically qualify.[3516]

[3512] I am not aware of any authoritative interpretation of "on or before a specific date or event." Presumably the trust might provide that the trust terminates when it holds no voting stock or perhaps when each individual in a named list of people has died.

[3513] Reg. § 1.1361-1(h)(1)(v)(C). If the beneficiary originally transferred the stock to the trust, then it is a grantor trust under Code § 677. Otherwise, the trust needs to qualify as an investment trust; see part II.D.4.a Investment Trusts, which also describes the income tax consequences when a voting trust that is an investment trust sells stock. This regulation was adopted by TD 8600 (7/20/1995). For the IRS' interpretation before then, see Letter Ruling 9344020.

[3514] Code § 677(a) combined with Reg. § 1.1361-1(h)(1)(v)(B).

[3515] When the beneficiary has the right to withdraw such distributions, Code § 678(a)(1) would treat the beneficiary as the owner. After that withdrawal right has lapsed, the IRS' Letter Ruling position would support a position that Code §§ 678(a)(2) and 677(a) would treat the beneficiary as the owner.

[3516] See part II.D.4.a Investment Trust. Letter Ruling 201226019 approved this approach, holding:

1. During the lives of A and B and after their deaths, Voting Trust will be classified as an "investment trust" under § 301.7701-4(c) for U.S. federal income tax purposes.
2. During the lives of A and B (assuming they are the only holders of the Certificates during their lives), Voting Trust will be considered a qualified voting trust under § 1361(c)(2)(A)(iv) and § 1.1361-1(h)(1)(v). Accordingly, Voting Trust will be a permitted S corporation shareholder. If, during their lives, A or B transfer all or a portion of their Certificates to a transferee that is a permitted S corporation shareholder, the transferee will be treated as a successor grantor of the Voting Trust. Therefore,
   (i) Voting Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
   (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.
3. After the death of A or B, when the executor of their respective Wills (the "Executor") holds the Certificates held by A or B, as applicable, prior to their deaths, A's and B's

III.A.3.b.v. **An Electing Small Business Trust**

Code § 1361(c)(2)(A)(v). In such a case, each potential current beneficiary of the trust is treated as the owner for purposes of the 100-shareholder limitation.[3517] The 100-shareholder limitation is made less severe by a family attribution rule, treating a person, his or her spouse, and his or her descendants as one shareholder.[3518] A charitable remainder trust cannot own stock in an S corporation, so an ESBT election would not

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> respective estates (if the period during which such estates hold the Certificates does not exceed the period actually required to fully administer the estates as described in § 1.641(b)-3(a)) will be treated as successor grantors of the Voting Trust. After the Executor distributes the Certificates held by A or B in accordance with the terms and provisions of their estate planning documents, as applicable, such transferees of the Certificates will be treated as successor grantors of their portions of the Voting Trust. Therefore,
>
> (i) Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
>
> (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.

[3517] Code § 1361(c)(2)(B)(v) applied in Reg. § 1.1361-1(m)(4)(vii).

[3518] Code § 1361(c)(1). see 2004 Blue Book (General Explanation of Tax Legislation Enacted in the 108th Congress), p. 189, footnote 321. Reg. § 1.1361-1(e)(3)(i) interprets the family attribution rule:

> *In general*. For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

help it; instead, consider donating the stock to a charity in exchange for a charitable gift annuity, after considering unrelated business taxable income issues.[3519]

III.A.3.b.vi. Observations About Trusts As S Corporation Shareholders

The shareholder agreement does not need to specify these trusts, as the reference to causing the corporation not to be a "small business corporation" as defined in Code § 1361(b)(1) should be sufficient to limit which kinds of trusts may be owners without going into all the detail described above. However, when preparing shareholders' estate plans, make sure the beneficiaries of the estate plans qualify.

Retirement plans are trusts, so let's discuss those for a moment. First, IRAs are qualified under Code § 408, not § 401(a). Therefore, IRAs are not eligible shareholders, as they are not trusts that qualify under these rules.[3520] Second, qualified retirement plans are taxed on unrelated business taxable income,[3521] including income from S corporations.[3522] However, employee stock ownership plans (ESOPs) are not subject to this tax.[3523]

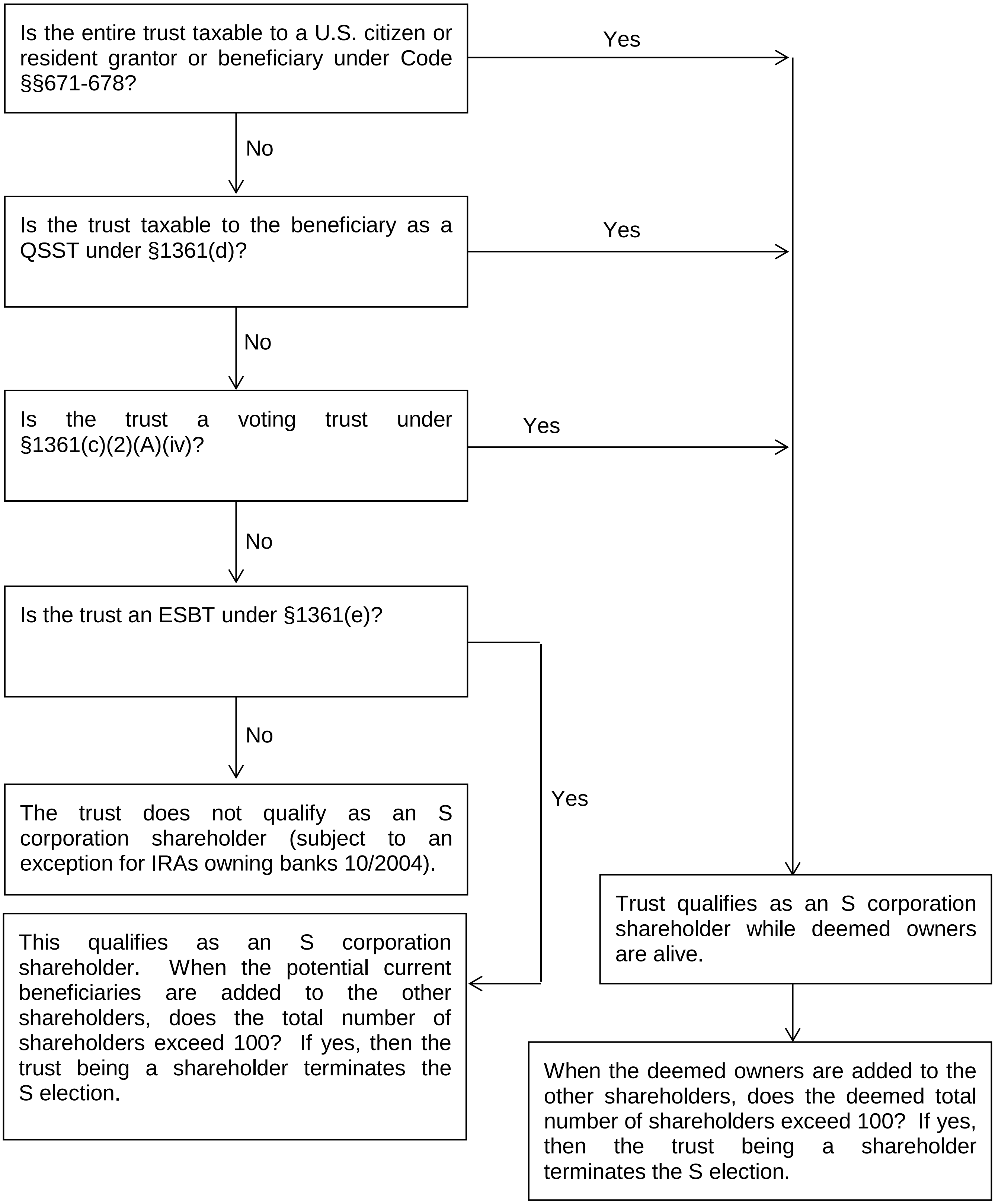
Charities are permitted shareholders.[3524] The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[3525]

III.A.3.c. Deadlines for Trust Qualifying as S Corporation Shareholder

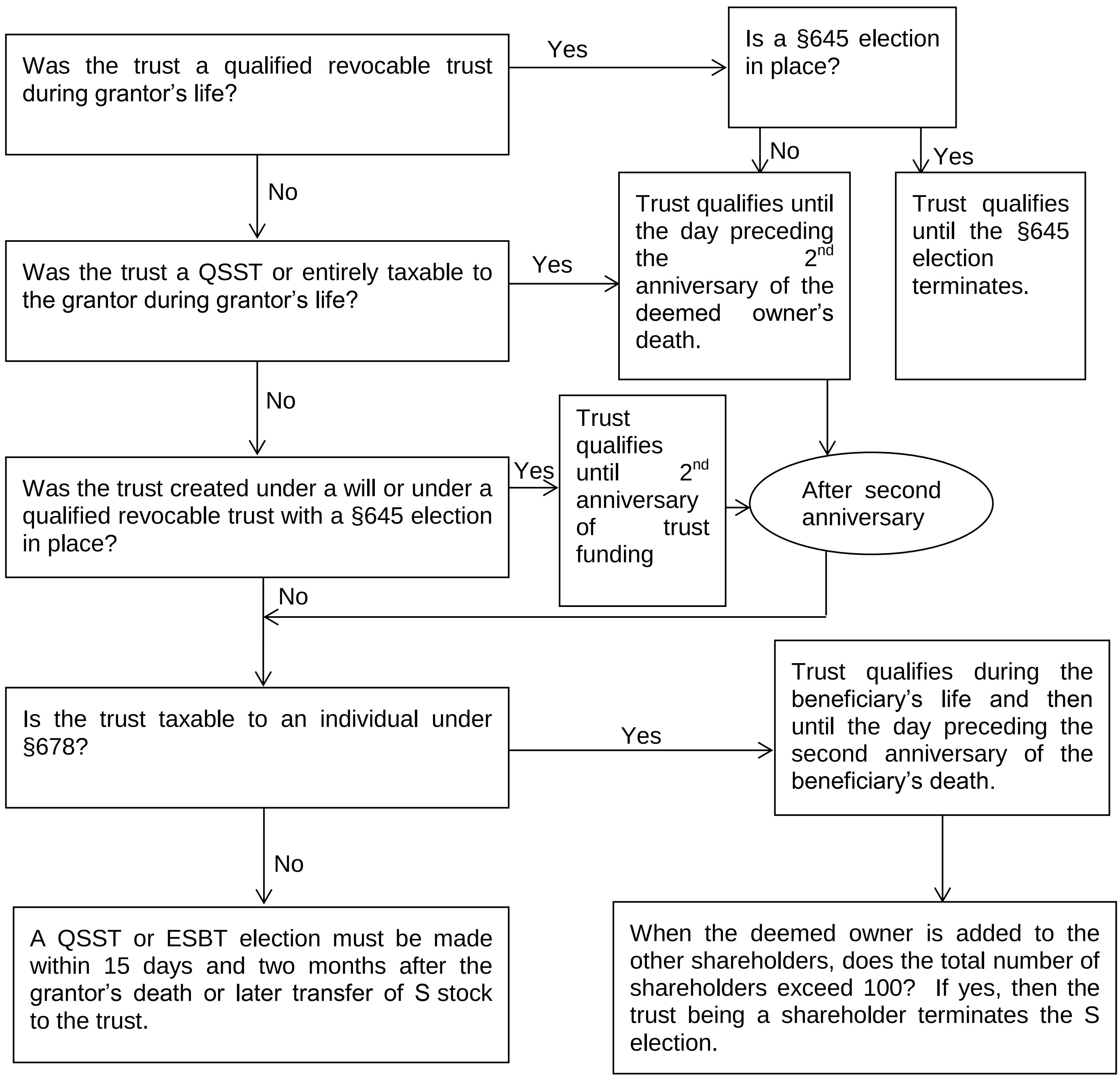
Below are some flowcharts illustrating trust qualification as a shareholder of an S corporation. The flowcharts do not consider trusts that are tax-exempt.

[3519] See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity.
[3520] Reg. § 1.1361-1(h)(1)(vii), which became final on August 13, 2008, provides that individual retirement accounts (including Roth IRAs) are not eligible S corporation shareholders, unless they satisfy the exception created in Code § 1361(c)(2)(A)(vi) for bank stock that was held by the IRA as of October 22, 2004. That regulation is extremely unlikely to be challenged as, for various reasons, a reviewed opinion of the Tax Court concluded that IRAs, including Roth IRAs, were not eligible shareholders before that regulation was promulgated. *Taproot Administrative Services, Inc. v. Commissioner*, 133 T.C. 202.
[3521] Code § 511(a)(1), 501(a).
[3522] Code § 512(e)(1).
[3523] Code § 512(e)(3).
[3524] Code § 1361(c)(6) provides that an organization, which not only is described in Code § 401(a) or 501(c)(3) but also is exempt from taxation under Code § 501(a), may be a shareholder in an S corporation.
[3525] Letter Ruling 201441018.

III.A.3.c.i. Flowchart of Inter Vivos Trusts (Trusts Created while Grantor is Alive)



III.A.3.c.ii. Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death or Continued after QSST Beneficiary's Death)



III.A.3.c.iii. Deadlines for QSST and ESBT Elections

III.A.3.c.iii.(a). General Description of Deadlines for QSST and ESBT Elections

A separate QSST election must be made with respect to each S corporation in which the trust owns stock.[3526] Although initially an ESBT election needs to be filed at every IRS Service Center that receives the returns of the S corporations the trust owns, no future ESBT elections are required when the trust acquires stock in another S Corporation.[3527]

The beneficiary must make a QSST election no later than fifteen days and two months after the trust received the stock.[3528] The trustee of an ESBT must file the ESBT election within the same time framework.[3529] If the trust is a wholly owned grantor trust or meets some other exception allowing it to be an eligible shareholder,[3530] the deadline would be based on whenever the election's effective date is required or desired. If the trust is already an eligible shareholder and the QSST or ESBT election is made with an effective date that is later than when the trust first acquired the stock, when drafting the QSST or ESBT election I generally include the fact of that qualification when I say when the trust first acquired the stock, so that any IRS reviewer of the election will see that there does not appear to be any time gap in the trust's eligibility as a shareholder.

If an ESBT or QSST election is made late or is in some manner defective, the S corporation status can be retroactively reinstated if the termination or invalidity was inadvertent, within a reasonable period of time after discovery of the terminating event or invalid election steps were taken to rectify the situation, and the corporation and shareholders agree to adjustments that the IRS may require for the period;[3531] retroactive reinstatement is required to prevent the accumulated adjustments account (AAA) from being wiped out.[3532] The corporation and all persons who were shareholders of the corporation at any time during the period must consent to make to any adjustments that the IRS may require.[3533] Each consent should be in the form of a statement agreeing to make the adjustments:[3534]

[3526] Reg. § 1.1361-1(j)(6)(i).
[3527] Reg § 1.1361-1(m)(2)(i).
[3528] Reg. § 1.1361-1(j)(6)(ii)(C). A QSST election by a person who is under a legal disability by reason of age may be made on that person's behalf by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent. Reg. § 1.1361-1(j)(6)(i).
[3529] Reg. § 1.1361-1(m)(3)(i) provides that trust is an ESBT on the effective date of the ESBT election.
[3530] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.
[3531] Reg. § 1.1362-4(a).
[3532] For AAA's importance, see part II.Q.7.b Redemptions or Distributions Involving S Corporations. For the idea that termination of the S election wipes out AAA, see part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.
[3533] Reg. § 1.1362-4(e). However, if relief under Rev. Proc. 2013-30 applies, Section 6.01(4) of that procedure requires:

> Statements from all shareholders during the period between the date the S corporation election was to have become effective or was terminated and the date the completed Election Form is filed that they have reported their income on all affected returns

- The statement must be signed by the shareholder and corporation.

- A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock.

- The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

A late ESBT or QSST election may be made within 3 years and 75 days after the effective date of the election, without the $28,300 fee generally required for letter rulings under Code § 9100, illustrated by the following chart provided by the IRS:[3535]

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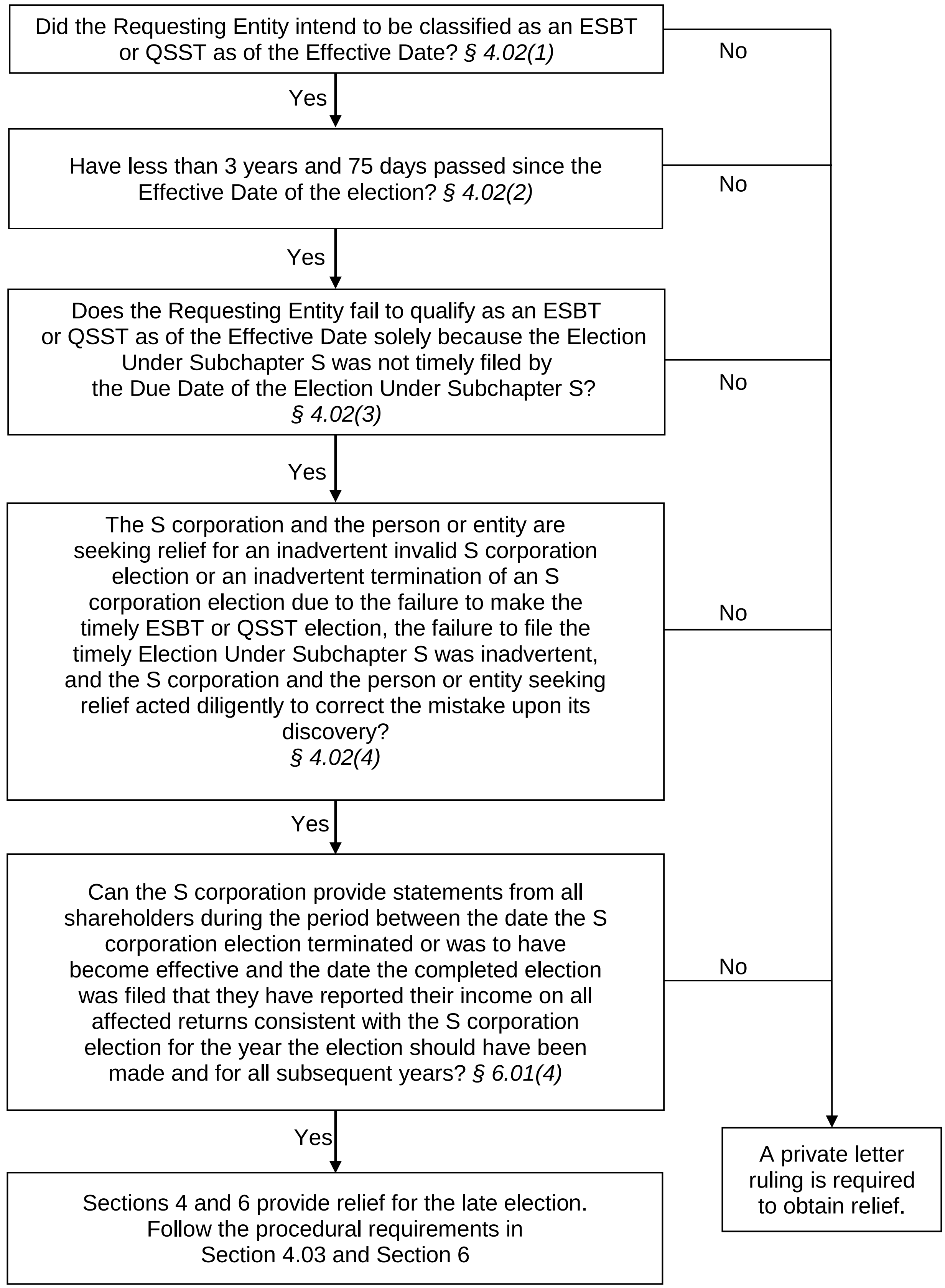
consistent with the S corporation election for the year the election should have been made and for all subsequent years.

Presumably, these statements are in lieu of consenting to adjustments. One might consider supplementing the statements by agreeing to make adjustments as required by Reg. § 1.1362-4(e), but supplementing the statements does not appear to be required. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

[3534] Reg. § 1.1362-4(e).

[3535] Rev. Proc. 2013-30, modifying and superseding Rev. Procs. 2003-43, 2004-48, and 2007-62. One might consider checking the most recent annual Revenue Procedure for issuing letter rulings, the successor to Rev. Proc. 2016-1, for any updates to user fees and to verify the status of Rev. Proc. 2013-30. Also, some taxpayers might qualify for reduced user fees. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

III.A.3.c.iii.(b). Flowchart Showing Relief for Late QSST & ESBT Elections



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III.A.3.d. Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests

If one bequeaths S corporation stock, consider expressly providing that any distributions with respect to that stock are to be passed on to the beneficiary receiving that stock. Not only does such a provision ensure fairness if the trust/estate administration lasts any significant amount of time, it also prevents a potentially unfair tax result from occurring, as described below.

A bequest of a partnership interest or S corporation stock that is "ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust" is a specific bequest that does not count as a distribution that carries with it distributable net income.[3536] On the other hand, income allocated to a beneficiary *does* count a distribution that carries with it distributable net income.[3537] The bequest of the partnership interest or S corporation stock does not constitute a separate share, but distributions bequeathed to the recipient of that business interest *do* constitute a separate share.[3538]

The distributive share of partnership or S corporation income that does not constitute trust accounting income:[3539]

> is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

Tying together the separate share rules[3540] with the above rules regarding distributive shares of partnership or S corporation income, one can distill the following rules:[3541]

[3536] Reg. § 1.663(a)-1(b)(1), delineating items that qualify for the exclusion under Reg. § 1.663(a)-1(a). See Reg. § 1.663(a)-1(b)(3), Example (1).

[3537] Reg. § 1.663(a)-1(b)(2)(i), defining items that do not qualify for the exclusion under Reg. § 1.663(a)-1(a).

[3538] Reg. § 1.663(c)-5, Example (8). Reg. § 1.663(c)-4(a) provides:

> Separate shares include… the income on bequeathed property if the recipient of the specific bequest is entitled to such income …. Conversely, a gift or bequest … of property as defined in section 663(a)(1) is not a separate share.

[3539] Reg. § 1.663(c)-2(b)(4), which applies to:

> the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items).

[3540] See generally part II.J.9.a Separate Share Rule.

[3541] Reg. § 1.663(c)-5, Examples (4) and (5) provide:

> *Example 4*. (i) *Facts*. Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child of the largest amount that can pass free of Federal estate tax and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000

- DNI equal to undistributed income is allocated among the separate shares according to the amount of income to which each share is entitled.

- DNI equal to distributions from an S corporation or partnership constituting trust accounting income is allocated among the separate shares according to the amount of income to which each share is entitled.[3542] DNI equal to distributions from an S corporation or partnership not constituting trust accounting income would be allocated to each share according to "its portion of gross income that is includible in

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taxable year, the estate receives dividend income of $200,000 and pays expenses of $15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of $350,000 and a fair market value of $380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of $30,000.

(ii) *Conclusion*. The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the $380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is $214,400 ($200,000 (dividend income) plus $30,000 (capital gain) minus $15,000 (expenses) and minus $600 (personal exemption)).

Example 5. The facts are the same as in Example 4, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the $380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

Example 6. The facts are the same as in Example 4, except that during 2000 the estate receives a distribution of $900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire $900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the $900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the $900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

[3542] Reg. § 1.663(c)-2(b)(2) provides that:

> gross income includible in distributable net income that is income within the meaning of section 643(b) … is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

For income under Code § 643(b), see part II.J.8.c.i Capital Gain Allocated to Income Under State Law; although focused on capital gain, it discusses Code § 643(b) generally as well.

distributable net income and its portion of any applicable deductions or losses."[3543] Note that distributions from an S corporation or partnership that do not constitute trust accounting income but constitute gross income would constitute DNI only if they are (a) not from the sale of a capital asset,[3544] or (b) from the sale of a capital asset but satisfy the rules for including capital gain in DNI.[3545]

- Note that the amounts deducted by the trust or estate and included in the beneficiary's income are the lesser of the beneficiary's allocable share of DNI and the amount actually distributed.[3546] If and to the extent that the trust or estate does not make distributions (or is not required to make) to the beneficiary attributable to DNI, the distributive shares of partnership or S corporation income are trapped inside the trust or estate to the extent not distributed (or required to be made). Thus, the estate or trust is taxed on that income, even though the recipient of the specific bequest ultimately benefits from the undistributed income.

However, practical logistics might suggest not allocating distributions to the recipient of the specific bequest. It is not unusual for tax distributions to be made after yearend. For example, A dies January 31, 2016. The partnership or S corporation makes distributions April 1, 2016 to the owners to pay taxes incurred with respect to 2015 income. A's estate or revocable trust will need that cash to pay its 2015 tax that is due April 15, 2016. Therefore, if A's estate plan bequeathed the partnership or S corporation to B, B should be allocated all of the distributions with respect to the partnership or S corporation, other than distributions relating to 2015 tax and other than distributions relating to tax on income earned between January 1, 2016 and January 31, 2016. Furthermore, these distributions might also draw an allocation of DNI. Thus, consider a clause along these lines (after further thought if the specific bequest is to a QTIP trust):[3547]

> If any partnership interest or stock in any S corporation is specifically allocated to one or more persons, the person(s) entitled to the allocation shall also be entitled to any distributions from the date of the allocation until the date the partnership interest or stock is distributed; however, any distributions that were intended for the payment of tax imposed on taxable items with respect to periods before the event that caused that allocation shall be paid to the person reporting those items.

Also note that state corporate law might not permit distributions using record dates (determining who is the shareholder of record) more than a certain number of days before the distribution. For example, Missouri law does not allow a corporation to make a distribution with a record date more than 70 days before the date of distribution.[3548] If these statutes apply, one might consider declaring a distribution in the form of a promissory note, the principal of which is any taxes, interest, and penalties imposed on

[3543] Reg. § 1.663(c)-2(b)(1).
[3544] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[3545] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.
[3546] See part II.J.9.a Separate Share Rule, especially the text accompanying fns. 1440-1442.
[3547] If the specific bequest is to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.
[3548] R.S.Mo. § 351.250.

the shareholders by reason of any examination of any prior year returns. This method might also be needed for taxes during the current year, depending on whether the tax laws allow the corporation to close its books as of the date of death. One might also consider converting the corporation into an LLC taxed as an S corporation using a tax-free reorganization,[3549] because LLC laws might not impose such a requirement.

If the trust is a QSST, [3550] coordinate these concerns with those found in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, which also includes a reference to marital deduction issues relating to the payment of income.[3551]

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

III.A.3.e.i.(a). QSSTs Generally

A QSST may have only one beneficiary[3552] (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its

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[3549] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[3550] See part III.A.3.e.i QSSTs.

[3551] See fn. 3580.

[3552] Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. § 1.1361-1(j)(2)(iv). On the other hand, Letter Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 3554 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one should avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 1316, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed income[3553] must be distributed currently to that beneficiary[3554] while the trust[3555] holds S stock.[3556] The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year.[3557] Special rules apply to an inter vivos QTIP or another trust for a spouse.[3558]

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owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 3558) confirms that result.

3553 All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under Code § 1361(d)(3)(B) was not required to be distributed. Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2).

3554 Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity. This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

3555 In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate in the shares of stock to give rise to a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

3556 Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

3557 Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.h.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

3558 Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set

forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

(i) *Transfers to QTIP trust*. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce*. Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted*. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 3478); therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.g How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see fn. 3552.

Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. Reg. § 1.677(a)-1(b)(2) concludes with:

With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distributions to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

Reg. § 1.682(a)-1(a)(1)(i) is quite clear that Code § 682 shifts only so much of the income as is "paid, credited, or required to be distributed" to the ex-spouse beneficiary. Therefore, the cross-reference to Code § 682 might lead one to believe that Code § 677(a) would apply to the extent that distributions are not made to the ex-spouse, consistent with certain legislation history to the Tax Reform Act of 1969:

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[3559] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law[3560] or the governing instrument.[3561] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[3562]

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[3563] For example, a grantor sets up an irrevocable trust for the benefit of his four

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> Both versions of the bill provide that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

However, Reg. § 1.1361-1(k)(1), Example (10), paragraph (ii), indicates that the more expansive reading of the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) applies, so that Code § 677(a) will never tax the grantor on distributions that are accumulated for possible future distribution to the ex-spouse. Note, however, that the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) does not apply to a spouse who is separated, so the more limited rules of Reg. § 1.682(a)-1(a)(1)(i) would apply. Thus, if distributions are made after separation, the trust no longer qualifies as a grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made.

Code § 672(e) does not seem to coordinate with Code § 682. However, Reg. § 1.1361-1(k) was promulgated after Code § 672(e) was enacted, so Reg. § 1.1361-1(k)(1), Example (10), would appear to clarify somewhat the scope of Code § 672(e).

For the interaction of divorce with Chapter 14, see parts III.B.4.b.iv Divorce Planning to Avoid Code § 2701 and III.B.4.d Code § 2702 Overview, especially the text accompanying fns. 4526-4531.

[3559] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

[3560] See part II.J.8.c.i.(a) Power to Adjust.

[3561] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 1374-1378 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[3562] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act. For form language that might facilitate this allocation, see fn. 1374, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[3563] Code § 1361(d)(3). Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a Separate Share Rule), the test is more stringent than that.

children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[3564] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion; [3565] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues.

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[3566] (although the trust still needs to get its own tax ID).[3567] However, when

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Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).

[3564] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[3565] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[3566] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[3567] Reg. § 1.671-4(b)(6)(iii).

the QSST sells the stock, the trust itself is taxable on any gain on the sale,[3568] including any gain the corporation incurs after adopting a plan of complete liquidation[3569] or from deemed asset sale resulting from a Code § 338(h)(10) election;[3570] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[3571]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[3572]

See part II.A.2.d Estate Planning Strategies Available Only for S Corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[3573]

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[3574]

[3568] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[3569] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[3570] Letter Rulings 9828006, 199920007, and 201232003.

[3571] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.

[3572] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.

[3573] See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity, especially the text accompanying fn. 2745.

[3574] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[3575]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[3576] at the trust's presumably higher income tax rates.[3577] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share[3578] of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[3579] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide

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Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death.

[3575] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2).

[3576] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

[3577] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.

[3578] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[3579] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[3580] However, if the trust us included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests, which addresses timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

[3580] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

III.A.3.e.ii. ESBTs

III.A.3.e.ii.(a). Qualification as an ESBT

An ESBT may have more than one beneficiary.[3581] However, each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[3582] A potential current beneficiary means any person who at any time during a particular taxable year may receive a distribution of principal or income from the trust, whether the distribution was mandatory or discretionary.[3583]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period,[3584] and the regulations now reflect this change.[3585] If a distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation shareholders;[3586] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[3587]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary of the ESBT portion.[3588]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[3589] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[3590]

[3581] For all of the ESBT requirements, see Code § 1361(e)(1).
[3582] Code § 1361(c)(2)(B)(v).
[3583] Code § 1361(e)(2).
[3584] Code § 1361(e)(2).
[3585] Reg. § 1.1361-1(m)(4)(vi)(A).
[3586] Reg. § 1.1361-1(m)(4)(iv)(B).
[3587] Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

[3588] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.
[3589] Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, "Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election," *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015).
Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
> ….

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of the Code.[3591] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[3592] The grantor trust rules trump this treatment.[3593] The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[3594]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[3595] Very few deductions are allowed against this income, and the income distribution deduction is not available;[3596] the IRS has taken the position that net operating losses (NOLs) are not allowable deductions,[3597] but capital loss carryforwards appear to be allowable.[3598]

> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

[3590] Reg. § 1.1361-1(m)(1)(iii).

[3591] Code § 641(c); Reg. § 1.641(c)-1(a).

[3592] Reg. § 1.641(c)-1(a).

[3593] Reg. § 1.641(c)-1(a).

[3594] Reg. § 1.641(c)-1(a).

[3595] Code § 641(c)(1); Reg. § 1.641(c)-1(e).

[3596] Code § 641(c)(2).

[3597] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).

Making a Code § 645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, since estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under Code § 1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii) if a Code § 645 election is in place and therefore can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a Code § 645 election.

See also the text accompanying fn. 3602 for how to avoid the ESBT generating an NOL when it has significant losses from its S corporation stock; this generally requires advance planning.

[3598] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[3599] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[3600]

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction.[3601]

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules. In light of the IRS' position on NOLs for ESBTs,[3602] consider whether the trustee should be passive, as discussed in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good (and note that an ESBT avoiding NOLs might be at the cost of incurring the 3.8% tax on net investment income).[3603]

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[3604]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or

[3599] Reg. § 1.641(c)-1(d)(4)(i).
[3600] Reg. § 1.641(c)-1(h).
[3601] The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.
[3602] See fn. 3597.
[3603] See part II.I 3.8% Tax on Excess Net Investment Income (NII), especially parts II.I.8 Application of 3.8% Tax to Business Income and II.J.14 Application of 3.8% Tax to ESBTs.
[3604] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 1461-1462.

- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the ESBT into two separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust rules,[3605] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[3606]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[3607] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[3608] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[3609] A QSST's income is not

[3605] Code §§ 2056(b)(1) and 2523(b).
[3606] Code § 651.
[3607] Code § 1(e)(2).

subject to the 3.8% NII tax if the beneficiary is active in the business[3610] or has income below the threshold;[3611] however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[3612] Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[3613] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[3614] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[3615] the trust's ESBT taxation continues after death,[3616] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[3617]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).[3618] For inside basis step-up

[3608] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 1475 (which also refers to an example in the proposed regulations) and the accompanying text.
[3609] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[3610] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 1075.
[3611] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[3612] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[3613] See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 1213-1214.
[3614] See text accompanying fns. 3574-3575.
[3615] A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c).
[3616] Reg. § 1.1361-1(m)(8), Example (4).
[3617] part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 3595-3598 for ESBT taxation.
[3618] For a comparison of ESBTs and QSSTs, see text accompanying fn. 2850.

opportunities,[3619] see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[3620]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[3621] A better solution is a trust taxable to its beneficiary under Code § 678.[3622] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[3623]

III.A.3.e.iv. Flexible Trust Design When Holding S Corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[3624]

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[3625]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that

[3619] Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations explains such issues.
[3620] See part II.H.8.a.ii State Income Tax Disconnect.
[3621] Reg. § 1.641(c)-1(d)(4)(ii) provides, "(ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion." This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).
[3622] See fn 3463.
[3623] See part III.B.2.h.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.
[3624] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[3625] See fn. 3557.

the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[3626] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

Note that, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[3627] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[3628]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[3629] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[3630] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets.[3631] If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[3632] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[3633]

[3626] Letter Ruling 201122003.
[3627] See text accompanying fns. 3584-3585.
[3628] See fm. 3552.
[3629] See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[3630] See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 1075 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).
[3631] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[3632] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[3633] See part III.B.2.h.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[3634]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Income tax rates increased January 1, 2013, so that every dollar of ESBT income is taxed at 39.6% federal income tax and 3.8% tax on net investment income ("NII").[3635] The beneficiaries' federal income tax brackets might be significantly lower,[3636] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[3637]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[3638] in taxable income, so the accumulation strategy would have additional income tax costs.

[3634] See text accompanying fn. 3614.

[3635] See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% Tax to ESBTs.

[3636] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.

[3637] Reg. § 1.67-2T(b)(1).

[3638] $12,150 in 2014; $12,300 in 2015 per Rev. Proc. 2014-61, Section 3.01, Table 5; $12,400 in 2016 per Rev. Proc. 2015-53, Section 3.01, Table 5; presumably higher in future years.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:

  - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[3639] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

  - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[3640] Normally such fees and expenses are allocated one-half to income and one-half to one-

[3639] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).

[3640] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 3568-3570, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.

half to principal.[3641] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[3642]

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[3643]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.

- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.

- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.

- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[3644] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[3645]

- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[3646] A sale to an irrevocable grantor trust

[3641] Section 501 of the Uniform Principal & Income Act.
[3642] See text accompanying fn. 3637 and Code § 1366(a)(1)(A).
[3643] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[3644] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse "any individual who was the spouse of the grantor at the time of the creation of such power or interest." Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income "is paid, credited, or required to be distributed" and therefore taxed to the former spouse.
[3645] See fn. 3558, noting the contrast between paragraphs (ii) and (iii) within Example (10).
[3646] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

is a powerful estate planning technique.[3647] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.[3648]

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[3649]

Beneficiary grantor trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[3650] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[3651]

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's <u>selling</u> or <u>distributing</u> the stock is attributable to the trust, not the beneficiary,[3652] but does not discuss the consequences of the trust <u>buying</u> S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a

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[3647] See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[3648] See part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

[3649] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

[3650] Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

[3651] Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made."

[3652] For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 3568-3570.

matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[3653] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is buying stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[3654]

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[3655]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[3656] The IRS has taken the position that, when the QSST buys

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[3653] T.D. 8600.

[3654] This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 3932.

The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned, "A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925)." The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13 reaffirmed this concept, and it should be applied to the sale to a QSST as well.

[3655] Letter Rulings 200441013, 200441014, and 200441015.

[3656] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, stock from a third party using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore is deductible by the beneficiary.[3657] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[3658]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST

Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 3621 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.

Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income. Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

[3657] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[3658] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering "interest expense" and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[3659]

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

- Inability to Divide S Corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[3660] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[3661] Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[3662]

  However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[3663] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[3664] or a sale of stock combined with a Code § 338(h)(10) election;[3665]

[3659] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

[3660] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.

[3661] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[3662] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

[3663] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.

[3664] See fn. 3569, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 2693, found within part II.Q.7.a.vii Corporate Liquidation.

[3665] See fn. 3570, found within part III.A.3.e.i.(a) QSSTs Generally.

either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[3666]

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[3667]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that failure to make a distribution constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions.[3668] If the right to require income lapses annually and the undistributed income does not exceed 5%, then presumably the lapse (if a lapse at all) would be with the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e).

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

Consider who pays income tax for the year in which the beneficiary dies.[3669] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well

[3666] In addition to the citations within fns. 3664 and 3665, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[3667] Reg. § 1.1361-1(j)(8); see fns. 3568-3570.
[3668] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 1373.
[3669] See part III.A.3.d Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

in advance of the beneficiary's death.[3670] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[3671] Furthermore, the partnership could later divide in a variety of ways on a tax-free basis,[3672] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[3673]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

See also parts II.A.2.d.ii Estate Planning and Income Tax Disadvantages of S Corporations, II.A.2.d.iii Which Type of Entity for Which Situation? and III.A.3.d Special Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[3674] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

[3670] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 2875.

[3671] Distributing in stages would tend to alleviate the concerns described in fn 2875.

[3672] See part II.Q.8 Exiting From or Dividing a Partnership.

[3673] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

[3674] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to pay to the beneficiary.[3675] Private letter rulings have readily accepted this theory for mandatory income trusts;[3676] this theory should apply to a discretionary income trust.[3677]

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note.[3678] Thus, although note payments complete the sale (the obligation to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the additional obligation to the beneficiary are repaid. However, if this additional obligation is not expected to repaid made for a while, consider that the inclusion of principal obligation in the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed. Consider the following ways to repay this additional obligation:

[3675] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[3676] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs, CCA 201327009 did not expressly consider this issue. However, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[3677] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[3678] See fn. 3675.

1. In planning stages, instead of the trust being a mandatory income trust, make it a discretionary income trust. An independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[3679] but might be possible using a *Clayton*-QTIP plan).[3680] After the note is repaid, the independent trustee turns off the mandatory income obligation, the trustee accumulates income, and when the accumulated income is recharacterized as principal then the trustee distributes it in repayment of the principal that it owes the beneficiary.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested S corporation taxable income).[3681] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[3682] or being used to determine a distribution[3683] should cause the capital gain to be taxed to the beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements between principal and income?[3684] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows: The IRS might argue that stock's value exceeded the sale price; therefore, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion. One might consider using a defined value clause,[3685] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right). With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift

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[3679] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[3680] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 3695.
[3681] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[3682] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law.
[3683] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[3684] For flexibility in allocating between income and principal, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
[3685] See part III.B.2.i Defined Value Clauses in Gift Agreements or Disclaimers.

portions.[3686] The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[3687] would make a QSST election unnecessary during the seller's life.

The possible Code § 2036 attack is a disadvantage of this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[3688] However, if one has an operating business in an S corporation, a preferred partnership is not available[3689] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[3690]

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[3691] who could make a distribution for welfare and then resign.

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[3692] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

[3686] See part III.B.2.i.xiii Adequate Disclosure on Gift Tax Returns.
[3687] Code § 677.
[3688] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[3689] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity

Shareholders.
[3690] If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[3691] As fn. 4006 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 1262).
[3692] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[3693] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[3694] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[3695]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Grantor Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary grantor trust.[3696] However, in either case, be sure to consider exit strategies upon the client's death, as described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.

III.A.4. Trust Accounting Income Regarding Business Interests

When a trust holds a business entity interest, complicated accounting and tax issues can arise. One of the main reasons for these complexities is the difference between accounting income and taxable income. Accounting income helps determine the amount of distributions a trust is required to make, under the governing instrument or state law,

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[3693] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.
[3694] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.
[3695] See fn. 3680.
[3696] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.

which in turn may determine how much taxable income is carried out to the beneficiaries of the trust. The Code defines "income required to be distributed currently" as the fiduciary accounting income that must be distributed currently pursuant to the governing instrument or state law. Because fiduciary accounting income is determined by state law or the governing instrument, differences between taxable income and accounting income generally arise. An example of such a difference would be capital gains. Capital gains are usually principal for fiduciary accounting purposes, but taxable income for income tax purposes.

III.A.4.a. General Strategies Regarding Fiduciary Income Taxation

Trusts and estates reach the top income tax brackets and are subjected to the 3.8% tax on net investment income[3697] far more rapidly than beneficiaries.

See part II.J Fiduciary Income Taxation.

III.A.4.b. Example for Trust Accounting Income Regarding Business Interests

A similar problem can arise when a trust holds a partnership interest. Often a partnership may report significant earnings on its K-1s, but may distribute a much smaller amount in cash to its partners. For example, a trust could receive a partnership K-1 with $100,000 of taxable income, but may only receive $60,000 of cash as a distribution. The $60,000 is all the accounting income, because the amount distributed does not exceed the amount of income attributable to the trust.[3698] When this happens, the trust will have distributable income equal to $60,000, but will be unable to distribute the additional $40,000 of "phantom income" from the K-1, meaning the trust will be taxed on the $40,000. This can lead to cash flow problems when the trust has no other income, since once the trust distributes the $60,000 to the beneficiary it will have no available cash to pay the taxes. The Uniform Principal and Income Act[3699] provides a solution to this problem. Under old section 505(c)(1), a tax that is required to be paid by a trustee on the trust's share of an entity's taxable income is proportionally divided between principal and income based on the receipts allocated to each.[3700] Thus, the trustee will be able to keep some of the cash to pay the taxes on the trust's undistributed income. See below for the 2008 clarification to section 505 that makes sure that the trustee has enough money to pay the tax.

Another example, with a flowchart, is at part III.D.2 Trust Accounting and Taxation.

III.A.4.c. 2008 Clarification of Uniform Principal & Income Act Regarding Business Entities, Taxed as Partnerships or S Corporations, Held in Trust

In the summer of 2008, the Uniform Law Commission amended Section 505 of the Uniform Principal & Income Act (the "UPAIA"); see Appendix to this article. The

[3697] See part II.I 3.8% Tax on Excess Net Investment Income.
[3698] Uniform Principal and Income Act § 401(b). See footnote 3699.
[3699] Citations to the Uniform Principal and Income Act are to the version adopted in 1997, as amended or revised in 2000, published August 21, 2003, by the National Conference of Commissioners on Uniform State Laws.
[3700] See also RSMo §469.459.3(1).

amendment responds to litigation over the income tax burden when a mandatory income trust holds an interest in a partnership or other pass-through entity. This article addresses the concerns underlying the changes, explains the changes, and discusses the planning implications of this change and related issues.

When a mandatory income trust holds an interest in a partnership or other flow-through entity, coordinating the UPAIA with fiduciary income tax rules can get tricky. The changes to UPAIA section 505 provide needed clarity regarding the treatment of taxes paid regarding a trust's distributive share of an entity's income; however, they do not address the other issues described in part II.J.5 Issues Arising with Mandatory Income Trusts.

III.A.4.c.i. Concerns Underlying the UPAIA Section 505 Changes

Before discussing the technical reasons for change, one must understand some of the basic income tax rules governing business entities, the rules governing the income taxation of trusts, and how they interact.

Income Tax Rules Governing Business Entities

Three different paradigms apply to business entities. A traditional corporation (also known as a "C corporation") pays income taxes on its own income. When it distributes its current or accumulated earnings, the distribution is taxed to its shareholders as a dividend. It might also make one or more distributions in partial or total liquidation, which is taxed to its shareholders as a sale of part or all of the stock rather than a dividend if certain tax law requirements are satisfied.

The Tax Reform Act of 1986 prevented C corporations from liquidating without both the shareholders and corporation being taxed. These new rules encouraged those who owned C corporations to convert them to S corporations. S corporation owners are taxed on the corporation's income rather than the corporation being taxed on the income. An example will help explain this difference:

- C Corporation. Suppose the corporation has one shareholder, A. A invests $1,000x. In Year 1, the corporation earns $100,000x and pays $40,000x in income tax, leaving $60,000x of after-tax earnings and a total of $61,000x of cash. The corporation liquidates, distributing $61,000x to A. A pays income tax of $12,000x on the excess of the $61,000x proceeds over the $1,000x that A invested. After paying taxes, A has $49,000x ($61,000x liquidation proceeds minus $12,000x taxes that A paid).

- S Corporation. Same situation, only an S election is in place. In Year 1, the corporation pays no income tax on its earnings; instead, A receives Schedule K-1 from the corporation reporting $100,000x of gross income and pays $40,000x income tax on the corporation's earnings. Section 1366(c) of the Internal Revenue Code of 1986, as amended (the "Code"). The corporation distributes $40,000x to A to pay the income taxes, so A has really not used any of A's own money to pay the income tax. Code Section 1368(b)(1) provides that this distribution is not taxed because it does not exceed the shareholder's tax basis. However, A's investment in the corporation has increased for income tax purposes. A's basis is now

$61,000x, which is the $1,000x that A invested, plus the $100,000x income on which A was taxed, minus the $40,000x that the corporation distributed to A to pay A's income tax. Code Section 1367. The corporation then liquidates, distributing $61,000x to A ($1,000x that A invested, plus $100,000x earnings, minus $40,000x distributed to A to pay A's income taxes). A keeps the entire $61,000x without paying any income tax on the distribution, because A received the same amount as A is deemed to have invested.

In the example, the sole shareholder has received more using an S corporation than using a C corporation. The $40,000x that the S corporation distributed to A really was not intended as a benefit to A; instead, it was reimbursing A for the taxes that A paid on the corporation's income. The $40,000x is referred to below as a "tax distribution."

C and S corporations are the first two of the three paradigms. Partnerships (including limited liability companies taxed as partnerships) have similar effects on the taxation of owners for purposes of UPAIA section 505. Therefore, this article refers to S corporations and partnerships as "flow-through" entities, and uses "Schedule K-1 income" to describe the income from the flow-through entity that an owner needs to report. For reasons beyond the scope of this article, partnerships have much more flexible income tax rules regarding distributions from the entity to owners.

In the example above, let's compare distributions from C corporations with distributions from flow-through entities.

- The owner of a C corporation receives no distribution.

- The owner of a pass-through entity receives a tax distribution, so that the owner retains no cash after paying income taxes.

Suppose that, in the example above, the owner is a mandatory income trust:

- A trust that owns stock in a C corporation has no trust accounting income because it has no receipts.

- How much trust accounting income does a trust that owns a pass-through entity have that must be distributed to the beneficiary? To achieve parity with the C corporation scenario, the income taxes paid using the tax distribution would be charged against income, so that again the beneficiary receives nothing. However, that result was not clear under UPAIA section 505 before the amendment.

One must understand trust income taxation to fully understand how UPAIA section 505 works.

Income Tax Rules Governing Trusts

Suppose a trust receives Schedule K-1 reporting $100,000x income. Ignoring the trust's small exemption amount and very modest use of lower tax brackets, the trust would be required to pay $40,000x of income tax, assuming a 40% federal and state income tax rate. However, if the trust distributes $100,000x to its beneficiary, it receives a

$100,000x income distribution deduction and pays no income tax;[3701] instead, the trust gives the beneficiary a Schedule K-1 reporting $100,000x income, and the beneficiary pays income tax on the $100,000x Schedule K-1 income (to the extent not offset by the beneficiary's deductions, exemptions, etc.).[3702]

Carrying this example further, suppose the trust receives only a $40,000x tax distribution and does not have other funds to distribute to the beneficiary. If the trust distributes the $40,000x to the beneficiary, then the trust receives a $40,000x income distribution deduction and must pay $24,000x income tax ($60,000x multiplied by 40%) on its remaining $60,000x ($100,000x Schedule K-1 income minus $40,000x income distribution deduction) taxable income. However, the trustee has no funds with which to pay the $24,000x income tax. In fact, the only way to prevent the trustee from not being able to pay income tax with respect to the Schedule K-1 income would be for the trustee to retain the entire tax distribution.

What are the principles that apply to determining the income distribution deduction described above? First, compute the amount of trust's distributable net income (taxable income, with certain adjustments). Next, determine the amount required to be distributed and any additional amounts actually distributed to the beneficiary. The income distribution deduction, which is always taxable to the beneficiary through the Schedule K-1 the trustee gives to the beneficiary, is the lesser of the distributable net income or the distributions described above. The rules become more complicated when one considers capital gains, tax-exempt income, or other similar issues, but the framework is similar.

Now let's apply this to a mandatory income trust. The trust accounting income, determined under the UPAIA, is an amount required to be distributed using the above principles. Some people assume that the Schedule K-1 income is the amount deemed distributed. That assumption is false. For income tax purposes, the amount of income required to be distributed is based on state law fiduciary accounting income.[3703] UPAIA Section 102(4) provides that "'income' means money or property that a fiduciary receives as a current return…." Thus, income would not exceed "money or property that a fiduciary receives" even if the Schedule K-1 income is higher.

In a trust that receives a $40,000x tax distribution, the trust has $40,000x of income receipts.[3704] How much income tax should the trustee deduct from the $40,000x receipt to determine the income that must be distributed? UPAIA section 505 answers that question. However, the answer was unclear and bred litigation, because beneficiaries receiving no cash from a mandatory income trust were understandably upset. Below, this article explains the UPAIA change and how attorneys drafting estate plans or representing disappointed beneficiaries might advise their clients in light of these changes and existing law.

[3701] Code §§ 651, 661.
[3702] Code §§ 652, 662.
[3703] Reg. §§ UPAIA Section 401(b).
[3704] UPAIA Section 401(b).

III.A.4.c.ii. Explanation of the UPAIA Section 505 Changes

Before this amendment, the language of UPAIA section 505 was ambiguous regarding accounting for tax distributions. The amendment clarifies the overriding principle that the trustee of a mandatory income trust uses tax distributions to the extent necessary to pay income taxes and distributes any remaining income to the beneficiary. The official comments contain an algebraic formula that might be used when an interrelated calculation is required, which is whenever distributions from a pass-through are less than its Schedule K-1 income and the trustee has no other funds to distribute to the beneficiary or pay income tax on its Schedule K-1 income.

The policy behind this change is that the UPAIA should not place trustees in a position where they cannot pay the trust's income tax. Generally, it is not practical or prudent for a trustee to borrow to pay income tax when the trustee has no idea when, if ever, a distribution in excess of a tax distribution will be made. Furthermore, if the trust owned C corporation stock rather than an interest in a flow-through entity, the trust would never have received a distribution from the business entity anyway.

In the example above, suppose the business entity annually accumulated the $40,000x excess of Schedule K-1 income over the tax distribution. Suppose these accumulated amounts were later distributed to the trust. UPAIA section 506(a)(3) would authorize additional distributions to the beneficiary because the beneficiary essentially paid the tax on these accumulated amounts when the trustee used the tax distributions to pay income tax instead of distributing part or all of them to the beneficiary.

- Before turning to advising clients about these changes, let's discuss particular rules affect how these rules apply to various trusts that own stock in S corporations:

- An electing small business trust ("ESBT") does not receive an income distribution deduction with respect to its Schedule K-1 income that is distributed to its beneficiary.[3705]

- A qualified subchapter S trust ("QSST") under Code Section 1361(d), or other trust treated as wholly owned by one grantor or one beneficiary, does not pay taxes on any of its Schedule K-1 income from an S corporation. Instead, the individual beneficiary or grantor treated for income tax purposes as receiving Schedule K-1 income pays all the income taxes attributable to the Schedule K-1 income.[3706] Therefore, the trustee would distribute to the beneficiary all of the tax distribution.

- Only in very limited situations may a trust not described above be qualified to hold stock in an S corporation. The main situations involve trusts that were grantor trusts during the grantor's or beneficiary's life (but only for the two years following the deemed owner's death), estates (including a revocable trust taxed as an estate if a Code Section 645 election is made), and trusts

[3705] Code § 1361(e); Reg. § 1.641(c)-1(i).
[3706] Code § 1361(d)(1)(B).

that are funded upon termination of an estate (but only for the two years following funding).[3707]

III.A.4.c.iii. Advising Clients about the UPAIA Section 505 Changes

The common yet extreme scenario posited – where a mandatory income trust owns only an interest in a flow-through entity that limits distributions to tax distributions – presents difficult challenges for settlors, trustees, and beneficiaries. The changes to UPAIA section 505 allow the trustee to pay the trust's taxes notwithstanding these significant other challenges. One must consider why this difficult situation arises, what the trustee must do to alter the trust's investments if the trust agreement does not address the issue, and how to minimize disputes about what the trustee should do.

III.A.4.c.iii.(a). Why This Difficult Situation Arises

The first question is why the settlor would provide for a mandatory income trust, while expecting that no income will be available to distribute to the beneficiary? Scenarios include:

- *Marital Deduction Mandatory Income Requirement*. The trust is for a surviving spouse who does not need distributions but must provide for mandatory income to qualify for the marital deduction. The trust has the usual clause allowing the spouse to require the trustee to make the property productive. In some cases, using a separate trust to hold a flow-through entity without holding any other assets might be necessary to minimize the estate tax risk of buy-sell agreements.[3708] The Internal Revenue Service has taken the position that a fixed-price buy-sell agreement, in which the sale price of a decedent's equity is less than the Internal Revenue Service-determined fair market value, effectively passes property to a person other than the surviving spouse and therefore disqualifies the marital trust from being eligible for a marital deduction.[3709] If the client uses a fixed-price buy-sell agreement, the client might protect the marital deduction with respect to other assets by placing the other assets into a marital deduction trust that is separate from the trust that holds the client's equity. In such a case, the settlor should make sure that the spouse understands the trust's purposes and does not expect any distributions from the trust. If, however, the surviving spouse is adverse to the remaindermen, then the grantor settlor consider a prenuptial agreement or other ways of documenting a particular expectation of cash flow to the surviving spouse.

- *Future Income Expected*. The settlor does not expect income to be generated initially but expects the business entity eventually to generate income and does not expect the beneficiary to need the income until later. In

[3707] Code Section 1361(c)(2). See part III.A.3 Trusts Holding Stock in S Corporations.
[3708] In addition to the estate tax reason mentioned below, a QSST that holds only S stock (and no other assets) is not required to take any particular action to continue to qualify as an S corporation shareholder within two years after the beneficiary dies. Code §§ 1361(c)(2)(A)(ii), 1361(d)(1)(B).
[3709] See part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction, especially fn 2072.

this case, the settlor might consider describing the settlor's expectation regarding income so that the trustee has more guidance on what the settlor expects and can respond to concerns that the income beneficiary might raise.

- *Post-Mortem Business Sale Expected*. The settlor wanted to mandate income distributions, knowing full well that the business would need to be sold. The settlor might not have been able to find a buyer while alive, might have wanted to have a place to work for as long as the settlor lived, or might have wanted to wait until death to save income (including capital gain) tax on the sale.

III.A.4.c.iii.(b). What The Trustee Must Do To Alter The Trust's Investments If The Trust Agreement Does Not Address The Issue

The Uniform Prudent Investor Act (the "Investor Act") imposes various requirements:

- The trustee must consider "the purposes, terms, distribution requirements, and other circumstances of the trust."[3710]

- The trustee must further consider not only total return from income and appreciation of capital but also needs for liquidity and regularity of income.[3711]

- "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[3712]

- "Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act]."[3713]

- "If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."[3714]

Thus, absent an expression of intent to the contrary, the trustee has a duty to sell enough of the business interest to generate income sufficient to fairly balance the income beneficiary's interests against the other beneficiaries' interests; note that a sale might not be required if the business already generates sufficient income to create that fair balance. The trustee also must sell enough of the business interest to create a diversified portfolio. Therefore, for all practical purposes, the trustee must dispose of substantially all of the business interest.

[3710] Section 2(a) of the Investor Act.
[3711] Section 2(c)(5) and (7) of the Investor Act.
[3712] Section 3 of the Investor Act.
[3713] Section 4 of the Investor Act.
[3714] Section 6 of the Investor Act.

The trust agreement can expressly modify this duty to sell. It might include some or all of the following provisions:

- Expressly authorize the trustee to hold the property (for a particular period of time or indefinitely), notwithstanding its failure to produce income and notwithstanding any requirement to diversify that might otherwise apply. However, this authorization might be insufficient when the stock is performing poorly.[3715] Although the lower court's decision was reversed, it indicates what some judges might do. Also, such a provision cannot be used for marital deduction trusts if it would deprive the surviving spouse of the right to income.[3716] The author routinely includes language authorizing the spouse to require that the trustee either make the trust's property productive or convert it to income-producing property within a reasonable time.[3717]

- Subject to the marital trust concerns described above, require the trustee to hold the property (for a particular period of time or indefinitely). The authorization to hold might be viewed as requiring the trustee to consider the merits of selling even if it places less pressure to sell, whereas the requirement to hold should remove any requirement to consider selling.

- Give family members interested in the business the power to direct the trustee to hold the business interest. Some states completely relieve the trustee of liability for following directions that the trust agreement authorizes; others might implicitly impose a duty to resist instructions if the instructions appear inconsistent with the trustee's duties to various beneficiaries.

- If the trust is not a marital trust, add as beneficiaries those family members working in the business by stating that a purpose of retaining the business interest is to provide jobs for those family members. Even if the trust agreement does not provide for distributions to them, some steps should be taken to recognize their interests; otherwise, the trustee has no duty to protect their interests.[3718]

III.A.4.c.iii.(c). How To Minimize Disputes About What The Trustee Should Do

The most effective way to minimize disputes is to have legally binding, unambiguous language in the trust. However, being too detailed might unduly tie the trustee's hands when the settlor really wanted to rely on the trustee's judgment. It is impossible to predict the future, and giving the trustee flexibility is often the best call.

The settlor should consider discussing with family members the settlor's intent in placing an essentially unproductive asset into a mandatory income trust. An income beneficiary

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[3715] *Testamentary Trust UW Dumont* , 791 N.Y.S.2d 868 (Surr. Ct. 2004), reversed *In re Chase Manhattan Bank*, 809 N.Y.S.2d 360 (N.Y.A.D. 2006).
[3716] Regs. §§ 20.2056(b)-5(f)(5) (general power of appointment marital trusts), 20.2056(b)-7(d)(2) (same rules apply to QTIP trusts).
[3717] Reg. § 20.2056(b)-5(f)(4) suggests such a provision if the trust's assets "consist substantially of unproductive property."
[3718] Section 5 of the Investor Act.

who has lowered expectations might be less demanding, especially if the trustee and the other beneficiaries are all in the room when the settlor expresses this intent.

The settlor might also consider writing a precatory letter to the trustee (and beneficiaries, if appropriate) expressing this intent. Although the trustee cannot rely on this letter to change the trustee's legal obligations, a trustee usually finds comfort to the extent the letter supports the trustee's discretionary actions under the trust agreement.

For example, to maximize flexibility in a trustee who is to make the ultimate decision, the settlor would:

- include in the trust agreement express authority (but not a mandate) for the trustee to retain assets originally contributed (or sold by the settlor) to the trust, including without limitation (name of the company, its affiliates, etc.), without any requirement to diversify under the Investor Act, and

- write a precatory letter to the trustee.

Extreme caution is recommended in using such provisions with a marital deduction trust or other trust that the tax laws require to have a mandatory income provision. Being too explicit might trigger an attack on the provision as undermining the mandatory income characterization; however, including a right to make productive should suffice.[3719]

III.A.4.c.iii.(d). Fairness When the Trust Sells Its Interest in the Entity

See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation.

III.A.4.c.iv. Conclusion

The amendment to UPAIA section 505 should prove helpful. It should avoid disputes over whether the trustee will be able to pay the trust's income taxes and place the focus where it belongs – whether a mandatory income trust should hold assets that, in the aggregate, produce no after-tax income. Trusts to hold most or all of their assets in the form of flow-through entities such as partnerships that sometimes make no more than tax distributions might be drafted with a discretionary instead of a mandatory income distribution and in any event should be drafted with careful consideration to the Uniform Prudent Investor Act.

III.A.4.c.v. Appendix to 505 Discussion

Below are the amendments to Uniform Principal and Income Act, which are incorporated into the UPAIA at http://www.law.upenn.edu/bll/archives/ulc/upaia/2008_final.htm:

[3719] See fn. 3717.

Section 505 is amended to read:

SECTION 505. INCOME TAXES

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ~~proportionately~~:

(1) from income to the extent that receipts from the entity are allocated only to income; ~~and~~

(2) from principal to the extent that~~:~~

~~(A)~~ receipts ~~from~~ the entity are allocated only to principal; ~~and~~

~~(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).~~

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) ~~For~~ purposes ~~of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.~~ After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Comment

~~**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion~~

~~of the trust even if some or all of that income is distributed to the beneficiaries.~~

~~A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.~~

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P

reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$$D = (C-R*K)/(1-R)$$

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769[3720]
Trust Taxable Income	$ 769,231
35% tax	269,231

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the trustee may exercise the

[3720] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

power to adjust under UPIA section 104 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

III.A.5. Fiduciary Duties Regarding Business Interests Held in Trust

Issues regarding the duty to diversify are discussed in part III.A.4.c.iii, Advising Clients about the UPAIA Section 505 Changes.

This author has heard of bank regulators requiring corporate trustees to revalue closely-held business interests annually, citing 12 CFR 9.6, which provides:

Sec. 9.6 Review of fiduciary accounts.

(a) *Pre-acceptance review*. Before accepting a fiduciary account, a national bank shall review the prospective account to determine whether it can properly administer the account.

(b) *Initial post-acceptance review*. Upon the acceptance of a fiduciary account for which a national bank has investment discretion, the bank shall conduct a prompt review of all assets of the account to evaluate whether they are appropriate for the account.

(c) *Annual review*. At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account.

III.B.2.d. Income Tax Effect of Irrevocable Grantor Trust Treatment

III.B.2.d.i. Federal Income Tax Effect of Irrevocable Grantor Trust Treatment

Both a GRAt and a sale to an irrevocable grantor trust rely on grantor trust treatment.[3927] If a GRAT were not a grantor trust, using property other than cash to satisfy the annuity would constitute a taxable sale.[3928]

If the grantor or another person is treated as the owner of any portion of a trust under the grantor trust rules, that person's taxable income and credits includes those items of income, deductions, and credits against tax of the trust which are attributable to that

[3927] Key rulings include Rev. Ruls. 81-6, 85-13, 2004-64, 2007-13, 2008-22, and 2011-28, as well as Rev. Procs. 2008-45 and 2008-46. Other pronouncements touching upon these rules include Notice 90-1 and Rev. Ruls. 88-103, 90-7 and 2004-86. For more on Rev. Rul. 2004-64, see fns. 4242-4245, found in part III.B.2.j.iv.(a) Reimbursing the Grantor.
[3928] Reg. § 1.661(a)-2(f).

portion of the trust.[3929] Such an item of income, deduction, or credit is treated as if it had been received or paid directly by the grantor or other person.[3930]

CCA 201343021, issued by policy maker Bradford R. Poston, Senior Counsel, Branch 2, Passthroughs & Special Industries, commented:

> We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner. As Rev. Rul. 85-13 states, it would be anomalous for the existence of a grantor trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its identity as a separate entity capable of entering into a sales transaction with the owner. When a grantor or other person exercises dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the owner's benefit, the owner has treated the trust property as though it were the owner's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is consistent with and supported by the rationale for attributing items of income, deduction, and credit to the owner. Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes, including §§ 267 and 707(b)(1)(A).

The CCA continued:

> [I]t should be noted that there have been a very limited set of circumstances after the publication of Rev. Rul. 85-13 where the Service or the courts have treated a grantor trust and its owner as separate entities for a federal income tax purpose:
>
> (1) *Rothstein* itself has never been overturned, and theoretically is still good law in the Second Circuit. We have found only one case which, in dicta, follows the reasoning in *Rothstein*. In *Zand v. Comm'r*, T.C. Memo 1996-19, the Tax Court found that a grantor was not the owner of a trust under § 675(3), relating to grantor borrowings from the trust, because the loan met the exceptions provided in § 675(3) for borrowings with adequate interest and security made by an independent trustee. The Court continued, however, that even had the grantor been properly treated as the owner, he still would have been able to deduct interest paid to the trust because the grantor trust provisions only relate to income attribution.
>
> (2) Rev. Rul. 85-13 never explicitly revoked or modified Rev. Rul. 74-243, 1974-1 C.B. 106. Rev. Rul. 85-13 cites numerous cases and rulings for its conclusion, but also mentions Rev. Rul. 74-243 as one counter-example. In Rev. Rul. 74-243, a corporate executive accepted a government appointment and transferred property, including a qualified stock option, to a "blind trust" which would have been a grantor trust under §677, although the ruling does not explicitly describe it as a grantor trust. The ruling concludes that the

[3929] Code § 671.
[3930] Reg. § 1.671-2(c)

transfer of the option to the trust was a taxable disposition under § 425. Rev. Rul. 74-243 has not been applied or cited approvingly by the Service or a court after 1985, although it arguably still technically reflects the Service's position under the narrow facts of the ruling. Moreover, at least two PLRs (9124019, 9309027) (both issued by CC:TEGE apparently without coordinating with CC:PSI) have allowed similar transfers to grantor trusts without triggering a taxable disposition.

(3) *Textron v. Comm'r*, 117 T.C. 67 (2001) was arguably inconsistent with Rev. Rul. 85-13. In *Textron*, a domestic corporation owned substantially all the stock of a foreign corporation, which it was ordered (initially by the Federal Trade Commission, and later confirmed by a federal district court injunction) to transfer to a voting trust with a court-appointed trustee. It was uncontested that the voting trust was a grantor trust to Textron under § 677. The issue before the Tax Court was whether Textron was taxable on the foreign corporation's subpart F income during the existence of the voting trust; the Court found that the trust, not Textron, was the shareholder for purposes of §§ 951(a) and 958(a), but then ruled in favor of the government on the alternative ground that the trust was taxable as the subsidiary's U.S. shareholder, with the subpart F income then flowing through to Textron. The decision was criticized for its inconsistency with Rev. Rul. 85-13 and other grantor trust authority in Stevens, Matthew A., "A Grantor Trust Visits Subpart F: Ruminations on *Textron v. Commissioner* and other Anomalies", 21 *Va. Tax Rev. 507* (2002).

(4) PLRs 201117042 and 201129045 appear to conflict with Rev. Rul. 85-13. PLRs 201117042 and 201129045 were issued by IRS Employee Plans, and state that an individual retirement account (IRA) cannot be transferred to a grantor trust of the IRA owner.[3931] The conflict between these rulings and Rev. Rul. 85-13 was noted in Beers, Deborah M., "IRS Issues Two Seemingly Contradictory Rulings on Effects of Transfer of IRA to Special Needs Grantor Trust," 36 *Tax Mgmt. Est. & Tr. J* 230 (2011) and Jones, Michael J., "The Economy and other Retirement Mysteries," *Trusts & Estates*, January 2012, at 35. Both articles mention prior PLRs issued by the same office appearing to accept that the owner of a grantor trust is the owner of its assets, which may include an IRA. See PLRs 200620025, 200826008, and 201116005.

The deemed owner of a portion of the trust is also deemed to directly own that portion of the trust's property.[3932] Thus, when a person who is deemed to own all of a trust sells

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[3931] [This is my footnote and not from the CCA:] Reg. § 1.408-4(a)(2) prohibits an individual from assigning the IRA. How does this interact with the fact that grantor trusts generally are disregarded? Choate, ¶ 6.1.06, *Life and Death Planning for Retirement Benefits* (Digital Edition, viewed 6/28/2016), suggests that a transfer to a grantor trust that permitted distributions to anyone other than the individual IRA owner during that individual's life would be a transfer triggering Reg. § 1.408-4(a)(2). Given that Letter Rulings 200620025, 200826008, and 201116005 approved transfers of inherited IRAs to special needs trusts for the benefit of the beneficiary, that suggestion appears consistent with the IRS' approach.

[3932] Notice 90-1 stated, "If the grantor is treated as the owner of all the trust under sections 671 through 677, the grantor is considered to be the owner of the trust assets for federal income tax purposes." Rev. Rul. 2004-86 followed that idea. Rev. Rul. 87-61 points that, under Rev.

assets to that trust, no transaction is deemed to have occurred.[3933] Furthermore, when the grantor trust status is turned off, the sale does not spring into existence merely because a sale had occurred.[3934]

Therefore, a gift to a trust occurs for income tax purposes not when the gift is made but rather when the grantor trust powers are turned off.[3935]

Code § 1015(d) provides a basis increase when gift tax is paid on a gift. However, because a transfer to a grantor trust does not exist for income tax purposes, is it a gift under Code § 1015(d), or does Code § 1015(d) merely look to whether a gift was made for gift tax purposes? The latter appears to be the rule.[3936] However, to avoid doubt on the consequence of any gift tax paid when a transfer is made to a trust, consider having the grantor trust status with respect to such a gift arise, through an automatic trigger, at some point after the tax-triggering gift is made.

Generally, converting from a nongrantor trust to a grantor trust is not a realization event.[3937] However, one might exercise caution where the nongrantor trust has debt in excess of basis, in case a rule similar to the converse situation arises: when a trust converts from a grantor trust to a nongrantor trust during the grantor's life, the grantor

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Rul. 85-13, "a grantor who is treated as the owner of a portion of a trust represented by specific trust property is considered to be the owner of that property," and Rev. Rul. 88-103 makes a similar statement. Rev. Rul. 90-7 applied that concept to an exchange of closely-held business stock. Rev. Rul. 2007-13 reaffirmed this principle; see fn. 2417.

[3933] Rev. Rul. 85-13, reasoning, "A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925)."

[3934] See Letter Rulings 201436006 and 201436007 in fn. 3589.

[3935] Reg. § 1.671-2(e)(2)(i) provides, "A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes."

[3936] Without mentioning why this might be a concern, Letter Ruling 9109027 ruled that gift tax paid on a GRIT that was a wholly owned grantor trust caused a basis increase.

[3937] CCA 200923024 made a strong statement to this effect:

> Assuming the transaction in the present case is abusive, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations. A nongrantor trust may become a grantor trust in several situations: examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b). No prior guidance dealing with these events has indicated that they result in taxable income to the deemed transferee (the owner of the grantor trust). Rev. Rul. 85-13 concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income under § 61 or any other section. Therefore, while we agree that this appears to be an abusive transaction, the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

The CCA suggesting attacking a transaction that potentially abused the grantor trust rules instead by considering applying the step transaction, the economic substance doctrine or other judicial doctrines.

being relieved of debt in excess of the basis of the trust's assets causes income to be recognized.[3938] See also part III.B.2.j Tax Allocations upon Change of Interest, given that a change in grantor trust status is a change in ownership for income tax purposes.

An irrevocable grantor trust's assets that are not included in the grantor's estate generally would not receive a new basis at the grantor's death. See part II.H.5 Irrevocable Trust Planning and Basis Issues.

Reg. § 1.108-9, dealing with excluding cancellation of indebtedness income under the insolvency and bankruptcy provisions of Code § 108, would not disregard a grantor trust in all cases.

A grantor trust owned by a business in a large multinational enterprise might be required to file Form 8975.[3939]

III.B.2.d.ii. State Income Tax Effect of Irrevocable Grantor Trust Treatment

Not all states recognize grantor trust status.[3940]

Thus, a transaction that might be ignored for federal income tax purposes might be subjected to state income tax.

III.B.2.d.iii. Effect of State Tax on Logistics Involving S Corporations and Partnerships Held in Grantor Trusts

Often states require withholding or similar payments regarding an owner's share of state tax liabilities.

When an irrevocable grantor trust owns an interest in an S corporation or partnership, the business entity might be required to make payments on behalf of the deemed owner. This can be awkward, in that the deemed owner is not the actual owner, and the business entity might not have a legal relationship with the deemed owner.

Consider how the business entity, trust, and deemed owner might contract regarding this flow of cash, so that the deemed owner is not treated as receiving a distribution from the business entity or the trust. When the deemed owner has sold assets to the trust and holds a note from the trust, these arrangements might be made in the form of deemed distributions from the entity to the trust, followed by note payments. When the note is fully repaid or the ownership structure is more complex, one might need to spend more time carefully planning any necessary arrangements and documenting them as burdens on the business entity under by state tax law and not something that is voluntarily arranged for the deemed owner's benefit.

[3938] See parts III.B.2.j.i Changing Grantor Trust Status and III.B.2.f Income Tax Concerns When Removing Property from the Estate Tax System, fn. 3949.
[3939] See text accompanying fn. 429 in part II.D.2 Business Entity as Grantor of Trust.
[3940] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence, especially fn. 1254.

III.B.2.e. Grantor Trust Tax Identification Number

Subject to certain exceptions,[3941] a grantor trust may use the taxpayer identification number (TIN) of the deemed owner rather than obtaining its own TIN.[3942] The deemed owner is required to give the trustee a Form W-9 reporting the deemed owner's TIN.[3943] Unless the deemed owner is the trustee or a co-trustee of the trust, the trustee must furnish the deemed owner of the trust with a statement that:[3944]

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the deemed owner with the information necessary to take the items into account in computing the deemed owner's taxable income; and

(4) Informs the deemed owner that the items of income, deduction and credit and other information shown on the statement must be included in computing the deemed owner's taxable income and credits on the deemed owner's income tax return.

As a practical matter, usually the trustee simply forwards to the deemed owner all information reporting forms the trustee receives.

If the trust does not use this reporting, then the trustee files fiduciary income tax returns (IRS Form 1041) and attaches a grantor information statement reporting the trust's income, etc. to be included on the deemed owner's return.[3945]

The trustee might want to consider the latter if:

- The grantor trust treatment is uncertain, so that the statute of limitations on the issue of grantor trust status can start running.

- The deemed owner has creditor issues. Although grantor trust status does not change a trust's asset protection features, a financial institution might use the deemed owner's TIN to determine which accounts to turn over to a creditor garnishing accounts held at the financial institution. The deemed owner then expends time and money to correct the financial institution's mistake. I have seen this happen.

If a trust has more than one owner, then generally the trust must report on Form 1041 using the latter procedure.[3946] However, if all of the trust is treated as owned by spouses who file a joint return, the spouses are treated as one owner.[3947] Whose social security

[3941] Reg. § 1.671-4(b)(6) lists various exceptions, including requiring that a qualified subchapter S trust not use its beneficiary's social security number.
[3942] Reg. § 1.671-4(b)(2)(i)(A).
[3943] Reg. § 1.671-4(b)(1).
[3944] Reg. § 1.671-4(b)(2)(ii)(A).
[3945] See Reg. § 1.671-4(b)(2)(B).
[3946] Reg. § 1.671-4(b)(3).
[3947] Reg. § 1.671-4(b)(8).

number should be used presumably is a moot point for federal income tax purposes; if contributions are unequal, one might use the number of the spouse who contributed more than the other. However, in Missouri (and perhaps some other states), spouses have separate run-ups through the brackets, so one should consider what might be least likely to cause the state income tax return preparer to incorrectly allocate income.